

Pooling and Unitization

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by Austin T. Lee, Bracewell, LLP

A. Difference between Pooling and Unitization; History; Importance/Effect

1. *Difference between Pooling and Unitization*

Both pooling and unitization are legal structures which allow for the combination of mineral and/or oil and gas leasehold interests in order to accommodate certain regulatory requirements. Each of these structures provides for a defined method of sharing production among the interest owners in combined area or unit and the maintenance of the leases included in the applicable unit by allowing operations on, or production from, anywhere on the unitized area to serve as operations on or production from each of the tracts included within the unit. Pooling is generally thought of as the joining together of separately owned mineral interests and/or leasehold interests in multiple tracts (or portions of the same tract(s)) for the purposes of having sufficient acreage to receive a permit to drill a single well under relevant state or local density and spacing laws and regulations. It should be noted that the term “communization” is also used as the functional equivalent of pooling but is used principally in the context of federal oil and gas leases. See Bruce Kramer, “The Nuts and Bolts of Pooling: A Primer for the Uninitiated” [hereinafter “Kramer, Nuts and Bolts”], Section I.B. at 1. Unitization, on the other hand, refers to the combination of separately owned mineral or leasehold interests covering all, or part of, a common source of supply (i.e. a field/reservoir) for the principal purpose of the joint operation of that field/reservoir (or part thereof) in order to maximize production, create operational efficiencies and conserve resources (both financial and natural). Id.

Thus, while both pooling and unitization have similar impacts with respect to (1) production sharing between the interests combined into the applicable unit and (2) lease maintenance, the two are distinguishable in both their purpose (drilling of a single well vs. development of an entire field or reservoir) and the way they are formed.

2. *History*

The evolution of the concepts of pooling and unitization has largely followed as a response to the various regulatory measures taken by state and local governments to conserve oil and gas resources and regulate drilling. Beginning with massive discoveries such as Spindletop (around 1900) and continuing through the development of other prolific finds like the East Texas Field, state and local agencies have sought to regulate the development of oil and gas resources in a way that promotes certain public policy initiatives,

including the prevention of waste, the protection of human life and environmentally sensitive areas and the encouragement of efficient development of oil and gas resources through long-term, rather than short-term production of fields. Further, given the legal construct known as the “rule of capture” whereby the owner of a tract can legally drain oil and gas deposits from under his neighbors’ tracts by producing from a legally permitted well located on his own tract, regulatory agencies needed ways to curb the inefficiencies and waste prompted by a system that rewarded overproduction and the drilling of as many wells as possible. One way agencies have attempted to accomplish this is through the imposition of what are known as spacing and density requirements under which the applicable regulatory agency will not issue a permit for the drilling of a well unless the area attributable to that well is a specified minimum size and the surface location of the well is a specified minimum distance from the boundary of a neighboring tract and from other existing wells. These spacing and density requirements resulted in the need for legal constructs that could be used to combine acreage owned by different parties to allow for drilling and development of tracts that are either too small to support the issuance of drilling permits or on which drilling is prohibited due to density, spacing or other zoning regulations.

By allowing lessees to combine acreage that is either too small to meet these minimum size requirements or is configured in a way that does not allow any (or the most advantageous) path for a wellbore, pooling and unitization allow operators to drill wells that would otherwise be prohibited under state and local regulations. Additionally, these structures serve to protect the rights of lessors to participate in the development of minerals under their land and allow lessees the ability to optimize drilling plans to develop their acreage positions in more efficient and economical ways. By facilitating development within the confines of state regulatory requirements, pooling and unitization help to achieve the above-noted objectives of state and local regulatory agencies as well as serve the economic interests of many operators and lessors.

3. Importance / Effects of Pooling and Unitization

Section 20.01 of The Law of Pooling and Unitization, Bruce M. Kramer and Patrick H. Martin) provides a good summary of the effects of pooling and unitization on an oil and gas lease that is included in a unitized area (as summarized in [*Southland Royalty Co. v. Humble Oil & Ref. Co., 151 Tex. 324, 249 S.W.2d 914, 1 O.&G.R. 1431 \(1952\)*](#)):

- the life of the lease is extended as to all included tracts beyond the primary term and for as long as oil, gas or other minerals are produced from any one of the tracts included in the [communitized] lease;
- the commencement of a well on any one of the tracts operates to excuse the payment of delay rentals on all included tracts for the period stated in the [communitized] lease;
- production from a well on any one of the tracts relieves the obligation to pay delay rentals, during production, on all included tracts;
- the lessee is relieved of the usual obligation of an implied covenant for reasonable development of each tract separately;
- wells may be located without reference to property lines; and
- the lessee is relieved of the obligation to drill off-set wells on other included tracts to prevent drainage by a well on any included tract.

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As between the lessors themselves:

- each relinquishes his right to have his own tract separately developed,
- each relinquishes his right to receive all of the royalties from production from wells on his own tract,
- each relinquishes his right to have wells drilled on his tract off-setting other wells on the leased premises, and
- each gains the right to share proportionately in royalties from wells on the other included tracts.

See Bruce M. Kramer & Patrick H. Martin, [*The Law of Pooling and Unitization, Section 20.01*](#) (2014))[hereinafter “Kramer and Martin”].

Further, a central feature of pooling (and unitization) is that it establishes a basis upon which production from the area included in the pooled unit is shared between the tracts that comprise such unit. Under Texas law, “pooling effects a cross-conveyance among the owners of minerals under the various tracts of royalty or minerals in a pool so that they all own undivided interests under the unitized tract in the proportion their contribution bears to the unitized tract.” [*Montgomery v. Rittersbacher, 424 S.W.2d 210 at 213 \(Tex. 1968\)*](#) (citing [*Veal v. Thomason, 159 S.W.2d 472 at 475*](#)). It is through this cross-conveyance concept that the basis for allocation of production from the unitized tract is established. While many pooling clauses and pooling agreements attempt to disclaim the cross-conveyance of interests through pooling, such agreements almost always provide that production from the resulting pooled unit will be allocated on an acreage basis, thus resulting in the same effect (albeit by contract rather than by cross-conveyance) as noted above. Having the method of allocation approximate the result of actually cross-conveying the interests in the tracts in question is the favored method because Texas law is currently unsettled as to whether language disclaiming the cross-conveyance of interests is effective or not.

It should be noted that the excerpt quoted above lists the direct effects of pooling and/or unitization on an oil and gas lease without considering the impact that other lease provisions (or the provisions of other agreements) have on the leasehold estate. For instance, a “Pugh clause” will typically have the effect of limiting the area for which the life of the lease is extended through pooled-unit production to just those portions of the applicable leases included in such pooled unit (rather than maintaining the entirety of the leases).

As seen from the effects noted above, pooling and unitization serve a role well beyond providing a means of developing the mineral interests in different sized tracts within the confines of applicable regulatory requirements. These mechanisms also serve to allocate the risks and rewards of development between both the individual lessor and the lessee as well as between lessors that become included in the same unit. Lessors whose interests are subject to a lessee’s right to pool experience a trade-off with respect to their ability to participate in production from the mineral interests they own. Through pooling or unitization a lessor gets to participate in production (or the potential production) from a larger area but will participate in that production at a lower percentage than it would if its tract was developed separately. This obviously does not apply to the owners of interests in tracts that are too small to support an individual drilling permit. Instead, in that context, pooling or unitization serves to protect the rights of those interest owners to develop their mineral estate in a way that comports with the state and local regulations.

B. Pooling

1. Community Lease

According to Kramer, a lease that is executed by owners of separate tracts (or separate interests in the same tract) is known as a “community lease” and effectively pools the interests covered by the lease unless a contrary intent is expressly provided in the provisions of the lease itself or an amendment to the lease. See Kramer, Nuts and Bolts, Section II.B at 2. Under Texas law, a community lease effects an actual pooling as a matter of law, whereas in other states it merely creates a presumption that the community lessor’s interests are pooled. See *id.* Under a community lease, the lessee is entitled to treat all tracts/interests covered by the instrument as a single “leased premises”, and depending on the express terms of the lease itself, operations and/or production anywhere on the tracts covered by the lease will normally be deemed to relate to the entire area covered by the lease (or all interests in the lands covered by the lease, as applicable). Unless expressly agreed to the contrary, the execution by multiple lessors of a community lease will automatically result in royalties under that lease being divided amongst the lessors in the proportion that the area covered by the tract (or interest therein) owned by such lessor bears to the total area (or interest) covered by the lease. As seen below, this same apportionment concept is expressly written into most standard pooling clauses.

