



ARLINGTON, TEXAS

AAPL 2021 ANNUAL MEETING

PROFESSIONAL DEVELOPMENT AND LAND CONFERENCE

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AAPL 2021 **ANNUAL MEETING**

The Allocation Problem

Allocating Production in the Permian Basin and Beyond

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AAPL 2021 **ANNUAL MEETING**

Overview

- Background of Allocation Wells and Production Sharing Agreements
- Requirements for an Allocation Well
- Impact of Allocation Wells on Horizontal Drilling



Authority for Allocation Wells

- There is no Texas statute or regulation addressing production sharing agreements or allocation wells
- *Cockrell v. Texas Gulf Sulphur Co.*, 299 S.W.2d 672, 675 (Tex. 1956) (explaining the doctrine of the greatest possible estate granted, which permits the lessee to drill anywhere on the lease, including border to border, unless expressly prohibited by the lease)
- *Magnolia Petroleum Co. v. Railroad Comm'n of Texas*, 170 S.W.2d 189 (Tex. 1943) (explaining that a “reasonably satisfactory showing of good-faith claim of ownership in the property” is what is required to obtain a drilling permit).

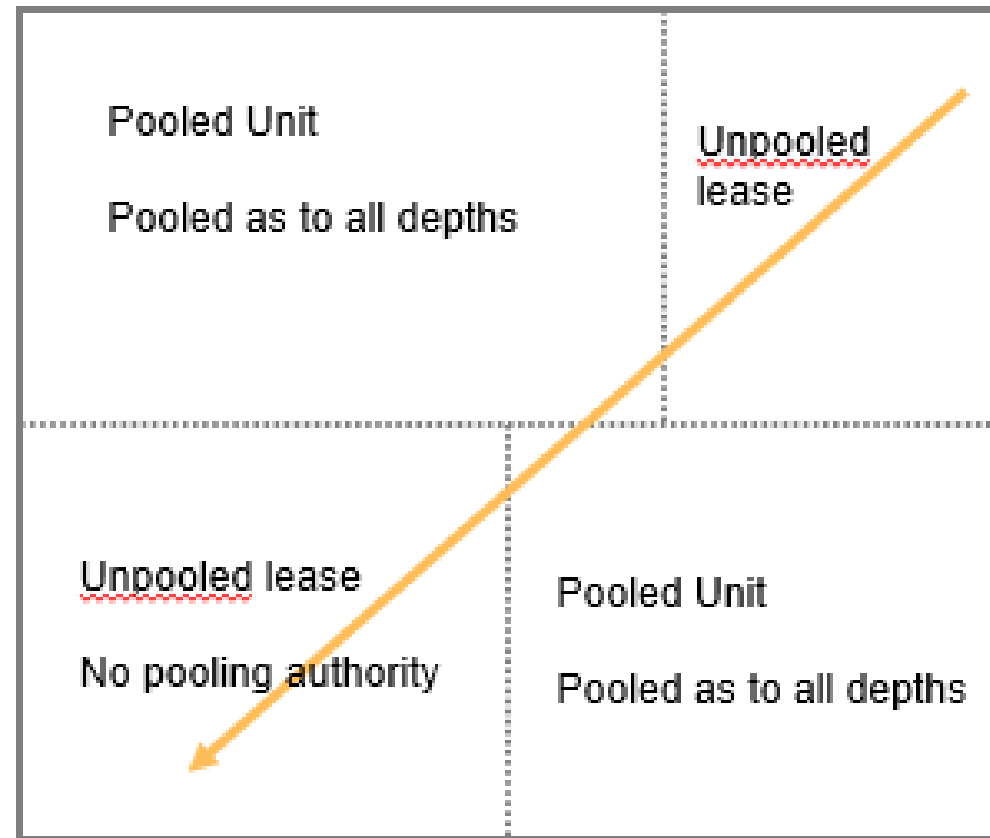


Allocation Wells

- An allocation well is 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.
- The ability to drill an allocation is a valuable alternative to pooling when the lease does not grant pooling authority or restrictive pooling provisions make pooling difficult or overly burdensome.



Why do Allocation Wells Exist?



