# ALLOCATION WELLS: TWISTS & TURNS & LEASE LINE ALLOCATION

**By**

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**State Bar of Texas**
**OIL, GAS & MINERAL TITLE EXAMINATION**
**June 18-19, 2020**

Allocation Wells. If the world of oil and gas were like the wild west, perhaps Allocation Wells would be the coming of the railroads. They have changed the way that things are done and thus have changed the way that title examiners set out ownership, particularly in Division Order Title Opinions.

Oil and gas leases, in my opinion, were metaphorically akin to a finely tuned watch - a chronometer, supported by years and years of Texas jurisprudence on everything from pooling forward. When the allocation railroad came to town, it was like throwing an extra gear into the watch. Arguably, the extra gear will make a better watch, but we have to make sure that all the parts and pieces work harmoniously.

We have seen twists and turns in Allocation Wells and their acceptance by the oil and gas industry, with limited support by the courts and the Texas legislature. There has been an evolution of the process, and as the process has grown, more and more practitioners are applying it to what I call "Lease Line Allocation Wells". Lease Line Allocation Wells are Allocation Wells where an operator places the wellbore directly on the lease or unit line. Whereas many, if not most, of the prior Allocation Wells were basic wells perpendicular to unit lines, these are *on the unit or lease line* and bring with them some distinct issues.

The purpose of this paper is to set out some of the individual gears for Allocation Wells. We will set out the history of the process so we can see how it affects the present and the next steps in the evolution.

## *I. The Past. We Don't Need No Stinkin' Pooling Anymore.*

An operator of Unit A can drill a horizontal well across its Unit. That same operator has Unit B and can drill a second horizontal well across that Unit. Why can't the Operator just drill one well across both Unit A and Unit B and allocate production? Doesn't that save everyone time and money? Doesn't that produce more hydrocarbons? Doesn't that make sense?

These basic questions prompted the evolution of Production Sharing Agreement (PSA) Wells and later, Allocation Wells. Simply put, PSA and Allocation Wells are regulatory creations to drill horizontal wells on or across multiple leases and/or units (usually across units that have already been formed and producing) <u>without pooling all of the leases traversed by the well</u>. Under these creations, production from horizontal wells will be "shared" between the royalty owners, and production will be allocated to each unit based on an allocation factor, usually productive lateral length, for lease and royalty payments. When a lessee drills an Allocation Well, "the lessee allocates production to the various tracts traversed by the horizontal wellbore by determining, to a reasonable probability, the amount of production that came from each such tract." [1]

[1] *Ernest E. Smith*, Applying Familiar Concepts to New Technology: Under the Traditional Oil and Gas Lease, a Lessee Does Not Need Pooling

In order to understand Allocation Wells, however, one must understand that it is a regulatory creation that rolls over into the contractual world. Once upon a time, in a world far, far away (Austin), I was a hearings examiner/administrative law judge at the Railroad Commission of Texas (the "RRC"). The RRC is sometimes a world unto itself. There is a regulatory universe and there is a contract, "real world" universe. There are a few areas of overlap and arguably the biggest examples of overlap are PSA Wells and/or Allocation Wells. For the purposes of this paper, I may use the term "Allocation Wells" as being inclusive of both PSA Wells and Allocation Wells, but please understand that they are slightly different concepts. In any event, an Allocation Well allows an operator to obtain a permit from the RRC to drill across units and/or multiple leases without pooling authority being required.

The process is not without its proponents and detractors. Proponents note that operators are faced with limited options to properly and fully develop oil and gas assets. The Mineral Interest Pooling Act is, in some regards, a paper tiger. Reformation of a unit is a task for Hercules. In theory, an operator could obtain the consent of all royalty owners to reform the unit, but, in reality, anyone who has worked in land knows that that is like herding cats and the likelihood of success in such an endeavor is small. People tend to prefer the bird in hand, even if there is a flock in the bush.

Proponents view Allocation Wells as a regulatory aid in adapting to the changing world of horizontal shale plays. One noted commentator has opined strongly that this regulatory creation is perfectly consistent with the rights granted under the lease. For additional insight, I would recommend Professor Ernest Smith's article, *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*.[2]

Additionally, supporters of the process argue that Allocation Wells are necessary to prevent waste and protect correlative rights. The argument is that there are situations where it is difficult, or maybe impossible, to get a well drilled between already pooled units. With the advent of increased technology in horizontal drilling, there are existing oil and gas units that could produce more, but due to regulatory spacing and pooling concerns, those wells could not be drilled. This is wasteful. Please remember that the RRC's mission is to prevent waste and to protect correlative rights. The mission is the underpinning of all regulations at the RRC, including allocation of acreage, density, and lease line spacing.