2. Voluntary Pooling

While the right to pool exists in many jurisdictions by virtue of compulsory pooling statutes administered by the applicable state’s oil and gas conservation agency, it is very common for lessors to grant the right to pool voluntarily, either through a separate agreement or by including a pooling provision in its oil and gas lease. This is done to encourage / allow the development of the minerals under its tract through the creation of economies of scale with other tracts. Given that compulsory pooling statutes have many effects beyond just allowing a lessee the right to “force-pool” mineral owners and other interests in the area it seeks to develop, we will discuss compulsory pooling in a separate section.

a. The Pooling Provision

Absent the use of forced pooling (through the Mineral Interest Pooling Act in Texas), the lessee under an oil and gas lease does not have any right to pool the estate covered by its lease without the express authority of the lessor. See [*Jones v. Killingsworth*, 403 S.W.2d 325 \(Tex. 1965\)](#); see also [*Brown v. Smith*, 174 S.W.2d 43, 46 \(Tex. 1943\)](#) (providing that an interest in land cannot be changed, altered, conveyed or in any way disposed of without consent). As such, most oil and gas leases executed in the past forty years provide the lessee the express right to pool the leased premises with outside lands to promote proper lease development. Absent such clause, a lessee would be required to negotiate and obtain an independent pooling agreement to pool the royalty interest under the lease. It should be noted that an independent pooling agreement does constitute a conveyance of real property and thus must meet the requirements of the statute of frauds. [*Kuklies v. Reinert*, 256 S.W. 2d 435, 2 O.&G.R. 794](#) (Tex.Civ.App. – Waco 1953, writ ref’d n.r.e). Nonetheless, stand-alone pooling agreements are not as common today because of the prevalence of pooling provisions contained in standardized leases. A sample form of pooling provision seen in many oil and gas leases would be one similar to the following:

Lessee, at its option, is hereby given the right and power to pool or combine the acreage covered by this lease or any portion thereof as to oil and gas, or either of them, with any other land covered by

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this lease, and/or with any other land, lease or leases in the immediate vicinity thereof to the extent hereinafter stipulated, when in Lessee's judgment it is necessary or advisable to do so in order properly to explore, or to develop and operate said leased premises in compliance with the rules or regulations of the Railroad Commission of Texas, or other lawful authority, or when to do so would, in the judgment of Lessee, promote the conservation of oil and gas in and under and that may be produced from said premises. Lessee may pool the acreage or interests above described, or any portion thereof, as above provided, as to oil or gas in any one or more zones, and units so formed need not conform in size or area with the unit or units into which the lease is pooled or combined as to any other zone, and oil units need not conform as to area with gas units. The pooling in one or more instances shall not exhaust the rights of the Lessee hereunder to pool this lease or portions thereof into other units. Lessee shall file for record in the appropriate records of the county in which the leased premises are situated an instrument describing and designating the pooled acreage as a pooled unit; and upon such recordation the unit shall be effective as to all parties hereto, their heirs, successors, and assigns, irrespective of whether or not the unit is likewise effective as to all other owners of surface, mineral, royalty, or other rights in land included in such unit. Lessee may at its election exercise its pooling option before or after commencing operations for or completing an oil or gas well on the leased premises, and the pooled unit may include, but it is not required to include, land or leases upon which a well capable of producing oil or gas in paying quantities has theretofore been completed or upon which operations for the drilling of a well for oil or gas have theretofore been commenced. In the event of operations for drilling on or production of oil or gas from any part of a pooled unit which includes all or a portion of the land covered by this lease, regardless of whether such operations for drilling were commenced or such production was secured before or after the execution of this instrument or the instrument designating the pooled unit, such operations shall be considered as operations for drilling on or production of oil or gas from land covered by this lease whether or not the well or wells be located on the premises covered by this lease and in such event operations for drilling shall be deemed to have been commenced on said land within the meaning of paragraph ___ of this lease; and the entire acreage constituting such unit or units, as to oil and gas, or either of them, as herein provided, shall be treated for all purposes, except the payment of royalties on production from the pooled unit, as if the same were included in this lease. For the purpose of computing the royalties to which owners of royalties and payments out of production and each of them shall be entitled on production of oil and gas, or either of them, from the pooled unit, there shall be allocated to the land covered by this lease and included in said unit (or to each separate tract within the unit if this lease covers separate tracts within the unit) a pro rata portion of the oil and gas, or either of them, produced from the pooled unit after deducting that used for operations on the pooled unit. Such allocation shall be on an acreage basis-that is to say, there shall be allocated to the acreage covered by this lease and included in the pooled unit (or to each separate tract within the unit if this lease covers separate tracts within the unit) that pro rata portion of the oil and gas, or either of them, produced from the pooled unit which the number of surface acres covered by this lease (or in each such separate tract) and included in the pooled unit bears to the total number of surface acres included in the pooled unit. Royalties hereunder shall be computed on the portion of such production, whether it be oil and gas, or either of them, so allocated to the land covered by this lease and included in the unit just as though such production were from such land. The production from an oil well will be considered as production from the lease or oil pooled unit from which it is producing and not as production from a gas pooled unit; and production from a gas well will be considered as production from the lease or gas pooled unit from which it is producing and not from an oil pooled unit. The

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formation of any unit hereunder shall not have the effect of changing the ownership of any delay rental or shut-in production royalty which may become payable under this lease. If this lease now or hereafter covers separate tracts, no pooling or unitization of royalty interests as between any such separate tracts is intended or shall be implied or result merely from the inclusion of such separate tracts within this lease but Lessee shall nevertheless have the right to pool as provided above with consequent allocation of production as above provided. As used in this paragraph ____, the words “separate tract” mean any tract with royalty ownership differing, now or hereafter, either as to parties or amounts, from that as to any other part of the leased premises.

While the above provides a representative example of a “common” pooling provision found in commercially-accepted oil and gas leases, these provisions can, and almost always do, vary from lease to lease as to the express requirements needed for a lessee to exercise its pooling power, as well as the limitations on when such power can be exercised. Some of these variables include the circumstances in which a lessee is allowed to pool, the express size of the units that can be formed through pooling, when formation of a unit is effective, whether a lessee can reform a unit, the effect of a change in the classification of a well on a pooled unit (i.e. from oil to gas or vice versa), whether the leased premises can be included in a unit that already has a producing well on it, and many others. See also Kramer, Nuts and Bolts at 2.

b. Requirements to exercise the pooling power

While most courts will interpret pooling provisions broadly with respect to the extent of the grant of the pooling power provided therein, courts typically require strict compliance by lessees with any express conditions or other limitations on that power that are contained in the lease. See [*Tittizer v. Union Gas Corp.*, 171 S.W. 3d 857 \(Tex. 2005\)](#) (drill-site tract royalty owners entitled to all production from a well on a pooled unit prior to recordation where the pooling provision required that any pooled unit was effective only upon recordation of the unit designation and the unit designation was recorded four months after production from the well was obtained). Additionally, courts place certain implied duties on a lessee’s right to exercise its pooling power. While this implied “duty” has been described (confusingly) in a variety of ways, it essentially boils down to a “good faith” and/or “fair dealing” standard. See Kramer and Martin at Section 8.06. It should be noted that, at least under Texas law, there is a general consensus that this duty does not rise to that of a “fiduciary.” [*Vela v. Pennzoil Producing Co.*, 723 S.W.2d 199, 95 O.&G.R. 388](#) (Tex.Civ.App.– San Antonio 1986, writ ref’d n.r.e.). Whether a lessee has appropriately pooled acreage consistent with its implied duty is nearly always a fact-specific determination, meaning that it cannot be determined at the motion to dismiss or summary judgment phase if litigation ensues. Certain common fact scenarios that have resulted in determinations of improper pooling include: (a) gerrymandered units that include small portions of many leases in the area; (b) inclusion of unproductive acreage in a pooled unit with a producing well and (c) last minute pooling at the end of the primary term of the lease. While inclusion of unproductive acreage in a pooled unit is the closest thing to an automatic violation of the implied duty a lessee has in exercising its pooling power, whether the other scenarios noted above (or other situations) will result in a finding of improper pooling will be fact-dependent and often somewhat complicated to finally determine.