- Restrictive pooling provisions
- Lack of pooling authority
- Existing pooled units



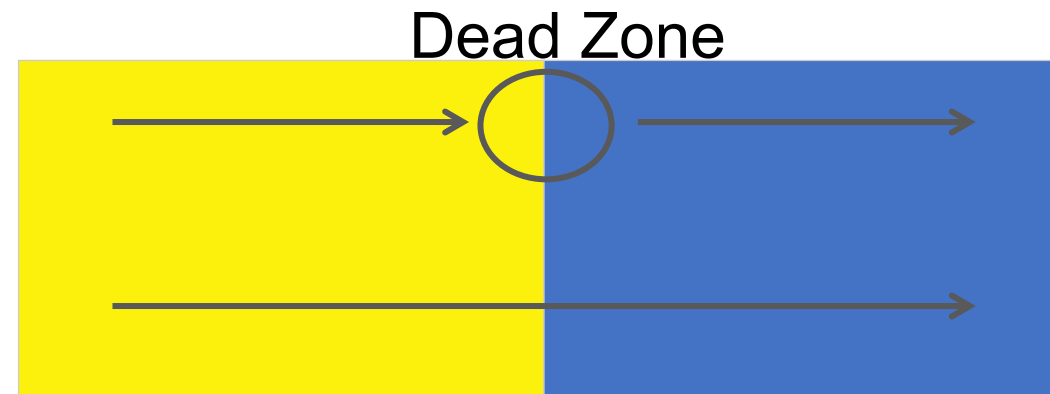
The RRC's Position

- The RRC has authority to permit commingling
- Developed as a response to combine multiple tracts in the absence of pooling authority or the consent of the working interest or royalty owners
- The RRC will issue a permit to drill a horizontal allocation well where the applicant shows a good-faith claim of a right to drill, which is satisfied by holding leasehold or mineral rights
- The RRC includes a disclaimer on allocation well permits that includes:
 - “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.”
 - “Payment of royalties is a contractual matter between the lessor and lessee.”



Benefits of an Allocation Well

- Promotes conservation by precluding drilling separate wells
- Prevents waste of oil and gas through a loss of reserves in dead zones (or non perf zones) between tracts

