Allocation Wells: How to Allocate Horizontal Wellbore Proceeds Without Getting Sued

Majors Gibson LLC
Meg Gibson

meg@majorsgibson.com
720.515.5580
www.majorsgibson.com
**What Is an Allocation Well?**

**Exception to Rule 37**
- Agreement of 65%
- Agreement of Less than 65%

**When Leases Can’t Be Renegotiated or Pooled Units Reformed**

[www.drillingformulas.com](http://www.drillingformulas.com)
PRODUCTION SHARING AGREEMENTS

“A PRIVATE, CONTRACTUAL AGREEMENT BETWEEN THE OPERATOR OF A PROPOSED WELL AND NON-OPERATING MINERAL INTEREST OWNERS IN TWO OR MORE LEASES OR UNITS THAT WILL BE PENETRATED BY A HORIZONTAL DRAINHOLE THAT PROVIDES FOR THE SHARING OF PRODUCTION PROCEEDS, BUT NOT FOR THE POOLING OF THE COMPONENT LEASES OR POOLED UNITS.”

- TEX. R.R. COMM’N, PROPOSED RULE AMENDING HORIZONTAL DRILLING REQUIREMENTS (MARCH 17, 2011)
Texas: RRC approves wells regularly since 2009

Colorado: No statute, regulation or COGCC policy, but approved with 92.5% written consent

Wyoming: No statute, regulation or WOGCC policy, but commingling regulation

Oklahoma: Statutory allocation (length calculation)
One Wellbore, Many Perforations

Many Tracts & Depths, Various Ownership

James Parrot, Beatty & Wozniak PC
WHO GETS THE YARDAGE?

James Parrot, Beatty & Wozniak PC

WHEN PRODUCTION FROM MULTIPLE TRACTS IS COMMINGLED IN A WELLBORE, OPERATORS MUST HAVE A METHOD FOR ALLOCATING PRODUCTION.
COMPLICATIONS

DEVIATED WELLBORE

PROXIMITY TO WATER BEARING ZONE

OPERATOR/TECHNOLOGY ERROR

James Parrot, Beatty & Wozniak PC
A reasonable allocation method, based on scientific evidence and common industry practices, can shift the burden of proving allocation error.
**Various Allocation Factors**

1. Wellbore length in tract
2. Perforations in tract
3. Area of tract relative to all tracts
4. Fractured area (measure fracs)
5. Amount of gas actually produced from each tract (reasonable probability)

*(See Browning Oil Co. v. Luecke, 38 S.W. 3d 625 (Tex.App.--Austin 2000, pet. denied).)*
CALCULATIONS - WELLBORE LENGTH
Calculations - Perforations

Clifton A. Squibb, Hamilton & Squibb, LLP
CALCULATIONS – TRACT AREA

http://www.oilandgaslawyerblog.com/
Calculations – Frac’d Area

A (Pooling)  B (PSA)

1/3rd of productive lateral within Tract A  2/3rds of productive lateral within Tract B

Clifton A. Squibb, Hamilton & Squibb, LLP
How to measure?

- Microseismic (fracture mapping and monitoring)
- Tracers (flow measurement)
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**RRC Rules**

- Rule 37, 38, 86, or the field’s special rules
- Rule 37 - spacing and setbacks:
  - “no well shall be drilled nearer than 467 feet to any property line, lease line, or subdivision line”
  - “No well . . . shall . . . be drilled nearer than 1,200 feet to any well completed in or drilling to the same” field on the same tract. 16 Tex. Admin. Code § 3.37(a)(1)
  - RI & ORRI owners don’t have to be notified about applications for exceptions
- Rule 38 – Not enough acreage (but must be half the size of a standard-drilling unit)
- Rule 86 – Horizontal wells (spacing, density, and proration)
A “drilling unit” is the minimum number of acres needed to be assigned to a well for issuance of a drilling permit.

A “proration unit” is the productive acreage assigned to a well to obtain an allowable.

Proration unit is typically the same size and shape as the drilling unit.
Allocation well permits are issued by the RRC as an exception to the spacing requirements of Rule 37. Theoretically, the permit has no pooling effect, but it authorizes an operator that does not have the power to pool in its leases to drill across two (or more) separately owned tracts as if the different tracts constituted a single unit.