c. Contractual Limitations

As noted above, one important consequence of pooling the leased premises is the potential impact it has on the lessor’s royalty interest. Where a lessor owns the entire mineral estate in the leased premises and a

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well is drilled thereon, the lessor will be entitled to its negotiated royalty percentage on the full 100% of production from that well. However, where that well is drilled on the leased premises and the leased premises have been pooled with other lands, the lessor's royalty will become diluted such that it is only paid on a portion of production attributable to that leased premise out of the entire pooled unit. This is often expressed as the "pro rata portion of the oil and gas . . . produced from the pooled unit which the number of surface acres covered by [the] lease (or in each such separate tract) and included in the pooled unit bears to the total number of surface acres included in the pooled unit." As such, when more sophisticated landowners (or their counsel) are involved in lease negotiations, one can expect to see a much more stringent set of limitations on the lessee's right to pool, including, limitations on the size and/or composition of the units with which the leased premises can be pooled into (known as "anti-dilution" clauses) as well as limitations on what portions of the lease are maintained by operations or production from pooled units (often referred to as "Pugh" clauses).

"Anti-dilution" provisions take many forms, including, without limitation, (a) conditioning the right of the lessee to exercise its pooling rights on meeting the requirement that it contribute a certain minimum portion of the leased premises to any pooled unit, (b) specifying the minimum percentage of the resulting pooled unit that the leased premises must comprise before pooling will be allowed, or (c) requiring full development of the leased premises through wells drilled only on leased land before allowing the lessee to pool a part of the leased premises with outside lands. Examples of these anti-dilution provisions are noted below:

- provided, however, the Lessee shall not be entitled to exercise its rights to pool the leased premises under this Section ____ unless the portion of the leased premises contributed to the pooled unit created thereby contains at least _____ (____) acres.
- if Lessee exercises its right to pool an oil or gas well located on the Lessor's land, it must place into the pool at least 50% of the leased premises as defined on Exhibit A.
- Notwithstanding any language in [the pooling clause], to the contrary, it is expressly agreed and understood by and between the parties hereto that before Lessee hereunder shall be allowed to pool or unitize any of the lands embraced by this lease with other lands not owned by the Lessor herein Lessee shall designate full units from the lands embraced by this lease first and in the event there is land in excess of a full unit remaining then same may be done in accordance with Paragraph __ above.

Additionally it is common for pooling provisions to place limitations on the size of pooled units permitted under the lease. These acreage limits are often distinguished by the well type and depth. For vertical wells it is common to see acreage limitations based on the depth of the well to be drilled within the pooled unit. For units pooled for horizontal wells, it is common to see limitations capping the size of the unit either at a specific negotiated size or at the maximum size of a drilling and spacing unit permitted in order to obtain the maximum allowable production from one well by the rules of the applicable regulatory agency (i.e., the Texas Railroad Commission or the Oklahoma Corporation Commission).

While "anti-dilution" provisions address the level of participation of the lessor (through its royalty) in production from wells on or attributable to a lease, lessors are also leery of allowing a lessee to pool a small portion of the lessor's tract and maintain the entirety of its lease beyond the primary term through production from the pooled unit at a diluted royalty level. To address this, lessors have used what is commonly known as a "Pugh" clause, which, at a specific point in time (typically from and after the end

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of the primary term of the lease or any extension of the primary term through continuous operations), will provide that operations or production from pooled units containing portions of the leased premises will only maintain the lease as to those portions of the leased premises included in such pooled unit (on a unit by unit basis). It should be noted that Pugh clauses can “sever” a lease both vertically (all depths of the leased premises included in the pooled unit are maintained) and/or horizontally (only specified depths or depths to which the pooled unit applies under the leased premises are maintained by production from the pooled unit). Examples of both vertical and horizontal Pugh clause are noted below:

Upon the later of (i) the end of the primary term of this lease, and (ii) the date Lessee is no longer conducting continuous operations (or is deemed to be no longer conducting continuous operations) under Section ___ of the body of this lease, and except for portions of the leased premises included in any pooled unit, unit, or lease well proration unit, this lease shall automatically terminate as to that portion of the leased premises upon which there is no drilling or reworking operations or from which there is no production of oil, gas or other liquid hydrocarbons. (representing a vertical severance)

Notwithstanding any other provision in this lease to the contrary, upon the later of (i) the expiration of the primary term of this lease, and (ii) the date upon which Lessee is no longer conducting continuous operations (or is deemed to be no longer conducting continuous operations) under Section ___ of the body of this lease, this lease shall then terminate with respect to the rights of the Lessee in the oil, gas and mineral estate in the above described tract of land from a depth of one hundred feet (100’) below the base of the deepest sand or horizon (or the stratigraphic equivalent thereto) then being produced on the leased premises or on lands pooled therewith. The Lessee shall, within thirty (30) days after the later of (A) the expiration of said primary term, and (B) the date upon which Lessee is no longer conducting continuous operations (or is deemed to be no longer conducting continuous operations) under Section ___ of the body of this lease, deliver to the Lessor a recordable release of the leasehold estate created hereby insofar as the same covers the oil, gas and mineral estate in said land below such depth. (representing a horizontal severance)

d. Declaration of a Pooled Unit

Often times the pooling provision of an oil and gas lease will require the lessee to file a document of record that designates the boundaries of a pooled unit (sometimes as a condition precedent to the effectiveness of such pooled unit). This serves the purpose of delineating what portions of the various leases are included in the unit and places third-parties on notice that, subject to the terms of the leases, production from wells located within that pooled unit will maintain those underlying leases (or portions thereof). It should be noted that a lessee will be required to follow any express requirements regarding the filing of pooled unit designations contained in its leases. As noted by one Texas court, a lessee’s authority to pool is controlled by the language of the pooling clause in the lease and cannot be enlarged by the language in the declaration of pooled unit. See [*Tittizer v. Union Gas Corp.*, 171 S.W.3d 857 \(Tex. 2005\)](#). In *Tittizer*, the lessor of a drillsite tract that was pooled with other tracts was entitled to its royalty based on 100% of production from the well located on its tract for the period prior to the lessee filing the pooled unit designation of record, due to the requirement in the lease that the lessee had to file a pooled unit designation of record as a condition precedent to the effectiveness of the pooled unit. See *id.* It was only after the lessee had complied with this condition precedent to effective pooling that the pooled unit was ruled to be effective and the royalty owners with respect to the other tracts were entitled to participate in production from the unit well. While this case highlights the rights of royalty owners on different tracts, one can see how this strict interpretation of the various contractual conditions to effective pooling can

impact whether or not a lease will be maintained (i.e. if the designation of pooled unit had been filed after the expiration of the primary term of one of the other leases that lease would have expired).

e. Which Interests are Pooled?

As stated above, absent the use of force pooling (or the Mineral Interest Pooling Act in Texas), the lessee under an oil and gas lease does not have any right to pool the estate covered by its lease without (and only to the extent of) express authority stated in the lease itself. [*Jones v. Killingsworth*, 403 S.W.2d 325 \(Tex. 1965\)](#). What follows from this is that a lessee must be mindful of whether the tract covered by its oil and gas lease is subject to “non-participating” royalty or mineral interests. A “non-participating” royalty or mineral interest is an interest carved out of a mineral estate with all the normal attributes of a royalty or mineral interest except the holder thereof will not receive the right to execute an oil and gas lease with respect to tract covered by such interest (i.e. they cannot “participate” in the leasing of that tract). Importantly, a non-participating royalty interest is distinguishable from an overriding royalty interest in that an overriding royalty interest is carved from an existing leasehold interest and, unless expressly provided in the document creating that overriding royalty interest, is subject to all of the terms of the oil and gas lease from which it was created. To the extent that these non-participating interests were created prior to execution of the oil and gas lease in question, those interests are not automatically subject to the pooling provisions in the oil and gas lease covering the tract from which those interests are created.