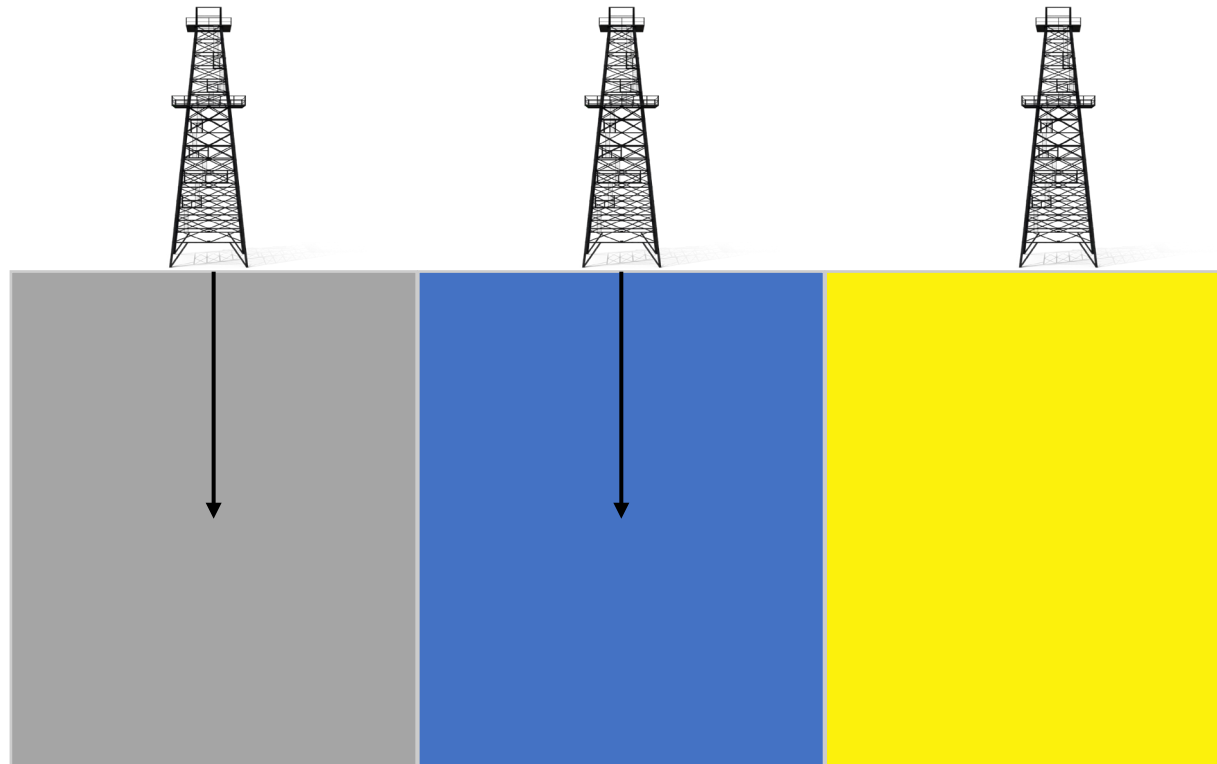


Authority to Form an Allocation Well

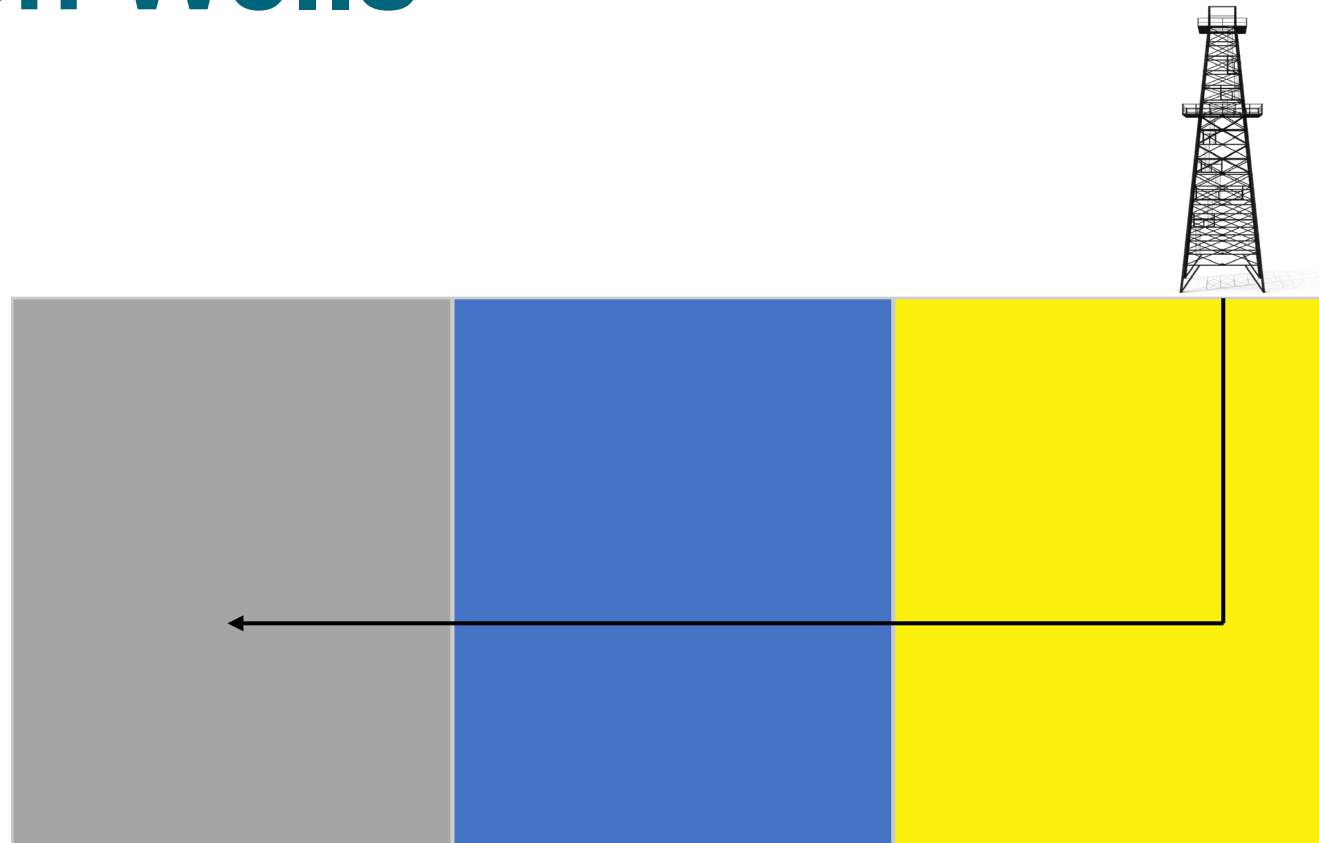
- Pooling authority is not necessary
- A horizontal allocation well across multiple tracts is treated the same as a series of vertical wells on each tract
- Drilling a horizontal well that crosses lease lines does not constitute a type of pooling because the horizontal well alone does not result in a cross-conveyance of royalty interests or change the allocation of production
- Thus, an allocation well does not breach the terms of a lease that prohibits pooling (or fails to grant pooling authority)



