Courts Address Important Questions About Allocation Wells in Texas

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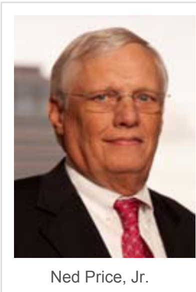
By Ned Price, Jr. and Greg W. Curry
Special Contributing Writers for The Texas Lawbook

The relatively recent drilling of horizontal wells continues to challenge settled Texas oil and gas law in several significant respects. Most recently, Texas courts have been faced with two important issues: (1) the legality of drilling allocation wells, and (2) the appropriate royalty allocation formula for unpooled interests affected by an allocation well. The answers to these issues will have far-reaching consequences for the pooling landscape in Texas.


Ned Price, Jr.

The term "allocation well" is new to the vernacular of the oil and gas industry and refers to a horizontal well that traverses the boundary between two or more leases that have not been pooled and for which no agreement exists among the royalty owners as to how production will be shared. An allocation well could include: (1) a well crossing two or more tracts of land covered by oil and gas leases, with none of such tracts included in a common pooled unit that is executed and filed of record by the leasehold owners; (2) a well crossing a pooled unit that includes a lease that has been improperly pooled (and, therefore, is not bound by the unit), with the well crossing under such lease and other properly pooled unit tracts; (3) a well crossing two pooled units, valid and binding on owners of production from each unit, but which units are separate from each other and not covered by a single unit agreement as to the entire wellbore; or (4) a well crossing some combination of the foregoing situations.

1.The Legality of Allocation Wells in Texas: Reilly v. Railroad Commission of Texas

In early 2013, several DeWitt County royalty owners protested working-interest owner EOG Resources Inc.'s ("EOG") application to the Texas Railroad Commission (the "Commission") to drill an allocation well. The Commission's Hearings Division issued a Proposal for Decision in favor of the royalty owners, recommending dismissal of the application because EOG lacked pooling authority under the leases. But the Commissioners rejected the Proposal's recommendation and approved the allocation well drilling permit.

The Commission order emphasized that, while the Commission had the authority to issue such permits, it was without jurisdiction to determine whether or not the leases permitted the operator to drill without pooling. Since EOG demonstrated the requisite "good faith" claim to drill, the Commission approved the permit. The underlying question—whether an operator may horizontally drill without pooling authority or a production sharing agreement—is a question for Texas courts or the legislature. The issue has not been squarely before a Texas court until now. The royalty owners have challenged the Commission's order by filing suit against the Commission in Travis County district court.

Greg W. Curry

The royalty owners are asking the Court for two things: (1) to reverse the Commission's order that approved the drilling permit and (2) to declare that a lessee that lacks pooling authority across the entire horizontal lateral is not entitled to a drilling permit because the lessee lacks the necessary good faith claim of the right to drill across all of the tracts and produce all of such tracts from that well.

The Commission has issued numerous drilling permits for other allocation wells in the past, but Reilly is the first Commission order that has been appealed to the courts. The Court's holding will have far-reaching consequences for the pooling landscape in Texas—whether or not it upholds the Commission order. Upholding the Commission's order would free operators to drill horizontally across lease lines or separate unit lines without necessarily obtaining pooling authority or complying with restrictive pooling provisions.

Reversing the Commission's order would require (i) an operator to obtain pooling or sharing agreements prior to applying for a drilling permit from the Commission and (ii) place the Commission in the position of having to determine whether such agreements are valid and support the application for the drilling permit. As to (i), an operator could have a difficult or impossible task to obtain pooling or sharing agreements executed by all of the owners of interests in the production from the proposed allocation well. As to (ii), in the Commission hearing on the application for the drilling permit that has been challenged in Reilly, it was asserted, and the Commission agreed, that the proper venue for construing pooling agreements and other sharing agreements between private parties is the courts, and not the Commission.

2. Royalty Allocation Methods: Browning Oil Co. v. Luecke and Springer Ranch, Ltd. v. Jones

If case law establishes that the Commission can issue drilling permits for allocation wells, the next question is how royalties are to be allocated among unpooled interests. In 2000, the Austin Court of Appeals considered this question in the context of quantifying an unpooled lessor's damages when a lessee exceeded its pooling authority by drilling an allocation well. The royalty owner argued that the "confusion of goods" doctrine required royalty payments on all production from the well. The Court rejected this argument and held that the lessee must allocate production on an unpooled basis by establishing "with reasonable probability" the actual production originating from the segment of the drainhole within the improperly pooled lease. Browning Oil Co. v. Luecke, 38 S.W.3d 625, 650 (Tex. App.—Austin 2000, pet. denied) (emphasis added).

The San Antonio Court of Appeals recently addressed royalty allocation methods in the context of allocation wells in Springer Ranch, Ltd. v. Jones, No. 04-12-00554-CV, 2013 WL 6714072, at *1 (Tex. App.—San Antonio Dec. 20, 2013, no pet. h.). In Springer Ranch, the Court interpreted a 1993 contract and partition agreement between surface and mineral owners. Based on Springer Ranch's interpretation of the 1993 contract, the subject well began on Springer Ranch's land, so it should be treated as being owned solely by Springer Ranch, notwithstanding that it was a horizontal well that terminated on Sullivan's land. Springer Ranch argued that the parties had not contemplated the possibility of a horizontal well when the contract was entered into in 1993, so the court should not integrate horizontal well concepts into its interpretation. Sullivan argued that the subject well was located on both parties' land, so royalties should be allocated between the two under the contract based on the location of the productive portions of the well bore.

The trial court agreed with Sullivan and allocated royalties between the two owners based on the productive portions of the wellbore situated on, and located under, their respective properties. Springer Ranch appealed.

The San Antonio Court of Appeals affirmed, thereby in effect holding that the well was an allocation well. The Court further held the parties were entitled to royalties on the productive portions of the well based on the take point distances on their respective properties. This wellbore royalty allocation method is more specific than the "reasonable probability" standard announced in Luecke; however, the Court in Springer Ranch was construing a specific contract, whereas in Luecke there was no specific written agreement governing the allocation.

It remains to be seen whether these two cases conflict with each other. But they provide insight as to how Texas courts are currently analyzing the allocation of production from allocation wells. It is also important to note that the holdings in these cases presume that drilling an allocation well is a valid method of horizontal drilling. In Luecke, the court held that the operator exceeded anti-dilution provisions in the lease by drilling its allocation well, so the mineral interest owner was entitled to damages. This holding is premised on the concept that the operators could validly drill an allocation well unless doing so violated other express provisions in the leases.

Ned Price Jr. is a counsel in Thompson & Knight's Houston office, and Greg Curry is a partner in the firm's Dallas office. TK attorneys Catherine W. Clemons, Gregory D. Binns, Gaye White, Debra J. Villarreal, and Richard B. Hemingway, Jr. also contributed to this article.

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