Clifton A. Squibb, The Age of Allocation: The End of Pooling as We Know It, 45 Tex. Tech L. Rev. 929 (2013).
Risks Involved with Allocation Wells

• 2 Major Issues:
  • Are these wells legal?
  • What is your exposure?

• Texas law is...unsettled.
  • Regulations and cases based on vertical wells
  • Not much law
Are These Wells Legal?

• Regulatory: YES

• How did we get here?
  • 2006 – permitted when 100% of interest owners signed PSA
  • 2007 – Legal Staff denied, Commission approved with 98.5%
  • 2008 – Legal Staff denied, Commission approved with 65%
  • 2009 – Allocation well permits begin to be regularly granted (55 of them)
  • 2012-2013 – Klotzman
**Are These Wells Legal?**

- **The Klotzman case**

  - EOG 100% Leased (no pooling clause)
  - EOG Allocation Well
  - EOG 100% Leased (no pooling clause)

- **EOG applied for a permit; Klotzmans filed a complaint** (after trying to negotiate higher royalty)
Are These Wells Legal?

EOG

1) Have title; not pooling
2) RRC duty to promote development
3) Not the RRC’s job to determine royalty allocation
4) Established practice

Klotzman

1) This is pooling w/o authority
2) Can develop, just need to get lessor agreement
3) Can’t measure production from the different leases
4) No established law

Who won?
Are These Wells Legal?

- June 2013 – Examiner rules in favor of Klotzmans
- September 2013 – Commission reverses and issues the permit
- December 2013 – Appealed to district court
- March 2014 – Settled
- Today: RRC permits allocation wells
  - No legal distinction between “Allocation Well” and “PSA Well”
Are These Wells Legal?

• What about Texas courts – any guidance?
  • Very little
  • *Browning Oil v. Luedke*

• Commentators?
  • Bret Wells (UH law professor)
  • Ernest Smith (UT law professor)
Are These Wells Legal?

- Bret Wells (Baylor Law Review May 2016)

- Combining 2 tracts for one well = pooling

- Unless pooling allowed in lease, no multi-tract drilling

- Remedies – set aside drilling permit, slander of title, injunction, damages
Are These Wells Legal?

• Ernest Smith (TJOGEL, Volume 12.1)

• Geologically no difference; wasteful to disallow

• Lease doesn’t prevent this

• Not pooling just b/c wellbore crosses lease line

• As long as properly paying royalties, what’s the problem?
Are These Wells Legal?

• Who is right?

• Little guidance from courts; none from legislature

• RRC seems to have made its decision
  • Texas courts likely to follow RRC lead?
What Is Your Exposure?

• Unless you have 100% PSA – have at least some folks who are unhappy

• What can they do?
  • Try to re-negotiate their leases
  • Sue for damages? Cancel permit?

• Main issue – challenging allocation
How to Properly Allocate?

- Surface Acreage Basis – 33% to A, 67% to B
- Horizontal Drainhole Length – 67% to A, 33% to B
- Number of Perforations – 33% to A, 67% to B
- Other? Consider all factors, plus geology, etc.
What Is Your Exposure?

• Allocation: How sure do you need to be – unclear

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<thead>
<tr>
<th>Reasonable Probability</th>
<th>Reasonable Certainty</th>
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<tr>
<td><strong>Browning Oil case</strong></td>
<td><strong>West case</strong></td>
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<tr>
<td>1) Involves unpooled leases traversed by horizontal well</td>
<td>1) Addresses commingling (Browning did not)</td>
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<td>2) Texas Supreme Court denied review</td>
<td>2) Texas Supreme Court case</td>
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<td>3) Promotes horizontal drilling</td>
<td>3) Promotes more detailed analysis in allocation</td>
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Other Concerns

- Duty to protect from drainage
- Surface use issues
- Lease perpetuation
Texas Legislation

• HB 1552 was filed in 2015
• Key points:
  • Allocation wells allowed
  • If no agreement, operator allocates based on “reasonable” determination of production from each tract
  • Affected parties can apply to RRC for a ruling
• Died in committee
Best Practices to Mitigate Risk

• Get pooling authority
• Get a PSA signed by as many interest holders as possible
• If no PSA, be confident about your allocation
Andrew Zeve
BRACEWELL LLP
Andrew.Zeve@bracewelllaw.com

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