Allocation Wells



Allocation Wells



Production from Allocation Wells

- Production is allocated to each tract to recognize the production contributed by each tract
- *Humble v. West*, 508 S.W.2d 812 (Tex. 1974) (explaining that the burden of proof is on the commingler of gas to prove each party's share with "reasonable certainty" by expert testimony)
- *Springer Ranch v. Jones*, 421 S.W.3d 273 (Tex. App.—San Antonio 2013) (concluding that an expert's opinion that production from multiple tracts allocated on the basis of the horizontal well's distance between first and last take points within the correlative interval was reasonable)
- Contrast: When tracts are pooled, production from any tract in the pooled unit is treated as production from every tract in the pooled unit and is allocated to every tract in the pooled unit



Possible Challenges to Allocation Wells

- Method to allocate production
 - The Texas Supreme Court has not specified a formula for allocation of production (other than allocation to each tract with reasonable certainty)
- Lack of pooling authority
- Excessive use of the surface
 - *Robinson v. Robbins Petroleum Co.*, 501 S.W.2d 865 (Tex. 1973) (“[T]he use of the surface by a mineral owner or lessee in connection with operations on other premises constitutes an excessive use of his surface easements.”)
- Trespass



Production Sharing Agreements

- A creation of the Railroad Commission (“RRC”) to combine multiple tracts in absence of pooling
- Allows an operator to form a production sharing agreement by obtaining consent of at least 65% of the working interest and 65% of the royalty interest.
- If the requisite consent is obtained, then the RRC will permit the operator to treat the production sharing agreement as a single drillsite tract
- A PSA will require a Rule 37 lease line exception (but if the operator owns 100% of the working interest it can waive the notice and hearing under Rule 37 as an “own-offset waiver”)



Types of Production Sharing Agreements

Single Well PSA

- Signed by owners within two or more pooled units or leases
- Agreement is limited to the identified well

Designated Area PSA

- Signed by owners within two or more pooled units or leases
- Agreement applies to one or more wells

Sharing Well PSA

- Signed by lessors of a lease that may or may not be within an existing pooled unit authorizing the lessees/operator to allocate production from a “sharing well” (one or more horizontal wells that traverse lease or pooled unit or other lands)
- Lessee may include the lease/pooled unit in more than one shared well
- No specific acreage is designated in the agreement



Production Sharing Agreements

WHEREAS, to avoid any uncertainties concerning the manner in which the Interest Owners will share the proceeds of production attributable to that portion of the Horizontal Drainhole Well traversing any portion of the Lands covered by the Pooled Unit and the Leases, the Interest Owners and Operator desire to enter into this Agreement to agree upon the basis for sharing and allocating the proceeds of production of Hydrocarbons attributable to that portion of any Horizontal Drainhole Well traversing any portion of the Lands covered by the Pooled Unit and/or the Leases.



Production Sharing Agreements –Terms

Sharing Well – Horizontal Drainhole Well in which a portion of the productive Drainhole Length is located under the Lands and/or the Pooled Unit, and another portion or portions are located under one or more other tracts of land...

Allocation Factor – A fraction, the numerator of which is equal to the length of that portion of the Productive Drainhole length of the Sharing Well that lies under the Pooled Unit (or lease tract) in which each Interest Owner owns an interest in the proceeds of production of Hydrocarbons, and the denominator of which is equal to the Productive Drainhole Length of the Sharing Well.



Production Sharing Agreements – Provisions

Each Interest Owner will share in the proceeds of Hydrocarbons produced and saved from a Sharing Well on the basis of that Interest Owner's ownership interest in the Pooled Unit (lease tract) payable pursuant to the terms and provisions of the Lease covering such Interest Owner's interest, multiplied by the Allocation Factor.

Operator will have reasonable use of the surface of the Lands to conduct operations for the exploration, drilling, production, transportation and marketing of Hydrocarbons and a Sharing Well.



Production Sharing Agreements – Provisions

Interest Owners grant Operator the authority to conduct operations to drill, operate and produce Hydrocarbons from a Horizontal Drainhole Well and/or its Horizontal Drainhole that is drilled across and through any property line of the Lands, or lease line of a Lease included in the Pooled Unit (or lease tract) into and under lands not included in the Pooled Unit.