Given that overriding royalty interests are inherently subject to the terms of the oil and gas lease from which they are created (absent express provision to the contrary), the pooling of the underlying oil and gas lease will have the effect of pooling the overriding royalty interests created from such oil and gas lease. See [*Union Pacific Resources Co. v. Hutchinson*, 990 S.W.2d 368, 141 O.&G.R. 622 \(Tex.App.—Austin 1999, pet. denied.\)](#).

The greater problem for lessees exists with respect to non-participating interests. Unless the holders of these interests execute a stand-alone pooling agreement or ratify the lease under which the tract in question was pooled, these interests will not be subject to the lessee’s pooling power under the an oil and gas lease covering the mineral estate of the tract from which these non-participating interests were created. See [*Brown v. Smith*, 141 Tex. 425m 174 S.W.2d \(1943\)](#) and [*Montgomery v. Rittersbacher*, 424 S.W.2d 210 \(Tex. 1968\)](#). Premised on the concept that pooling creates a cross-conveyance of interests among the owners of the minerals under the various tracts being pooled and any conveyance of interests requires the consent of the holder of that interest, Texas courts have long maintained that the “mere reservation of a non-participating royalty interest under a tract does not show that the royalty owner intended to give to the holder of the executive rights the power to diminish the royalty owner's interest under that tract” through pooling without the consent of the non-participating royalty interest holder. See [*Rittersbacher*, 424 S.W.2d at 213](#). While the above reflects the current position of Texas courts with respect to the ability of the executive to bind holders of non-participating royalty interests, there is some, though very little, case law from other states—Louisiana, for example--which takes the opposite position. See [*Viator v. Haynesville Mercantile Co.*, 230 La. 132, 88 So. 2d 1 \(1956\)](#) and [*Le Blanc v. Haynesville Mercantile Co.*, 230 La. 299, 88 So. 2d 377 \(1956\)](#).

In jurisdictions like Texas, an un-pooled non-participating interest in the drillsite tract of a pooled unit will participate for its share of production based on 100% of the production from the drillsite tract. This leaves the other (pooled) interests in the drillsite tract and the interests in the other tracts included in the pooled unit to participate in the balance of production from the unit based on the percentage that the tract

in which they have an interest bears to the entire acreage included in the pooled unit. Thus the non-participating interest dilutes the interest of the lessee whose tract is subject to the non-participating interest because the lessee has to pay the non-participating interest owner based on a larger share of production than it would if such interest were pooled.

But what happens where the non-participating interest is carved from the mineral estate of a pooled tract that is not the drillsite tract for a well in the pooled unit. In these situations, Texas courts have ruled that the non-participating interest owner has the right to ratify the lease and become subject to the pooling power exercised by the lessee. Upon such a ratification, the non-participating interest is included in the pooled unit and will share in production (proportionately based on the acreage contribution of its tract to the pooled unit acreage) from the well drilled within the pooled unit. See [*Rittersbacher*, 424 S.W.2d 210](#). Further, many courts, such as in *Rittersbacher*, have allowed these non-participating interest owners great leeway in exercising this “option” to ratify an oil and gas lease covering their tract and avail themselves of the production sharing rights available under the pooling provisions, allowing ratification years after the well on the pooled unit in which their tract is included has been drilled. (See *id.*) Thus, non-participating interest owners often have the ability to elect to participate or not participate in a pooled unit based on whichever option allows them to maximize their participation in production from a pooled unit in which their tract is included. If wells are drilled on their tract, they will not ratify the pooled unit and instead take their share from 100% of the production from the wells on their tract. If wells are drilled on the pooled unit but located on tract(s) other than the tract they have a non-participating interest in, then those interest-owners have the option to ratify the pooled unit and participate for their diluted share of all production from wells drilled within the pooled unit—even long after such wells are drilled and the interest-owner has the opportunity to determine their level of productivity. As such, in Texas and jurisdictions like it, parties looking to acquire existing leases or take leases covering a given tract should consider their drilling plans and attempt to factor in the impact of any existing non-participating interests in the tracts included in their pooled units.

3. Summary

While this guide tries to provide a sampling of some of the fundamental issues regarding pooling, there are many other issues and nuances than those noted above that often present themselves in the pooling context and which are beyond the scope of this practice series. In either case, most of the issues regarding pooling will deserve both a fact-specific and jurisdiction-specific analysis of the laws and agreements applicable to the situation involved.

C. Unitization

1. Generally

As noted above, while pooling focuses on efficiently combining lands for the purpose of obtaining a drilling permit to drill a single well, unitization focuses on the combination of interests covering a larger area to facilitate development of all or part of a common source of supply (i.e. a field/reservoir). Similar to pooling, unitization can be formed either voluntarily by agreement (i.e. through separate agreement or the inclusion of the right to unitize in a pooling or separate provision of an oil and gas lease) or, in many cases, involuntarily under compulsory unitization statutes administered by the applicable state or federal

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regulatory agency. As with pooling, the right to unitize is not inherent in the interest conveyed to a lessee under an oil and gas lease, and thus must be expressly provided for in the oil and gas lease or through some other agreement. Further, because unitization is frequently used in the context of the development of federal, state and/or tribal leases, it is common for “fee” lease forms (i.e. leases of privately owned minerals) in areas like the Rocky Mountain region--where there is an abundance of surrounding federal, state and tribal lands--to expressly provide lessees the right to unitize the minerals covered by such leases. The automatic inclusion of the right to unitize is not as common in other areas, such as Texas, where unitization is not as popular due to a dearth of federal, state and/or tribal leases.

In the federal context, the Mineral Leasing Act (*41 Stat. 437*, as amended, [30 U.S.C. Sec. 181 et seq.](#)) and 43 CFR Part 3180 expressly provide authority for unitization of federal leases and similar authority is provided in the context of state and tribal leases under the rules of respective governmental agencies charged with administering such leases.

The principal purposes of unitization are for the conservation and maximization of efficiency in the development of a reservoir or field. Unitized areas are commonly formed for unproven areas (i.e. exploratory units) and proven areas and for both primary development as well as secondary and tertiary recovery (such as water-flooding, pressure maintenance and other forms of enhanced recovery operations). That said, there are a number of additional benefits that serve as motivation for lessees to unitize a field as part of their development plans.

As noted above, unitization provides the same benefits as pooling. These include providing lessees the ability to maintain all (or the portions of the) leases committed to the unit, as well as providing certainty regarding the allocation to be used for production sharing for all tracts committed to the unit. Additionally, by maintaining the entire area under the unit, the owners of those leases can create a unified plan of development of the reservoir that maximizes the ultimate recovery of hydrocarbons through pressure maintenance and strategic drilling. Further, the developing parties are able to consolidate capital through avoiding duplication of surface facilities, roads and other infrastructure and drilling only the wells absolutely necessary to accomplish the plan of development for the reservoir. The certainty regarding cost sharing and lease maintenance that unitization provides allows operators a greater ability to attract investments from third party partners (such as capital providers and farmee candidates) to participate in the development of the unit area.

Finally, certain operations like secondary or tertiary recovery and/or pressure maintenance of reservoirs cannot be conducted without a specific unified plan of development and so unitization serves as an essential and efficient mechanic for conducting these projects. In fact, in recognizing the benefits of secondary recovery operations to increase the ultimate recovery of hydrocarbons as well as the need to promote these enhanced methods of development and production, the Texas Supreme Court has granted limited relief, in some instances, from the technical rules of common law trespass to those that conduct operations under an approved unitization plan. See [Railroad Commission v. Manziel, 361 S.W. 2d 560 \(Tex. 1962\)](#). The court in *Manziel* allowed the operator of a secondary recovery unit that had been formally approved by an order of the Railroad Commission of Texas to avoid an injunction requested by a neighboring operator with respect to saltwater injected to conduct its water-flood operations which traversed the unit boundaries into the neighboring operator’s leased property. See *id.* While the plaintiff in *Manziel* did not make a claim for damages (and the court left open the question as to whether a plaintiff could recover damages for such a trespass, even if it could not obtain an injunction to stop the trespass), the decision in *Manziel* essentially replaces the standard trespass law principles with a more lenient

standard that is commonly applied to the torts of nuisance in the context of Railroad Commission-approved secondary recovery operations. Thus, rather than allowing these claims to be made under the normal common law rules regarding trespass (which would entitle a claimant to an injunction by merely proving that a trespass exists and was intentional), the courts in Texas have been willing to limit relief for such a trespass to only a claim for damages and have required a showing that the conduct is not only intentional but also unreasonable before such a claim can become actionable.