Authority to Drill a Horizontal Well That Crosses Lease Lines, 3 Oil & Gas, Nat. Resources & Energy J. 553, 565 (2017).

[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, 3 Oil & Gas, Nat. Resources & Energy J. 553, 565 (2017).

Most detractors, on the other hand, simply cannot get around the idea that Allocation Wells are an end run around pooling. We have had pooling for decades, why are we taking rights away from lessors? Weren't restrictive pooling provisions created to prevent exactly this situation? To such practitioners, Allocation Wells twist up the whole intent of the pooling provision and the watch is broken. If you wish to drill a well across existing units, you should reform your units to allow it. For an interesting read generally against Allocation Wells, see Bret Wells' article, *Allocation Wells, Unauthorized Pooling, and the Lessor's Remedies.*[3]

*History.*

To understand Allocation Wells and PSA Wells, however, it is helpful to view it in terms of an evolutionary process at the RRC. Starting in 1998, the idea of a Production Sharing Agreement was first brought to the RRC for permitting vertical wells. Then in 2006, the process was applied to permitting horizontal wells. A horizontal Production Sharing Agreement Well was an attractive option for operators wishing to drill across older units that were held by production. Under the process, a party had to get most of the interest owners on board via a Production Sharing Agreement.[4]

The PSA Well processes were not adopted by standard RRC rulemaking processes that provide notice to the public. It started on an ad hoc basis, and arguably led to some moving targets. On October 23, 2007, the first horizontal PSA Well was approved by the RRC Commissioners via a 2-1 vote in Rule 37 Case No. 0253549. In this case, Devon had 98% of the interest owners signed up in one tract and 100% in the second tract.

Devon applied for a different PSA Well permit in 2008, but this time with less than 90% of interest owners signed up. RRC staff originally denied the permit, but Devon appealed this decision and the Commissioners approved the PSA process so long as 65% of interest owners signed up. Secondary recovery unitization hearings require 65%, but other than that, I am not aware of why the RRC considers this to be a magic number that protects correlative rights. This is the current threshold for a well to be considered a PSA Well.

In 2010, the process twisted again with a name change. On April 21, 2010, the RRC approved Devon's permit application for the "Taylor-Abney-Obanion Allocation Well". Even though Devon did not have the requisite 65% of interest owners for a PSA, the RRC still approved the permit. This is the first instance of an "Allocation Well". An Allocation Well is a horizontal well that traverses the boundary between two or more existing leases or units that requires

[3] *Bret Wells*, Allocation Wells, Unauthorized Pooling, and the Lessor's Remedies, online at https://www.baylor.edu/law/review/doc.php/271080.pdf

[4] For the purposes of this paper, please note that the term "Production Sharing Agreement" and "Production Allocation Agreement" are used interchangeably. Both are agreements that specify how the production is to be allocated.

no agreement between interest owners. So, basically if you have more than 65% signed up, you can permit as a Production Sharing Agreement Well. If you have less than 65% signed up, such as ZERO, you can permit as an Allocation Well. Allocation Wells have gained traction, and it is noted that "[e]xcluding amended permits, as of November 9, 2017, the Commission had issued permits to 3,324 wells classified as allocation wells."[5]

So why the change at the RRC? Like the coming of the railroad to the west, the RRC acknowledged that the shale plays were a changing environment. Practitioners before the RRC actively pushed for it, as did operators, and brought in industry experts to express support for the process. Specifically, Devon asked Professor Ernest Smith, former dean of UT Law and co-author of the treatise on oil and gas law, if a PSA Well - and by extension an Allocation Well - was supported by oil and gas law and lease interpretation. His response was that PSA Wells are "highly desirable" to avoid litigation and that it might be logistically impossible to get royalty owners to agree. However, I would note that his letter also asserts that allocation must be done on the basis of actual production from each Unit.

Allocating the actual production, however, is the rather large elephant in the room. As one noted commentator has opined, "[t]he absence of an agreed upon formula creates room for disputes over the operator's allocation method."[6]

In an Allocation Well, the hydrocarbons are commingled, and all production come up the same wellbore. So, the technical question that one must ask is, can anyone say with reasonable probability which tract produces how much oil or gas? Can you tell me that 50% of the wellbore produces 50% of the oil? Or is there a sweet spot down there such that 50% of the well produces 80% of the oil? That is basically what the Klotzmans were arguing before the RRC as discussed in the section below. Does such an issue devolve to a battle of experts? The court in *Springer Ranch, Ltd. v. Jones*, 421 S.W.3d 273 (Tex. App.—San Antonio 2013, no pet.) asserted that "the royalties must be allocated on the basis that the productive portions of the …well are situated on both… properties", which is helpful, but *Springer Ranch* was, in my opinion, primarily a contract interpretation case.