Provisions in a PSA

- Identification of the agreed method of allocation
- Modification of the habendum clause to specify whether production, whether or not on a certain lease, will be deemed production from each lease and maintain leases
- May address or negate offset obligations
- If the surface owner is a party to the PSA, then inclusion of a provision granting the lessee authority to use the surface estate for production from all tracts covered by the PSA



Pooling and Allocation Wells

- When a lessee creates a pooled unit, the lessee engages in a cross-conveyance of property:
 - The lessee conveys to each of the tracts in the pooled unit a portion of the royalty interest from the other tracts in the pooled unit
- The lessors under each of the leases in the pool become joint owners of the royalties
- *Key Operating & Equipment v. Hegar*, 435 S.W.3d 794 (Tex. 2014) (the right of ingress and egress extended to pooled acreage to produce minerals from the pooled acreage)



Browning Oil Co. Inc. v. Luecke, 38 S.W. 3d 625 (Tex. App. – Austin 2000, pet. denied)

- Luecke’s oil and gas leases contained anti-dilution provisions. The lessee attempted to amend the anti-dilution provision, but the Lueckes refused.
- Lessee drilled two horizontal wells that did not satisfy the anti-dilution provision and the Lueckes filed suit asserting that the horizontal wells violated the pooling provisions in the lease
- Lueckes asserted that because their tracts were not validly pooled, they were entitled to royalty on all production resulting from the two horizontal wells.
- Lessees proposed to allocate royalties based upon the shared production from the wells that could be attributed to Luecke’s tracts (this resulted in a difference of approximately \$1,000,000 of royalties)



Browning Oil Co. Inc. v. Luecke

- The appellate court concluded that “[t]he proper remedy for a breach of the pooling provisions may not ignore or exceed the ownership interest conveyed under the leases. The Lueckes contracted for a share in royalties based on total production from their land.”
- As a result, the Lueckes were allowed to recover royalties as specified in their lease, compelling a determination of what production can be attributed to their tracts with reasonable certainty.
- Confusion of Goods Doctrine:
 - Provides that if the operator cannot determine with reasonable certainty the amount of production coming from each of the tracts penetrated by a horizontal wellbore, then the operator may be required to account to each of the owners of each tract penetrated as if all of the production is allocable to each tract penetrated by the wellbore
 - To meet this burden, the operator would have to show by a preponderance of the evidence and with reasonable certainty the amount of oil and gas produced from each tract penetrated by the horizontal wellbore



Browning Oil Co. Inc. v. Luecke

- *Browning* concluded that the pooling provision was breached because the lessee attempted to create a pooled unit that did not comply with the lease.
 - Thus, a valid pooled unit was never formed.
 - In the absence of a pooled unit, each lessor was entitled to be paid royalties on production from lessor's tract
- Concluded that each party in a horizontal well is entitled to its share of production attributed to each individual tract with "reasonable certainty"
- The breach of the pooling provision was not because the lessee drilled a horizontal well across lease lines



The End of Pooling?

- Why would a lessee seek to exercise pooling authority or obtain consent when not required if the lessee drilled an allocation well?
 1. Pooling can eliminate the problems associated with allocating production
 2. Pooling affords greater operational flexibility
 3. Production Sharing Agreements address the question of allocation of production among multiple tracts by agreement
 4. An allocation well may invite challenge by royalty owners



Implications of an Allocation Well

- Mineral interest owners and nonparticipating royalty owners on non-drill site tracts are excluded from participating in an allocation well
- The court system will have to address whether the formula used in an allocation well allocated production to each tract with reasonable certainty.
- Possible allocation formulas:
 - Productive lateral length
 - Percentage of horizontal lateral
 - The number of take points within a tract compared to the total number of take points along the lateral
 - Surface acreage
- Potential litigation



Klotzman v. EOG Resources, Inc.

- The productive segment of the horizontal drainhole traversed the boundary between a 515.569 acre lease and a 304.97 acre lease.
- The application required a Rule 37 exception
 - Only offset mineral interest or working interest owners are entitled to notice of a requested exception
 - An offset royalty owner, as the owner of a nonpossessory interest, is not entitled to notice
- The RRC concluded that lease, which did not grant any pooling authority, did give the operator “a sufficient good faith claim to drill its proposed [allocation well].”



Recent Litigation

- *Monroe Properties, Inc. v. Devon Energy Production Co., L.P.*
 - RRC dismissed the complaint and explained:
 - RRC has a practice to allow the drilling of allocation wells
 - *Browning* does not establish that pooling authority is necessary to drill an allocation well
 - Suit filed in Travis County and subsequently dismissed on July 27, 2018



- *Opiela v. EnerVest* (Karnes County)

Response to Allocation Wells

- Lessors including provisions in leases prohibiting wells from crossing lease lines without an agreement from the lessor specifying the allocation
- GLO Relinquishment Act Lease
- SMU Lease Form



Methods for Calculating Interests

- Productive lateral length
- Percentage of horizontal lateral
- The number of take points within a tract compared to the total number of take points along the lateral
- Surface acreage