Last, within the federal lease context, there are additional benefits to which lessees can avail themselves through unitization. For example, in certain situations, federal leases committed to a formal unit will be automatically extended beyond their scheduled expiration. Further, lessees of federal land receive relief from the statutory limitation on the number of acres a party is allowed to hold under federal lease in a given state due to a statutory carve-out for acreage under federal lease committed to a federally approved unit agreement. This can be a powerful tool for large energy companies, as well as for those that seek to develop large swathes of federally-owned offshore fields. While beyond the scope of this practice note, for a comprehensive discussion of some of the motivations behind unitization in the federal lease context, see ARTICLE: THE AGE OF ALLOCATION: THE END OF POOLING AS WE KNOW IT?, [45 Tex. Tech L. Rev. 929](#).

2. *Voluntary Unitization*

As one can see there are a number of motivating factors that lead a lessee to seek to unitize a reservoir or field as part of its development. That said, given the inherently larger scope of the area to be included under unitization (as opposed to pooling) a more comprehensive set of documents are necessary to formalize the relationship of the interest owners, and to allocate production and the costs of development of the unit area among the affected parties. Further, because of the size of the areas covered by most units, a contractual scheme to govern joint operations (similar to and/or on top of a standard joint operating agreement) is necessary to allow the parties who hold interests in the unit to conduct operations within the unit. At a minimum, these agreements will include a unit agreement and a unit operating agreement, which together establish the framework of contractual rights and obligations of the parties subject to unitization.

While there are standardized forms of unit agreements and unit operating agreements which are commonly used (or mandated) for use with federal leases (See e.g., [43 C.F.R. § 3186.1](#)), the process to effect a voluntary unitization for proven areas or areas where there are fee interests involved typically requires a cumbersome negotiation that must result in sufficient buy-in of working interest and royalty interest owners holding varying sizes of interests in the unitized area. The joinder of all interest owners is not required to effect a valid pooling or unitization. See [Samson Lone Star, Ltd. Partn. v. Hooks, 389 S.W.3d 409, 431 \(Tex. App.--Hous. \[1st Dist.\] 2012\)](#) aff'd in part, rev'd in part sub nom. [Hooks v. Samson Lone Star, LP, 457 S.W.3d 52 \(Tex. 2015\)](#) (citing [Ladd Petroleum Corp. v. Eagle Oil & Gas Co., 695 S.W.2d 99, 106 \(Tex.App.-Fort Worth 1985, writ ref'd n.r.e.\)](#) and [Whelan v. Placid Oil Co., 274 S.W.2d 125, 128 \(Tex.Civ.App.-Texarkana 1954, writ ref'd n.r.e.\)](#) (holding that tenant in common has right to execute lease on his undivided interest in common property, notwithstanding nonjoinder of cotenant)) and [Heath v. Fellows, 526 F. Supp. 71 O.&G.R. 542 \(W.D. Okla. 1981\)](#). However, it should be noted that generally the non-joinder of a working interest owner or royalty interest owner within a unit will result in that owner's interest not being subject to the unit and all of its provisions and protections. See [Boggess v. Milam, 127 W. Va. 654, 34 S.E.2d 267 \(1945\)](#); [California Co. v. Britt, 247 Miss 718, 154 So.2d. 144, 19 O.&G.R. 36 \(1963\)](#). Thus, depending upon whether unit production results from the tract in which such

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outstanding interest is held, having an interest not subject to the unit arrangements interspersed within the unit could have a dilutive effect on the parties to the unit agreement similar to that discussed above in the context of non-participating royalty interest owners. Practically speaking, having an interest-owner that is not subject to the unit arrangement also makes accounting and decision-making within the unit very challenging.

Negotiations for voluntary unitization generally begin with an interested party--usually the party with the largest ownership interest in the prospect in question--instigating discussions and providing background materials and studies to the other interest owners concerning the proposed unit. The parties to be included in the unit will need to reach agreement not only on the participation of each party's interest in production from the unitized area, but also on the scheme and process for conducting operations with respect to the unitized area. In the voluntary unitization context, these arrangements can take any form the interested parties can devise (and agree on), with the most material issue normally being the formula for participation in expenses and production by each tract within the unit. It is this participation scheme that will govern both the portion of total unit production on which each lessee will pay royalties and bear other burdens with respect to its tract and the proportion of sharing of the costs and expenses of development between the working interest owners within the unit, which may not be on the same basis. Due to the varying sizes of interest owners, and the fact that it is common for significant (and diverse) tracts to be included in a unit, this sharing arrangement may not be on an equal basis solely related to acreage.

Whereas, in the pooling context, the sharing of production and expenses generally will follow the surface acreage allocation discussed above, in the context of unitization the formula for sharing of production and expenses will generally require a more substantive analysis of factors such as: (i) surface acreage contribution to the unitized area (or participating areas within the unit that are formed under many unit agreements); (ii) geological properties of the subsurface under the tracts in question; (iii) estimates of hydrocarbons in place for each tract; and (iv) other geologic and engineering factors. Negotiation of this formula and the incentive for interest owners that have a tract with a structural advantage within a reservoir (or who are able to get a spacing exception to drill a well on their own tract) to hold out for a disproportionate share of production are some of the primary reasons that voluntary unitization can be a long and arduous process. An additional obstacle to voluntary unitization is the hesitancy of interest owners to delay receipt of proceeds from production. Since unitized operations typically push the drilling and producing of a formation out over a longer period of time in the interest of maximizing the ultimate amount of production recovered, there is an inherent disincentive for those with shorter time horizons to delay the monetization of their interests regardless of the fact that they will receive a larger ultimate recovery.

As noted above, unit agreements and unit operating agreements in the voluntary unitization context can take many forms depending on the situation in which they are negotiated. While a comprehensive discussion of all of the facets of these agreements is beyond the scope of this practice guide, a listing of the general areas that each agreement would be expected to cover is provided below.

Ultimately, the unit agreement and the unit operating agreement should provide coverage of all aspects of joint development of a prospect similarly to the content and coverage of your standard joint operating agreement with adjustments to incorporate the production and expense sharing formula for each tract that is noted above and to provide that these documents will supersede the terms and provisions of the underlying leases and existing joint operating agreements in the event of a conflict.

3. *Unit Agreements*

Typically the unit agreement will control over the unit operating agreement if there is any conflict (though the two documents are designed to work in tandem to cover different aspects of the relationship between unit interest owners). Traditionally the unit agreement has prescribed the method / formula for allocating production for purposes of determining royalties, overriding royalties and other non-cost bearing burdens. Often, the unit agreement will not address the formula for allocating costs and expenses of development among working interest owners, as this is typically covered by the unit operating agreement. Further, it is common for the unit agreement to set forth the basic scheme for operation of the unit, including, without limitation, provisions that: (i) delineate the unit area; (ii) provide a mechanism for contraction or expansion of the unit area; (iii) name the unit operator and define the basis on which the unit operator may resign or be removed (though the voting process of approving a successor unit operator often resides in the unit operating agreement); (iv) define the rights and obligations of the unit operator; (v) define the drilling obligations and timelines for development necessary to maintain the unit; (vi) set forth the process for submitting (to the applicable regulatory authorities or operating committee) a plan of development for the unit which lists out all operations contemplated (and approved) by the parties for unit development; (vii) provide a process for determining participating areas which often act as “units within the unit” covering the productive areas around each producing well and are used to allocate production to the tracts within that participation area rather than on a unit-wide basis; (viii) provide that all underlying leases and contracts related to development of the unitized area are conformed to accommodate the provisions of the unit agreement; and (ix) provide that compliance with the development obligations under the unit agreement (i.e. continuous drilling clause, etc.) shall be deemed full performance of the obligations for operation and development of each tract included within the unit.