In sum, there is a good bit of support for Allocation Wells, but the watch needs some tweaking, preferably with guidance from the courts or legislature.

## *II. When the Law Comes to Town. Sorta.*

While case law on Allocation Wells is spartan, one should look to the court's

[5] RRC Oil & Gas Docket No. 08-0305330, Complaint of Monroe Properties, Inc., et al. that Devon Energy Production Co, LP does not have a Good Faith Claim to Operate the N I Helped 120 (Alloc) Lease, Well No. 6H, Phantom (Wolfcamp) Field, Ward County, Texas, Order Of Dismissal, Finding of Fact No. 12, found at https://www.rrc.texas.gov/media/43907/08-0305330-ord.pdf.

[6] *Clifton A. Squibb*, The Age of Allocation: The End of Pooling As We Know It?, 45 Tex. Tech L. Rev. 929, 930 (2013).

findings in *Browning v. Luecke* (38 S.W.3d 625 (Tex. App. – Austin, 2000) in informing a party whether they wish to use Allocation Wells. As of the date of this article, this case is approximately 20 years old. However, it is the basis for many of the arguments of proponents of PSA Wells and Allocation Wells. Indeed, the above-referenced Ernest Smith letter in the Devon application quoted *Browning v. Luecke*.

In *Browning v. Luecke*, the court held that the subject lease had an anti-dilution clause such that if the Lessee was going to pool it had to pool a designated percentage of the acreage in the unit. In this case, the Lessee wanted the Lessor to change the lease provisions, but the Lessor refused. So, the Lessee just ignored them and drilled their well anyway. Lessors sued, saying that pooling was not effective as to them and that they were entitled to royalties based on *all* production from the wellbore. The court addressed the advent of modern technology and held that each tract traversed by a horizontal wellbore should be considered a "drillsite tract".

However, the court also held that the Lessee must account to Lessors for production on an unpooled basis. Specifically, the court held that "[t]he better remedy is to allow the offended lessors to recover royalties as specified in the lease, compelling a determination of what production can be attributed to their tracts with **reasonable probability**."[7] (emphasis added). Again, the essential question arises: can anyone confirm with reasonable probability what production comes from which tract?

Additionally, please remember the procedural history of *Browning v. Luecke*. The case was not a Texas Supreme Court case and was remanded so that the district court and the parties could determine what production came from what part of the wellbore. We will never know the answer to that specific question because they settled that issue out of court.

One should remember the determination of production from constituent tracts when deciding to pursue Allocation Wells and/or PSA Wells. Most people are assuming that the pro rata share of the wellbore on a given tract equates to the pro rata share of production. However, the facts on the ground may not comport with this approach. So, what is "reasonable"?

As referenced above, the San Antonio Court of Appeals in *Springer Ranch, Ltd. v. Jones* noted that an expert's opinion that production from multiple tracts allocated on the basis of the horizontal wellbore's distance from the first to last take points within the correlative interval was reasonable. Please note, however, that there appears to be little additional caselaw on this issue. In *Spartan Texas Six Capital Partners, Ltd. v. Perryman,* Cause No. 2011-27476, 11th Judicial District Court, Harris County, the plaintiffs appeared to argue just this point. In this case, the parties alleged that allocating production on productive lateral length should be held to a higher standard of "**reasonable certainty**" rather than the

[7] Browning v. Luecke 38 S.W.3d 625, 647 (Tex. App. – Austin, 2000).

"reasonable probability" alluded to in *Browning v. Luecke.* This is informational only, though, given that *Spartan Texas Six Capital Partners, Ltd. v. Perryman* was also settled out of court.

Likewise, in *Monroe Properties, Inc. et al. vs Railroad Commission of Texas*, Cause No. D-1-GN-18-001111, 53rd Judicial District Court, Travis County, the plaintiffs noted that "[n]o Texas case has ever construed an oil and gas lease to permit the lessee to pay royalties on an estimated share of commingled production. The only method authorized by the Lease for commingling production from multiple tracts is by forming pooled units."[8] It went on to assert that Devon did not therefore meet the RRC's threshold of "colorable claim to the right to drill" (i.e. a good faith claim).