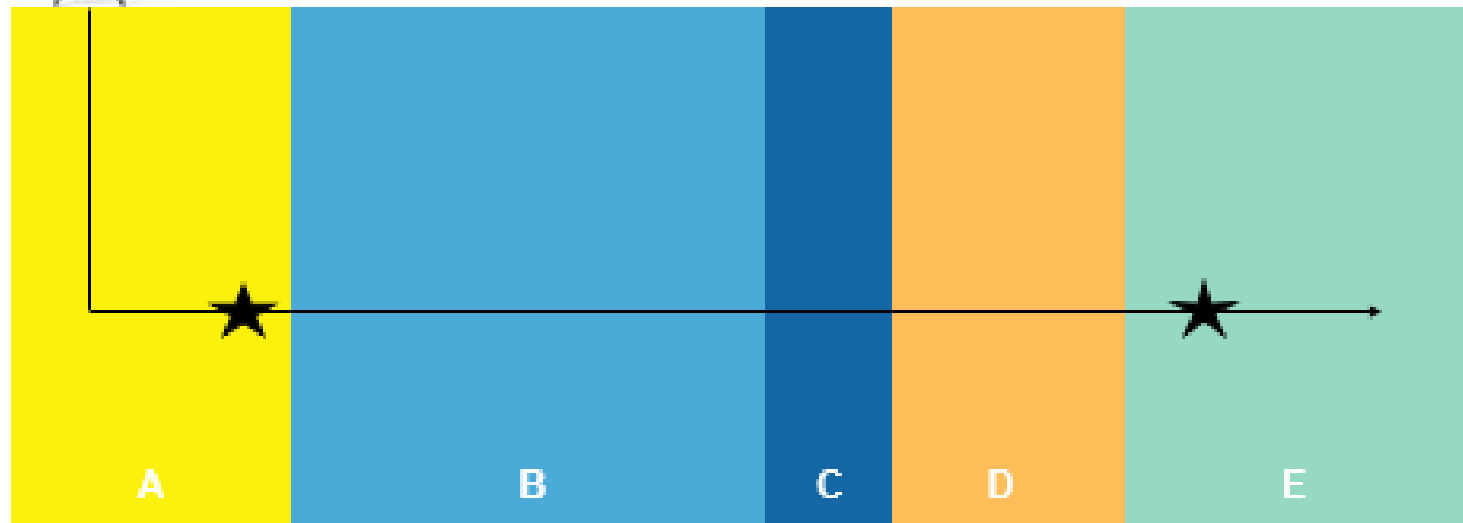


Productive/Effective Lateral Length



First take point to last take point – less any NPZ;
allocated to each tract

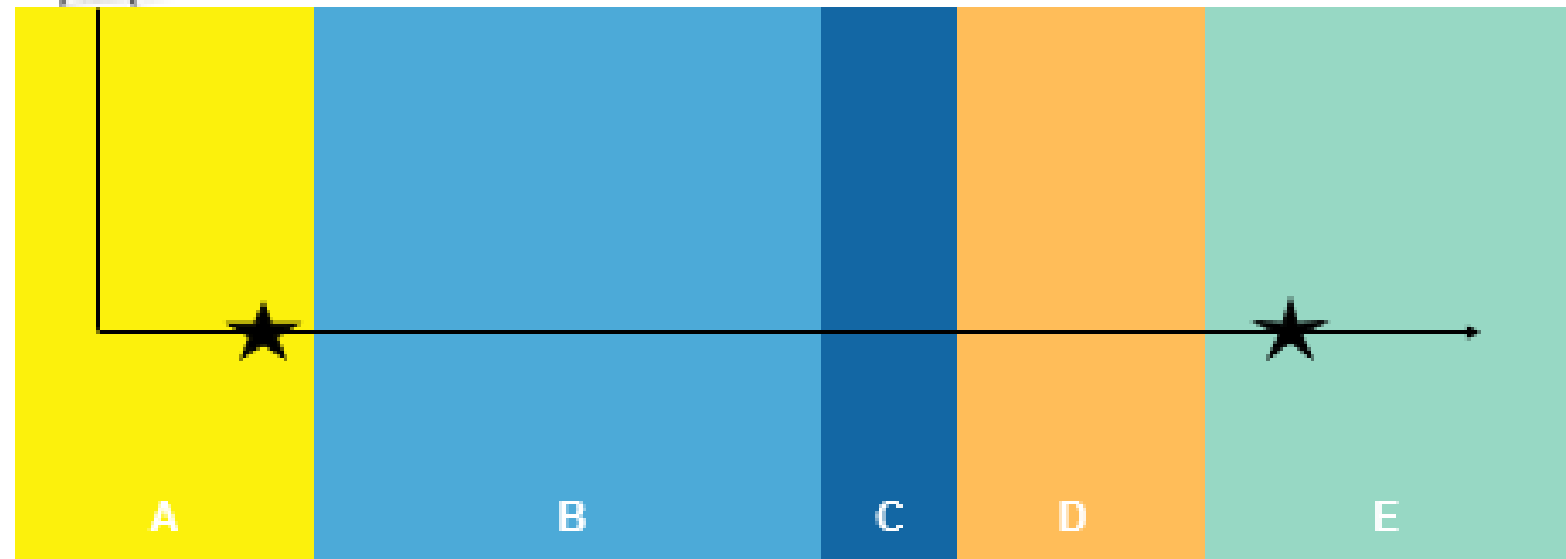
8,000' effective lateral; Tract D = 2,000'; then
Tract D would receive 25% of production