4. *Unit Operating Agreements*

Unit operating agreements are entered into by the working interest owners within the unitized area and typically cover the mechanics regarding the process for development of the unitized area and the different rights of the working interest owners to elect to participate (or not participate) in certain operations. Importantly the unit operating agreement normally provides for the method or formula for allocating the costs and expenses of development of the unit between the working interest owners as well as how the working interest owners will share in production from unit operations. As noted above, this is typically a complex formula that considers geological, engineering and many other factors. In addition to setting out this allocation, the unit operating agreement will typically provide other mechanics and provisions normally found in a joint operating agreement such as: (i) the different working interest owners’ duties and obligations to each other; (ii) the process for approval of successor unit operators; (iii) the process for approval of participating areas (and the adjustment of participating areas); (iv) a method of calculating “investment adjustments” for the working interest owners to true up the split of costs and allocations of production upon the formation (or adjustment) of a participating area covering a producing well; (v) the process for the approval of the plans of development called for under the unit agreement or adjustments of those plans of development; (vi) the mechanics of allowing working interest owners to participate or elect not to participate in various operations proposed under the unit operating agreement and the non-consent penalties that accompany any election not to participate; (vii) the rights of the parties to propose wells (or other operations); (viii) the rights of the parties to take in kind; (ix) the right of the operator to market production from parties that do not take their production in kind; (x) procedures for examining title and the impact of a loss of title to leases within the unit; and (xi) liens that the parties have on the other parties

interests in the unit (and their production therefrom) to secure performance of the parties obligations under the unit operating agreement.

5. *Summary*

While the above description of the unitization process and the coverage of unit agreements and unit operating agreements is admittedly generalized, it should be stressed that these arrangements can take many forms. What is set forth above hopefully provides an introduction to the general structure in which voluntarily unitization is created, and alerts the practitioner to some of the principal aspects which distinguishes unitization from pooling.

D. Texas Mineral Interest Pooling Act

The Texas Mineral Interest Pooling Act (“MIPA”) was designed to protect small tract holders who otherwise could not economically drill a well. See ARTICLE: FORCED POOLING WITHIN THE BARNETT SHALE: HOW SHOULD THE TEXAS MINERAL INTEREST POOLING ACT APPLY TO UNITS WITH HORIZONTAL WELLS?, [*17 Tex. Wesleyan L. Rev. 1*](#). Under Texas law small tract holders, unless their tract has been voluntarily subdivided, have a right to drill a well no matter how small how their tract is. *Id.* Even though small tract holders are entitled to drill a well, Railroad Commission (“RRC”) pro-ration rules ensure that most of those wells end up as un-economic. *Id.* The Texas Legislature created MIPA to allow these small tract holders to economically produce their minerals by allowing these interest holders to force pool themselves into larger units.

The following elements must be met before a tract holder can make use of MIPA:

- 1 Separately Owned Tracts. There must be two or more separately owned tracts within the proposed area. “Separately owned tracts” could include two leases on the same property, but could not include land that is held in co-tenancy;
- 2 Common reservoir. Only tracts within a common reservoir can be pooled. Therefore, for a field with several horizons that are distinctly separated from each other, the applicant must file a separate pooling application for each horizon;
- 3 Reservoir with field rules. For tracts to be pooled under MIPA they must be in a reservoir where the RRC has already established the size and shape of the proration units;
- 4 Timing of Pooling. The RRC cannot pool tracts until an owner with the right to drill (generally, a working-interest owner) has actually drilled or proposed to drill a well. Therefore, royalty owners cannot propose the pooling of tracts until a well has been drilled or proposed;
- 5 No Voluntary Agreement to Pool. If there is a pre-existing voluntary pooling agreement, then MIPA cannot be used. Furthermore, MIPA requires that the applicant has made “a fair and reasonable” offer to voluntarily pool the other tract holders, and that offer has been denied;
- 6 Purposes of Pooling: The RRC can only pool tracts when the pooling will i) avoid the drilling of unnecessary wells, ii) protect correlative rights, or iii) prevent waste. Because of this constraint, the RRC will probably not pool a unit through MIPA that is larger than the minimum acreage for that field. *Id.*

- 7 If the above six elements are shown, then the RRC must establish the unit and pool the interests in the unit. The unit pooled through MIPA must be approximately the size of the standard proration unit in the field. But MIPA does create an upper boundary for the unit of 160 acres for oil fields and 640 acres for gas fields. *Id.*

The result of this limitation is that MIPA normally cannot be used for pooled units with horizontal wells, because a horizontal well may often travel more than a mile horizontally before reaching the zones that it is attempting to produce. Therefore if the fractures from a horizontal well are draining a tract-owners land, that tract owner cannot use MIPA to muscle into the pooled unit containing the horizontal well draining his land.

Many commentators consider MIPA, in practice, to be more of an inducement to voluntarily pool than an act through which forced-pooling actually occurs. MIPA encourages voluntary pooling because of the requirement that applicants must make a fair and reasonable offer prior to utilizing its provisions. If all of the other elements are met and a fair and reasonable offer is made, then the other tract holders in the proposed unit will normally accept the offer, rather than fight through the MIPA process. Otherwise it is likely that they are just delaying the inevitable as they will be forced pooled under MIPA.

E. Forced Pooling in Other Jurisdictions (outside of Texas)

Unlike the Texas MIPA, forced pooling in many other jurisdictions is designed to allow operators who want to drill a well to compel holdouts to join the pooled unit. State forced pooling statutes are all different, but the following elements are present in many forced pooling statutes: 1) The relevant regulatory agency has established a drilling unit; 2) the interest owners in the drilling unit have the option to voluntarily pool their interests thereby eliminating the need for statutory pooling; 3) before seeking compulsory pooling, an interest owner in the drilling unit must offer the other interest owners the option to participate in the well; 4) the interest owner must give notice to all other interest owners in the unit, and have a hearing before the state regulatory agency before that agency can grant a forced pooling order; 5) any forced pooling order issued must allow each interest owner to recover his proportionate share of production from the unit; and 6) the drilling owners will receive any drilling costs and a “risk penalty” paid out of production from the well from any interest owners who elect not to participate in the well. See Michael J. Wozniak and Matthew J. Lepore, *Fundamentals of Drilling and Spacing Units and Statutory Pooling*, available at 2012-1 RMMLF PROC 17 (2015).

The Colorado forced pooling statute is an excellent example of how many forced pooling statutes work outside of Texas. The Colorado statute addresses what interests may be pooled and who can pool those interests. First, a Colorado pooling order will pool all the mineral interests in a unit. *Id.* This means that a lessee could force pool a lessor who owns all the mineral interests in a unit, but has only leased some of them. Second, no minimum ownership is required under the Colorado statute, so a 5% drilling owner could theoretically pool the other 90% provided that the drilling owner is prepared to pay 100% of the costs should no other owners opt into the pooling unit. *Id.*

The Colorado statute further requires that any interest owner who is pooled must be given the option to participate in the well, and the pooling owner must provide an estimate for the cost of participation. *Id.* The pooling owner must also offer any unleased mineral owners market-based leases. The mineral owner

can choose to accept the offered lease, pay their way as a working interest owner or be pooled by statute, in which case the unleased owner will receive a proportionate 1/8 royalty from the well beginning at first production. *Id.*

Working interest owners have two options. They can choose to participate in the well which means paying their proportionate share of the drilling and development costs up front, or they can go non-consent. *Id.* A non-consenting owner is not cut out of the well forever, but rather they will pay back their share of the drilling and development costs from production over time, assuming the well is successful. The non-consenting owner must also pay the drilling owner a risk penalty out of production before the non-consenting owner may receive any proceeds from the well. *Id.* In Colorado there is a 100% risk penalty, meaning a non-consenting owner will pay back twice their drilling and development costs before they begin to receive proceeds from production. While seemingly harsh, this allows a working interest owner who chooses to go the non-consent route to avoid all risk (much like a royalty-interest owner) in return for a potential future payout.