The Petition also noted that the RRC was failing to abide by its own rules. Plaintiffs asserted that the Allocation Well permit violated both Statewide Rule 40, Assignment of Acreage to Pooled Development and Proration Units, and Statewide Rule 26, Separating Devices, Tanks, and Surface Commingling of Oil. Per the Petition, "Devon's proposed completion would render it impossible to measure all hydrocarbon production before it leaves the lease from which it is produced" and violates Rule 26's requirement that "all 'oil and other liquid hydrocarbons' [are] to be measured before the same leaves the lease from which they are produced."[9]

Separately, as one commentator has noted, the RRC's rules on commingling of oil and gas and "the applicability of these rules to allocation wells is questionable." The commentator opines that "[r]egardless of their applicability, however, if extending them to allocation wells would achieve the policy objectives for which the rules were adopted, a strong argument can be made that the rules should apply. In any event, the novelty of allocation wells prompts consideration of the question of whether rules or statutes should be adopted to expressly regulate commingling within allocation wells."[10]

The Petition in the *Monroe Properties* case pointed out some very real concerns about allocating production properly. However, like in *Spartan*, this case was settled out of court and can only be looked at for informational value. For the time being, it seems, there is limited legal guidance on Allocation Wells and PSA Wells.

*Railroad Commission.*

While the RRC does not have the authority to adjudicate contract, as part of its rules it must determine whether an operator has a good faith claim sufficient to warrant the issuance of a drilling permit. This issue was central in RRC Oil & Gas Docket No. 02-0278952, being the *Application of EOG Resources, Inc. for its*

[8] PLAINTIFFS' ORIGINAL PETITION FOR JUDICIAL REVIEW in the 53rd District Court, Travis County. Monroe Properties , Inc. et al. vs Railroad Commission of Texas, No. D-1-GN-18-001111.

[9] Id, at Paragraph 24 – 25.

[10] *Clifton A. Squibb*, The Age of Allocation: The End of Pooling As We Know It?, 45 Tex. Tech L. Rev. 929, 948 (2013).

*Klotzman Lease (Allocation), Well No. 1H (Status No. 744730), Eagleville (Eagleford-2) Field, Dewitt County, as an Allocation Well Drilled on Acreage Assigned from Two Leases*. The Proposal for Decision in this matter was issued June 25, 2013.

The case and the issuance of the Proposal for Decision by the Hearings Examiners had a number of interesting points. EOG wanted to drill an Allocation Well where the "…proposed well would be on 80 acres, composed of 40 acres from the Georgia Dubose Glassell 516.569-acre lease and 40 acres from the Georgia Dubose-Pierce 304.97-acre lease. The two leases were entered into in 1956. EOG states it has 100% of the determinable fee mineral estate in each lease. However, the subject leases do not grant pooling authority for oil".[11]

From a permitting side of the equation, this is a Rule 37 issue. 16 Texas Administrative Code Section 3.37 is clear about who gets notice: (i) unleased mineral interest owners, (ii) the lessees of record for tracts that have no designated operator and (iii) the designated operator.[12] As with many Allocation Well operators, EOG was purporting to be its own offset. Given that it was the designated operator, it duly gave notice to…itself. However, the situation here was a little different because the mineral owner, who also happened to be an attorney, was aware of the application and protested at the RRC. The fact that the mineral interest owner was allowed standing to request a hearing shows that the RRC thought that there were notice concerns.

In the hearing, the Klotzmans argued that EOG did not have pooling authority and therefore should not be granted a permit. The RRC hearing examiner (administrative law judge) referred to the Klotzmans as "knowledgeable affected parties".

During the hearing, EOG acknowledged that there was no pooling authority. The interesting aspect is that EOG *flat out stated* that it had tried to get the pooling authority but was denied. Instead, they argued that they were just taking acreage from two leases to form a separate unit.[13] The hearings examiner noted that "EOG's denial that it is pooling is untenable. Its actions are the definition of pooling." He went on to assert that EOG was pooling, that it had no authority to do so under the leases, and that without the power to pool, EOG had no good faith claim to drill the well. Therefore, it was not entitled to a permit under the RRC rules.

The hearings examiner also noted in his Proposal for Decision that there were no Texas statutes, RRC rules or any other final orders that authorized Allocation Wells. He stated that "[t]he Commission has no authority, by Final Order or rule, to

[11] Proposal for Decision, Oil & Gas Docket No. 02-0278952, Application of EOG Resources, Inc. for its Klotzman Lease (Allocation), Well No. 1H (Status No. 744730), Eagleville (Eagleford-2) Field, Dewitt County, Page 4.