Percentage of Horizontal Lateral

Total length of horizontal wellbore – does not take into account NPZs

10,000' lateral; Tract D = 2,000'; then Tract D would receive 20% of production

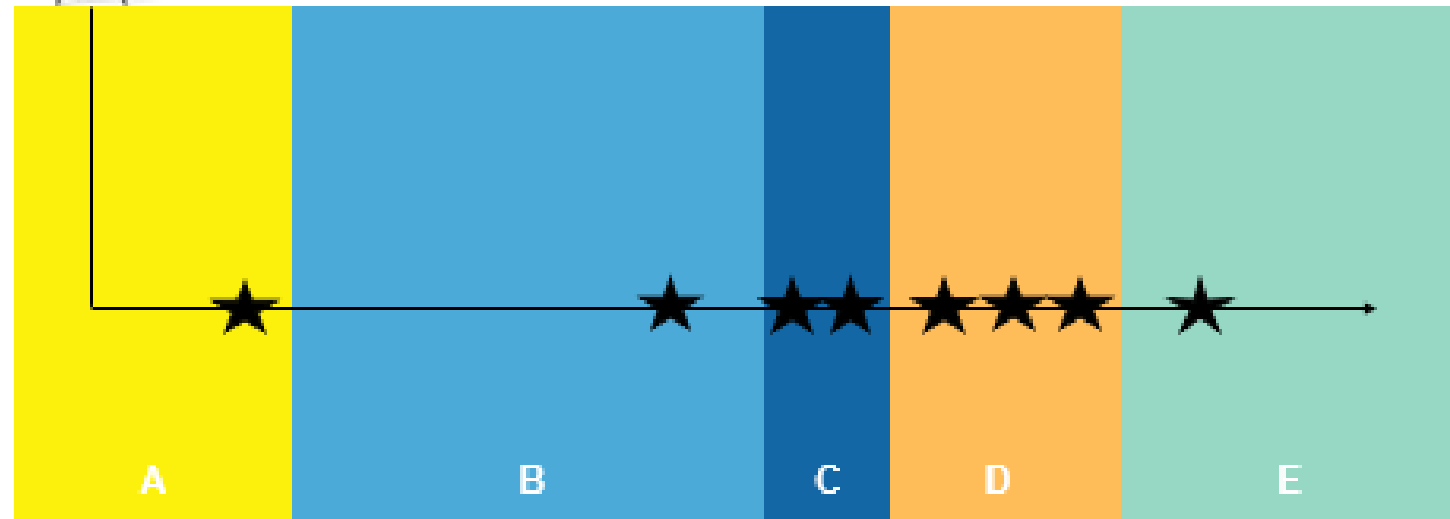


Take Points

Number of take points within a tract compared to the total number of take points along the lateral

Tract D – 3 of 8 TPs (37.5% of production)