Many states use a risk penalty mechanic that is similar to the one used by Colorado, but Oklahoma is a notable exception. In Oklahoma, once a spacing and drilling order has been issued, then any owner of an interest in the drilling unit may apply for a pooling order. See Larry S. Eubanks and Michael J. Mueller, *An Economic Analysis of Oklahoma's Oil and Gas Forced Pooling Law*, *Natural Resources Journal* Vol. 26, at 471 for further explanation. The pooling order, if granted by the Oklahoma Corporation Commission, will offer any working interest owners who have not voluntarily joined the pooling unit the choice to either pay their proportionate costs of the drilling and development costs or receive a bonus and lose their option to participate in the working interest. *Id.* A non-consenting owner who chooses the bonus is therefore shut out of any of the upside of the well forever. The practical effect of Oklahoma's forced pooling law is that well-capitalized companies can drill poorly capitalized companies who cannot afford the upfront drilling and development costs out of units as an inexpensive alternative to having to pay market value to acquire the acreage of the poorly capitalized company. The only choice for those companies is to accept the bonus and forego any potential upside of a successful well, or attempt to obtain funding to allow for full participation in the well in question.

F. Substitutes for Pooling

The explosion in the drilling of horizontal wells and the modernization of fracking techniques has tested the bounds of legal and regulatory constructs in the oil and gas industry over the past decade. As most of the case law, regulatory rules and legacy contracts were created in the context of only vertical wells that could be located on (or at least produced from) only a single tract, the increased use of horizontal wells that produce from multiple tracts has left practitioners and courts in the position of trying to apply imperfect legal and contractual schemes to modern day problems. As would be expected, these issues have presented themselves in the pooling and unitization arena and have done so with a particular frequency in the state of Texas where operators are not able to avail themselves to the benefits of a true force-pooling statute like those that exist in other states. While these issues are not isolated to the state of Texas, Texas law is instructive in looking at some of the ways courts and industry participants are addressing the situations commonly encountered in drilling horizontal wells. The evolution of the law as it addresses these "horizontal" problems will certainly have wide ranging impacts in other jurisdictions and is something that is likely to affect all practitioners.

In order for many horizontal wells to be economically viable they must be drilled with laterals extending for a sufficient minimum distance and require the wellbore to be oriented in a specific direction within the formation. This will often require that an operator drill across multiple tracts and, in some cases, drill across established pooled units. Given the fragmented nature of mineral ownership in most areas where there is expansive oil and gas development, it is more likely that pooling (or some alternative to it) will need to be used in order to drill a horizontal well of sufficient length and with the proper orientation to meet economic justification. Also, while most modern leases do include a pooling clause, in places like Texas where oil and gas development started in the early 1900s, it is not uncommon to encounter leases that do not include pooling provisions but nonetheless are still held by production and provide economic benefit to a large fragmented body of interest-holders. Thus, when operators are faced with leases that are void of a pooling provision or have unduly restrictive pooling provisions they must seek alternatives arrangements in order to get these wells drilled.

There is a very limited amount of Texas case law dealing with the consequences of drilling horizontal wells that traverse un-pooled tracts. The principal case addressing the issue is [*Browning Oil Co. v. Luecke*, 38 S.W.3d 625 \(Tex. App.—Austin 2000\)](#). In *Browning* the lessee under an oil and gas lease violated the anti-dilution provisions contained in the underlying lease which rendered its attempted pooling of several tracts traversed by its horizontal well invalid. *Id.* at 638. Left with a producing horizontal well that was drilled across several un-pooled tracts, the court required the lessee to pay the lessors' royalties based upon "a determination of what production can be attributed to their tracts with reasonable probability." *Id.* at 647. In making its determination the court in *Browning* rejected the lessors' argument that they should each be entitled to a royalty calculated for each tract using 100% of production from the well based on the confusion of goods theory. The lessors' argument under the confusion of goods theory was that where the goods (in this case production from each tract) are co-mingled (in the horizontal wellbore) so as to "render the mixture incapable of proper division according to the pre-existing rights of the parties, the loss must fall on the one who occasioned the mixture." See [*Humble Oil & Ref. Co. v. West*, 508 S.W.2d 812 at 818 \(Tex. 1974\)](#). While the Texas Supreme Court has yet to address the issue, the ruling in *Browning* seemingly paves the way for allocating production on an un-pooled basis and avoiding the potential for double or triple royalty payments under the confusion of goods theory, so long as a lessee can prove with reasonable probability the amount of production that came from each un-pooled tract. While another Texas case, [*Springer Ranch, Ltd. v. Jones*, 421 S.W.3d 273 \(Tex. App.—San Antonio 2013\)](#), addressed the situation of a horizontal well traversing un-pooled tracts, where the court approved an allocation scheme based on the portions of the productive wellbore under each tract, again, based on the provisions of the underlying contract and partition agreement that was binding on the properties in question. The *Springer* decision was based upon the court's interpretation of an underlying contract and partition agreement and thus does not provide operable standards to apply to the situation where a lessee is simply drilling across un-pooled tracts without any contractual scheme to influence how the effected parties will share in production. *Id.*

Thus, at least in Texas, operators dealing with leases that do not allow pooling or which contain overly restrictive pooling provisions must weigh the potential administrative benefits of drilling a proposed horizontal well without pooling the tracts being traversed, with the economic risks of potential claims by lessors for improper allocation. This judgment will come down to the level of comfort the operator (or a non-operating working interest owner receiving a well proposal) has in its ability to establish the portion of production attributable to each tract traversed by the well with a reasonable probability. To such end, there are two somewhat established alternatives to pooling that have been used by operators in this

situation and which are accompanied by varying levels of risk. These alternatives include the use of production sharing agreements and the drilling of so-called allocation wells.

1. Production Sharing Agreements

One alternative to pooling that operators have employed is obtaining a production sharing agreement (a “PSA”) from as many of the interest owners in the tracts to be traversed by the planned horizontal well as possible. A PSA is the formal written agreement of the lessors and other working interest owners with interests in the tracts that will be traversed by a horizontal well (or area where multiple horizontal wells are planned) whereby such parties agree upon a formula by which production from such well(s) will be shared among those tracts. PSAs are frequently used both in the situation where pooling provisions are absent/burdensome and where a horizontal well is planned to be drilled across multiple existing pooled units.

PSAs can be tailored to provide any allocation arrangement that the affected parties can reach agreement on. They can cover multiple wells on the tracts subject to the agreement or can be limited to a single horizontal well. They can provide for a uniform allocation of production for all wells drilled across the tracts (or pooled units) or provide for variations in the allocation formula based on what tracts the well actually traverses. While the parties can come up with any method they choose to allocate production among the affected tracts, some of the more common methods that PSAs use to allocate production include: (i) the surface acreage basis seen for customary pooling provisions, (ii) a percentage basis equal to the portion of the total length of the horizontal drainhole of a wellbore that traverses a given tract compared to the total length of the horizontal drainhole of the given well (generally only based on the portion of the lateral wellbore between the first and last take points), and (iii) the number of take points or perforations located under a given tract as a percentage of total number of take points or perforations within the entire wellbore of the given well. Obviously, these provisions are often heavily negotiated, as it is very possible that certain interest-holders could be zeroed-out depending on which method is used.

Importantly, it should be noted that the tracts subject to a PSA are not pooled and thus will not enjoy the benefits of pooling noted above (i.e. lease maintenance for non-drillsite tracts, etc.). Rather, in such situation the parties to the PSA have simply agreed upon the portion of production that their interests in the applicable tracts will share with respect to wells drilled pursuant to the PSA.

A PSA will have no effect on the owners of interests in the effected tracts which do not execute the PSA and an operator will still have exposure to claims for improper allocation (among other things) from those parties. In this regard the PSA serves as a risk mitigation tool for operators, which allows them to drill horizontal wells across un-pooled tracts, knowing that, at least with respect to the percentage of the interests which have subscribed to the PSA, the operator will not have to worry about claims for improper allocation of production. With that knowledge the operator can put a range on its exposure level and weigh that against the potential returns of the proposed well and make its own decision as to whether it wishes to proceed or not. Thus, while PSAs are an option that will allow operators to drill horizontal wells without formally pooling the tracts associated with those wells, they are not without risk and do provide some disadvantages.