[12] See 16 T.A.C. 3.37, found online at https://texreg.sos.state.tx.us/public/readtac$ext.TacPage?sl=R&app=9&p_dir=&p_rloc=&p_tloc=&p_ploc=&pg=1&p_tac=&ti=16&pt=1&ch=3&rl=37 .

[13] Id at Page 20.

legitimize permits for Allocation Wells insofar as they are wells composed of leased acreage lacking pooling authority." Citing caselaw, he further opined that "...the acts of the Railroad Commission cannot be said to operate effectively to extend the restrictive terms of a lease. The orders of the Railroad Commission cannot compel pooling agreements that the parties themselves do not agree upon. The Railroad Commission has no power to determine property rights." Jones v. Killingsworth, 403 S.W.2d 325, 328 (Tex. 1966) (emphasis added)."[14] The hearing examiner in the Proposal for Decision recommended that EOG's application be dismissed.[15]

So, the hearings examiner analyzed the law in his Proposal for Decision and presented it to the elected Railroad Commissioners at public conference. Their response?

**DENIED**.

The elected Commissioners chose to ignore the legal analysis and granted EOG's permit anyway. Remember that the Commission does not adjudicate contract. The practice has always been when there is a contract interpretation issue that the RRC is supposed to "punt" the issue to the district court. However, here, the RRC dismissed the contested claims by the Klotzmans and said that EOG's basis was enough to reach the threshold of a good faith claim. Basically, the RRC said that for the regulatory world, having a lease is good enough for a good faith claim.

In RRC Oil & Gas Docket No. 08-0305330, styled *The Complaint of Monroe Properties, Inc., et al. that Devon Energy Production Co, LP does not have a Good Faith Claim to Operate the N I Helped 120 (Alloc) Lease, Well No. 6H, Phantom (Wolfcamp) Field, Ward County, Texas*, the Complainants argued that Devon did not and could not have a good faith claim to drill its well. The Complainants argued that in order for Devon to have authority to drill the well, it had to have either a contractual lease basis, i.e. pooling authority, or it had to have entered into a production sharing agreement. Devon did neither and Complainants claimed that it lacked a good faith claim as a result.[16]

The RRC summarily dismissed the Complaint. It said "[i]n the Klotzman case, the Commission has previously decided that it does not require proof of pooling authority for an applicant to show a good faith claim necessary to obtain a permit for an allocation well. There has been no change in the law since the decision in the Klotzman case… While the Complainants may have a bona fide lease dispute with Devon, the determination of whether there has been a breach and the

[14] Id at Page 21.

[15] We note that the Examiner's PFD is not binding unless approved by the elected Commissioners. We include the legal analysis for informational purposes only.

[16] RRC Oil & Gas Docket No. 08-0305330, Complaint of Monroe Properties, Inc., et al. that Devon Energy Production Co, LP does not have a Good Faith Claim to Operate the N I Helped 120 (Alloc) Lease, Well No. 6H, Phantom (Wolfcamp) Field, Ward County, Texas, Order Of Dismissal, found at https://www.rrc.texas.gov/media/43907/08-0305330-ord.pdf

appropriate remedy is outside the jurisdiction of the Commission." Finally, the RRC held that "[n]either pooling authority nor a production sharing agreement is required to establish a good faith claim for a permit to drill an allocation well."[17] As referenced earlier in this paper, the RRC's ruling was appealed to the District Court, but the case was subsequently settled.

### *III. The Latest Twist. Lease Line Allocation Wells Come to Town.*

As alluded to above, there are quite a few operators that have availed themselves of either PSA Well or Allocation Well drilling permits. One could argue that it has helped to fuel the explosive growth in West Texas. There are now thousands of Allocation Wells drilled across Texas.

The process in obtaining Allocation Well permits has evolved over time, but so have the needs of the industry. The original Allocation Wells were, to simplify, something like this:


Practitioners would base royalty payment on an allocation factor where the numerator was equal to the length of that portion of the productive drainhole length, from first take point to last take point, of the "Allocation Well" which traverses the subject leases and the denominator of which is the total productive drainhole length of the respective Allocation Well. Ideally, mineral interest owners would execute Production Allocation Agreements, and all was well.[18] Sure, there may have been some people grumbling, but receiving large checks helped a good bit, plus many royalty owners were not willing to incur the high cost of litigation to determine if they should have gotten a larger hypothetical share of production than what they received.