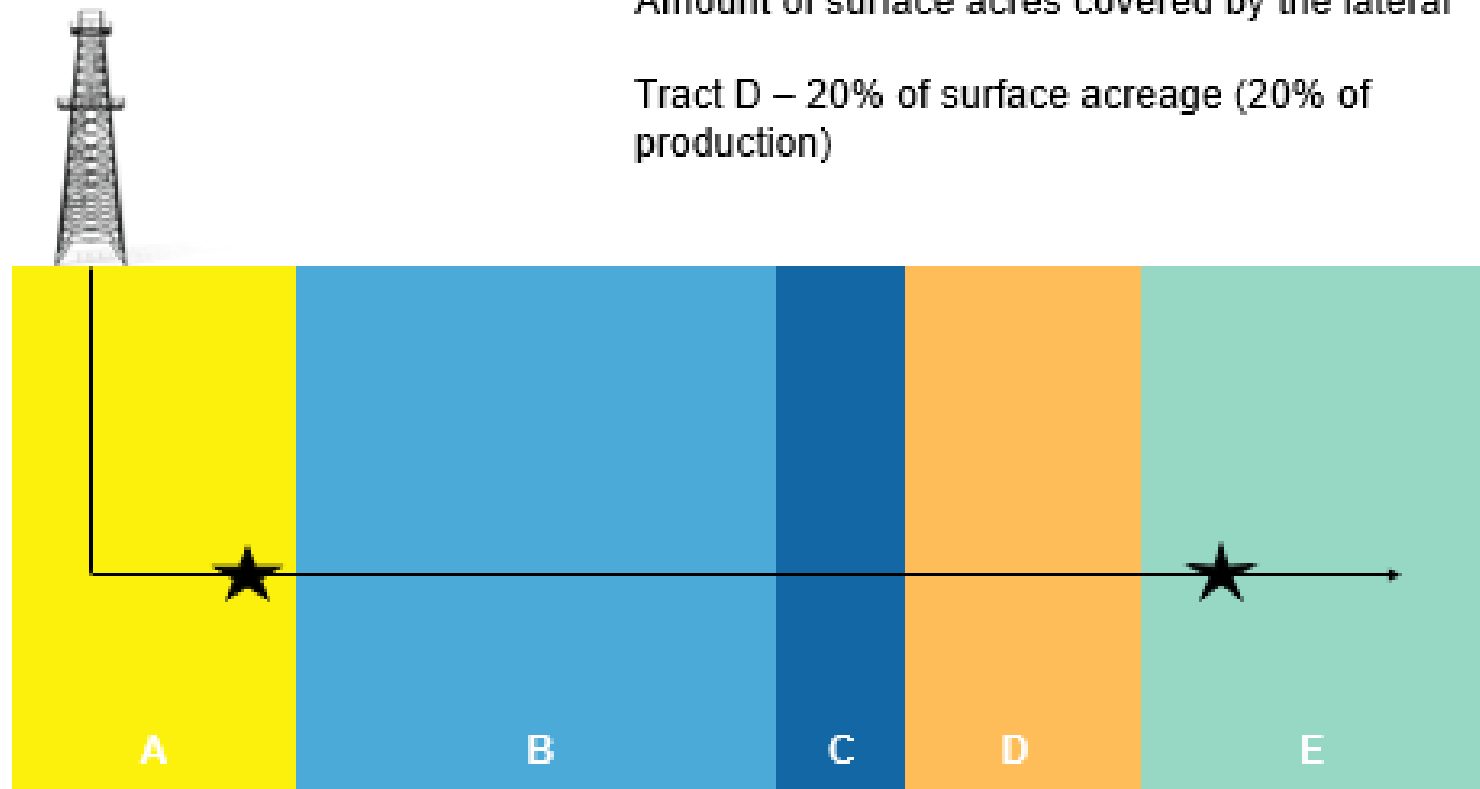
Tract B – 1 of 8 TPs (12.5% of production)



Surface Acreage

Amount of surface acres covered by the lateral

Tract D – 20% of surface acreage (20% of production)



Permitting a PSA Well

- Indicate horizontal wellbore type as PSA
- Sections V & VI are completed on Form P-16
 - The P-16 Data Sheet will replace the information that would be on Form PSA-12, Proration Acreage List and Form P-15
- Permit must include percentage of participation of all tracts contributing acreage to the PSA well
- Plat showing the external boundary of all tracts contributing acreage to the PSA well



Permitting an Allocation Well

- Indicate horizontal wellbore type as Allocation
- Significant difference from a permit perspective is that there is not a production sharing agreement in place
- Same permit process as a PSA well
- With an allocation well, the proposed well cannot include tracts not traversed by the wellbore



Rule 37

- No well shall be drilled nearer than 1,200 feet to any well
- No well shall be drilled nearer than 467 feet to any property line, lease line or subdivision line
- A PSA well or allocation well will always require a Rule 37 lease/property line exception
- An exception may be granted by the commission to prevent waste or to prevent confiscation of property



Rule 37 Exception Hearing

- Notice of the proposed Rule 37 exception provided to:
 - The designated operator
 - Lessees of record for tracts with no designated operator
 - Owners of unleased mineral interests
- Can obtain waivers from interested parties
- RRC will hold a public hearing at least 10 days after notice
- Applicant seeking the exception bears the burden to show that the exception is necessary
- Penalty for failure to comply is that violating well is plugged



Other Regulatory Considerations

- Is a Rule 38 density exception required?
- The plat must show all offset interests between the lease line spacing or half of the between well spacing, whichever is greatest
 - Vertical Well – from the location of the well
 - Directional Well – from the bottom hole location of the well
 - Horizontal Well – portion of the well within the correlative interval



Continued Education Component Code

- ARTX-7