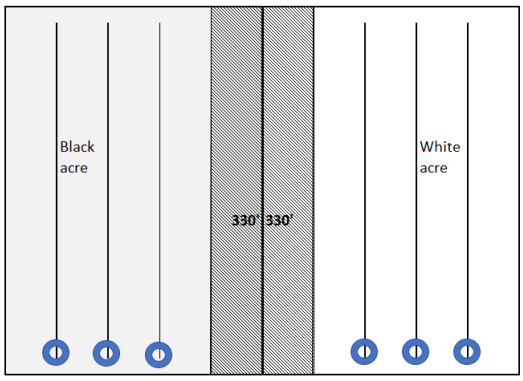
Additionally, Allocation Wells provide MORE productive lateral than if two wells were drilled, i.e. a horizontal wellbore on Blackacre and a separate horizontal wellbore on Whiteacre. The reasons for this are field rules, i.e. lease line spacing. Using the Wolfcamp special field rules as an example, without a Rule 37 exception, the operator is required to be within 330' from lease lines and 100' from lease lines perpendicular to the wellbore. So, without an Allocation Well permit, you would, as a simplification, have something like this for two regular wells:

[17] Id.

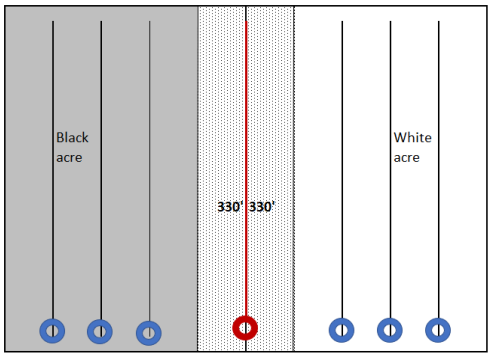
[18] Please note that some practitioners use "Production Allocation Agreement" whereas others use "Production Sharing Agreement". Regardless of term used, both refer to an agreement whereby the royalty owner acknowledges and agrees how royalty will be allocated under a PSA Well or Allocation Well.


An Allocation Well IS A RULE 37 EXCEPTION and 200' of additional productive lateral is obtained as a result. Again, additional money in the mailbox helps deter lawsuits.

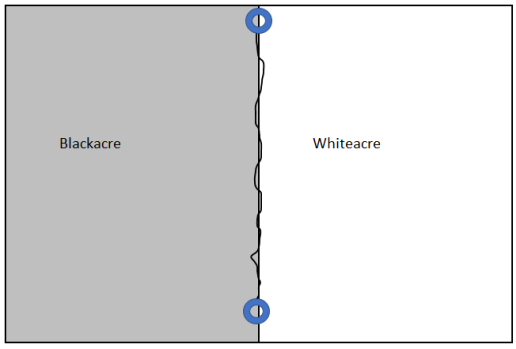
However, the next step in the evolutionary process is where things get interesting. If you are drilling a unit to capacity, then you might find yourself in the following situation:




Due to spacing in the special field rules, you have a 660' corridor going down the middle of the two units. You have both units under lease, and you have the ability to obtain an Allocation Well permit. Your idea is to drill something like this:




The Lease Line Allocation Well pictured above is great in theory and looks clean on a permit map. It is a straight line. However, I used to work in directional drilling and can attest that there is no such thing as a straight line in drilling wells. Rather, the as-drilled plat is usually something that looks like this:



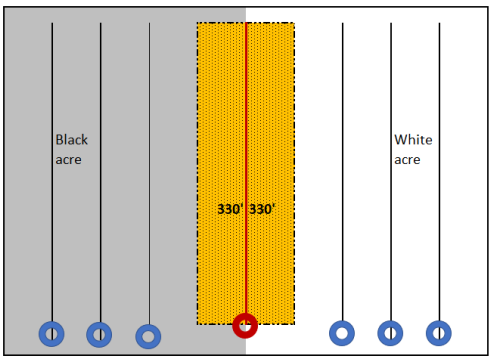

So, for the sake of discussion, let us assume that your client has drilled the above and is asking you to provide a Division Order Title Opinion. If your client has drilled the well without a Production Allocation Agreement, we are back to the essential question: How do you allocate the production?

*Methods*

There appear to be two methodologies that are gaining traction, but both should be done *with* Production Allocation

Agreements. The first method is what some refer to as the "fifty fifty". Simply enough, the production from the wellbore is shared 50% to the Whiteacre participants and 50% to the Blackacre participants. For many Lease Line Allocation Wells, the back and forth of a directionally drilled well would approximate 50% to either side. Usually, this methodology simplifies payment to royalty owners.

The second method is what some refer to as the "box rule". Under the box rule, a box is typically drawn 330' on each side of the proposed well and 100' perpendicular to the first and last take points. The "box" may look something like this:




We say "typically" because such a box comports to many special field rules, but please note that some operators use different size "boxes". My recommendation is to consult your field rules and have your box comport with the applicable field rules.

In any event, production is allocated according to the surface acreage amounts in said box, regardless of the well's ultimate location. Under the box rule, "threading the needle" down the lease line is less of a concern and accounts for wellbore drift.

Regardless of which method is chosen, a Production Allocation Agreement is **strongly recommended** for Lease Line Allocation Wells. Arguments have been made that the "standard oil and gas lease gives the lessee all of the authority needed to drill a horizontal well that crosses lease lines" and Allocation Wells are perfectly valid under the authority in the underlying leases.[19] But an argument could be made that Lease Line Allocation Wells are different. With Lease Line Allocation Wells there will inevitably be wellbore drift. It is entirely possible that due to unforeseen drift an operator may end up with a wellbore that is significantly more on one side of the lease line than the other.

Wellbore drift supports the need for Production Allocation Agreements. By way of example, suppose that due to drift, 70% of the wellbore is on the Blackacre side of the lease line. No Production Allocation Agreements are in effect. The operator may find itself subject to claims by the Blackacre royalty owners to royalty on 70% of the production. The Whiteacre royalty owners are demanding to be paid on 50% of the production. Where does "reasonable probability" for allocation fall when a party can prove that the wellbore is predominantly on its side of the unit line?

[19] *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, 3 Oil & Gas, Nat. Resources & Energy J. 553, 569 (2017).

*Drafting Production Allocation Agreements*.

A Production Allocation Agreement heads off most of the thorny issues before they arise and allows the watch to function as intended. Indeed, "the lessee can address the question of production allocation by reaching agreement with affected royalty owners as to how production will be allocated among the various tracts….When a lessee drills a horizontal well pursuant to a PSA, the PSA is normally executed before the lessee drills the horizontal well. Thus, by the time the lessee obtains production from the horizontal well, the lessee already knows how that production will be allocated."[20]

So, there are benefits to a Production Allocation Agreement, particularly in situations involving Lease Line Allocation Wells. Generally speaking, we have not encountered a "standard Production Allocation Agreement". However, there are several key aspects that should be looked for in a Production Allocation Agreement.

Here are some recommendations:

- The allocation formula should be as scientifically credible as possible and fair to the parties. *Springer Ranch*'s "first to last take point" in the correlative interval as part of the methodology would appear to be the most credible at this point.

- The agreement should include as many pertinent parties as possible as a risk mitigation approach. Remember that any signup, whether it is designated as a PSA (with >65%) or an Allocation Well (with <65%) gives added protection.

- Keep in mind the RRC's legislative goals to prevent waste and protect correlative rights. A defensible allocation formula should support these goals.

- If at all possible, the Production Allocation Agreement should include language that contemplates more than one Allocation Well, in the event that future Allocation Wells are on the drill schedule.

- The agreement should contain subsurface right of ingress and egress language in the event of subsurface easement claims by parties not in agreement with your Allocation or PSA Well.

- The agreement should be cognizant of offset drilling obligations and draft around them when possible.

- The agreement should include language that operations or production on an Allocation Well will be treated as operations or production from the subject leases (consider continuous drilling obligations).

- The agreement should amend the leases insofar as is necessary to allow the drilling of the Allocation Well. However likely or unlikely, in the

[20] Id, at 567.

event a court of law were to ever strike down Allocation or PSA Wells on the basis that it violates pooling provisions, an argument could be made that the parties contractually agreed to allow it.

The ability to have a Production Allocation Agreement that incorporates the above issues will likely head off problems and keep the watch ticking smoothly.

*Filings at the RRC for Allocation Wells.*

Regarding the nuts and bolts of actually filing a permit at the RRC for an Allocation Well, the process used to be quite cumbersome, whereby the RRC required you to file your W-1 Drilling permit, with a PSA 12, Authority Statement, Acreage Allocation Worksheet and plat. They have since streamlined this process and replaced the old forms with the Form P-16, which is mandatory. In this form, you need to provide the participation in the proposed unit in the "remarks section". The minimum signup percentage has to equal 65% as of the spud date for a proposed PSA well. However, again, remember if you do not have the 65%, you can call it an Allocation Well. A certified plat designating each lease/unit you are carving into the PSA, identifying the outline and each tract with a tract identifier, will also be needed.

In filing for an Allocation Well permit, please remember that the instructions require that you account for Statewide Rules 38 & 40. In other words, you cannot violate density provisions and you cannot double assign acreage. Failure to understand this will delay your permit and get you a friendly "problem letter" from the Commission. Regarding double assignment of acreage, the RRC has allowed it only in specific situations dealing with both a vertical wellbore and a horizontal wellbore, which is more often the case inapplicable to most operators. As a general rule, there is to be no double assignment of acreage.

Also, choose your terminology carefully. Remember that if you file for an Allocation or PSA Well permit, this is NOT pooling. In filling out the Form P-16, take special note of the language at the bottom of the form. You can be the owner or the lessee or have been authorized by the owner or lessee. You are filing under penalty of perjury. This is another provision which encourages the use of Production Allocation Agreements.

Please note the following language on the Commission's form:

"Commission Staff expresses no opinion as to whether a 100% ownership interest in each of the leases alone or in combination with a "production sharing agreement" confers the right to drill across lease/unit lines or whether a pooling agreement is also required. However, until that issue is ruled upon by a Texas court of competent jurisdiction it appears that a 100% interest in each of the leases and a production sharing agreement constitute a sufficient colorable claim to the right to drill a horizontal well as proposed to authorize the removal of the regulatory bar and the issuance

> of a drilling permit by the Commission, assuming the proposed well is in compliance with all other relevant Commission requirements."

Also, see:

> "Issuance of the permit is not an endorsement or **approval of the applicant's stated method of allocating production proceeds** among component leases or units. **All production** must be reported to the Commission as production from the lease or pooled unit on which the wellhead is located and reported production volume **must be determined by actual measurement of hydrocarbon volumes prior to leaving that tract and may not be based on allocation or estimation**." (emphasis added).

So, the Commission is allowing the permitting but is staying out of the fray. One can imagine that the RRC's boilerplate does not give an Allocation Well operator a warm and fuzzy feeling.

As alluded to earlier, case law is spartan on this matter. Legislative help would be greatly appreciated but is not coming soon. In 2015, House Bill 1552 would have allowed production to be allocated on a **reasonable basis** to be determined by the operator or lessee. Unfortunately, the bill was pretty much dead on arrival. While it was supported by many in the oil and gas industry, quite a few royalty owners protested the bill and the legislation failed. A resurrection of House Bill 1552 failed to materialize in the most recent legislative session.

And here we are, waiting to see how, or even if, the courts will rule on Allocation Wells. It is arguably well past time that the law catches up to the industry and helps the watch tick smoothly.

*Opinion Caveats.*

And while the industry waits, and title examiners continue to draft title opinions, many examiners are including language that acknowledges the situation. We have seen language in opinions similar to the following::

> "Based upon the information provided to this office, the Subject Well is an Allocation Well that crosses the ____Lease and the _____ Pooled Unit. As a cautionary note, we point out that the use of an allocation well permit in developing separate tracts is accepted by many in the oil and gas industry, but the use of same and its ability to circumvent traditional pooling provisions has not been fully litigated by the courts. Further, the Materials Examined do not include Production Allocation Agreements executed by and between all relevant parties. You are advised to obtain and submit for our review Production Allocation Agreements from all interest owners in order to reduce the risk of potential litigation. In the event that you are unable to secure Production Allocation Agreements from all parties agreeing to the allocation formula set out therein, you are

advised that additional comments, requirements and revisions may be necessary based upon evolving case law."

Similarly, we have seen language similar to the following in Lease Line Allocation Well situations:

> In setting out the ownership herein, we note that you have advised us that the Subject Well is an Allocation Well that follows the lease line between separate units. You have likewise requested that we set out ownership on the basis of [50/50 or box rule] of production to each group of lessors in and on each adjoining DPU. However, you are advised that an on the ground, as drilled plat may reflect a different ratio.
>
> If you do not receive completed Production Allocation Agreements from ALL parties, you are advised that additional investigation will be required to ascertain which portions of the as-drilled wellbore would be allocated to each of the parties refusing to execute the allocation agreement and to each party that remains an unleased cotenant. You are advised to obtain an on the ground, as drilled survey that properly outlines what portions, along with lateral lengths, are located on each tract. In the event that you are unable to secure Production Allocation Agreements from all parties agreeing to the allocation formula set out therein, you are advised that additional comments, requirements, and revisions will be forthcoming.

## *IV. Conclusion. For now.*

Allocation Wells are here in the industry and operators see the benefits. As the industry grows and Allocation Wells and PSA Wells grow with it, we will continue to see adaptation to facts on the ground. Hopefully, this paper has provided some basic information on how the process came to be and where it is going, along with some tools to keep the gears turning smoothly in the meantime.