From a regulatory perspective, it should be noted that the Railroad Commission of Texas (the regulatory agency in charge of administering the rules for oil and gas development in the State) will issue a drilling permit for a “PSA” well upon submission by the operator of applicable paperwork (including proof of

contractual rights to develop, plats delineating the tracts contributing acreage to the well and a breakdown of the agreed or proposed allocation of production among the effected tracts). These PSA permits will be administratively approved if the operator certifies that over 65% of the interests (royalty and working interests) in the tracts contributing acreage to the proposed well have signed on to a formal PSA. In situations where operators are unable to get subscription to a PSA by the requisite 65% of the royalty and working interests in the tracts that will be traversed by the horizontal well, operators have resorted to the potentially riskier and more controversial option of drilling that horizontal well as an allocation well.

2. *Allocation Wells*

An allocation well is horizontal well that traverses multiple tracts which are not pooled and for which there is not a separate agreement covering the basis by which such tracts will share in production from the well. These wells include any well that traverses a tract that is not properly pooled with other traversed tracts or is a well drilled between two separate pooled units. These wells differ from PSA wells in that there is no agreed upon allocation of production from the tracts traversed by the horizontal well. For purposes of getting a drilling permit “allocation wells” also include wells for which a PSA is signed by less than the requisite 65% of working and royalty interest owners as noted above. These wells obviously provide a lower risk profile than true allocation wells for which no PSA is signed. To illustrate the issues presented by allocation wells we will base our discussion on “true” allocation wells (for which no PSA is signed) but we note that the impact of those issues may be altered to the extent interest holders in those wells have signed PSAs. In any case, the operator who drills an allocation well is left to allocate production to each of the tracts in question on its own, and then pay royalties and other burdens on that basis without input from or agreement of any of the interest owners being paid.

Allocation wells, as presently used, are a relatively new phenomenon in the oil and gas industry and many of the regulatory and legal issues associated with them have yet to be decided. The two principal issues that are the subject of continuing debate (and legal action) are (i) what will qualify as an appropriate royalty allocation formula for un-pooled tracts traversed by an allocation well and (ii) whether the Railroad Commission of Texas has the authority to issue drilling permits for allocation wells in the first place.

Depending on the situation and the target formation of the well, operators have commonly used the same allocation methods that are used in PSAs (i.e. surface acreage basis, length of horizontal drainhole within the tract, number of take points/perforations within the tract). That said, operators can (and do) consider other engineering and geological factors in formulating an allocation scheme for these wells, which often can place some interest-holders at a disadvantage without their consent. Regardless of the allocation scheme used, an operator should be prepared to meet the “reasonable probability” standard in *Browning* in the event of any claims by the parties with interests in the tracts traversed by the allocation well. Further, allocation wells present a potentially riskier alternative to pooling than PSA wells due to the fact that no (or a lower) portion of the interests in the tracts in question have agreed upon an allocation scheme and thus an operator is susceptible to claims by a larger universe of parties. As such, operators drilling allocation wells must factor into their economic projections the impact of the potential larger body of claims that could be made with respect to these wells.

On the regulatory side, the Railroad Commission of Texas does issue permits for allocation wells so long as the applicant can prove it has the “good faith claim” to the right to drill the well which is required for any drilling permit. *Magnolia Petrol. Co. v. R.R. Comm’n*, [*170 S.W.2d 189, 191 \(Tex. 1943\)*](#). In recent

years, the issue of whether the Railroad Commission has the right to issue drilling permits for allocation wells has attracted much attention and debate as a result of an appeal raised by a group of royalty owners, the Klotzman family, regarding a permit for an allocation well that was issued to EOG Resources, Inc.. Ultimately the parties to the dispute reached a settlement before the court opined on the issue, so there has been no final resolution on what limits, if any, exist as to the Railroad Commission's ability to grant these permits. Nonetheless, the Railroad Commission has continued to grant drilling permits for allocation wells and thus, from a regulatory perspective, allocation wells remain a viable (although risky) option for operators who are unable to pool the tracts they need to drill horizontal wells. For a comprehensive discussion of the Klotzman dispute and the issues raised by the use of allocation wells, see ARTICLE: THE AGE OF ALLOCATION: THE END OF POOLING AS WE KNOW IT?, [45 Tex. Tech L. Rev. 929](#).

Finally, similar to PSA wells, allocation wells traverse at least one or more tracts that are not pooled and thus those tracts will not be subject to the benefits that pooling provides. Thus, while allocation wells remain an available alternative for drilling horizontal wells without formally pooling the tracts associated with those wells, they also are not without risk and provide some disadvantages. Next we will discuss some of the features distinguishing both PSA wells and allocation wells from wells drilled within pooled units.

3. *How are PSA Wells and Allocation Wells Different from Wells on Pooled Units?*

As mentioned above, both PSA wells and allocation wells involve having a well that is drilled across (at least) one un-pooled tract. While these can serve as important alternatives to pooling, they are inherently different conceptually and thus some of the features that distinguish them from the wells drilled in the pooled unit context should be identified and appreciated.

The most important feature of PSA and allocation wells is the un-pooled nature of the tracts that are impacted by them. Unlike the scenario of a horizontal well drilled in a pooled unit where production or operations anywhere on the unit is deemed to have occurred on all tracts committed to the unit, production from or operations on a PSA well or allocation well will only count as production on the tracts traversed by such well and on which such production/work takes place. Thus, an operator is left only maintaining leases on the tracts traversed by the wellbore of the applicable well. Further, because there is not a pooling scheme which allocates production uniformly across all of the tracts in the unit, the allocation of production and, in turn, the payment of burdens and other obligations with respect to PSA wells and allocation wells will require a separate calculation for each well. Similarly, areas outside of the tracts traversed by the PSA well or allocation well will remain subject to the lessee's obligations regarding payment of delay rentals and other burdens and the observation of implied covenants (i.e. to protect those areas from drainage), which can be onerous if there is a very productive horizontal well that results in drainage of properties in the surrounding area.

Logistically, an operator that drills an allocation well or a PSA well will not receive relief from spacing rules with respect to the property lines of tracts along the path of its horizontal wellbore and thus the operator will have to go through the process of getting spacing exceptions with respect to portions of the horizontal wellbore within the setback distances from the property lines of each tract traversed by the horizontal well. This issue is somewhat mitigated due to the fact that under Texas law only mineral interest/working interest owners of tracts effected by an application for a spacing exception are entitled to protest such applications. [H.G. Sledge, Inc. v. Prospective Inv. & Trading Co., 36 S.W.3d 597, 599 \(Tex.App.—Austin 2000, pet. denied\)](#). Because the operator and the other parties participating in an

allocation well will normally own all the working interests in the tracts impacted the well, those parties will be the only parties entitled to protest the application and they will simply waive their objection and obtain the exception administratively. See [16 Tex. Admin Code §3.37\(h\)\(2\)\(B\)](#) (explaining the required waivers needed to allow the director of the Oil and Gas Division or a delegate of the director to issue a spacing exception administratively). While this generally eliminates spacing issues with respect to interior lease lines for the tracts traversed by the wellbore of these wells, the operator will still need to observe the required spacing rules with respect to adjacent tracts which may provide a tighter runway than an operator would encounter in the pooled unit context.

PSA wells and allocation wells also impact the owners of non-participating royalty and mineral interests. As noted above, a party that holds a non-participating interest in a tract committed to a pooled unit will, in many cases, have the option regarding whether it ratifies the unit and participates on the acreage basis allocation prescribed under the pooling provisions of the applicable leases. These interest holders can wait and see whether a well is drilled on the tract they hold an interest in, in which case they will likely not ratify the unit and will share in production based on 100% of production from the well. Alternatively, if the well is drilled on another tract within the pooled unit, they can ratify the lease in order to become subject to the pooling and thus share proportionally in production from the unit well. In the context of PSA wells and allocation wells, the operator will only have to worry about non-participating interest owners that own interests in the tracts penetrated by the applicable well and thus could be used to avoid potentially dilutive elections by the holders of these interests. However, as noted above, if the operator also holds a lease covering adjacent tracts where these non-participating interests exist, they could be creating an obligation to drill an offset well on those tracts under the implied covenant to protect the lessors of those leases from drainage.

4. Summary

While PSA wells and allocation wells present workable alternatives to pooling the tracts needed to drill a horizontal well, these alternatives are not without risk and will often create additional issues regarding development of the operators underlying leasehold position. Both the potential risks and the impacts that these wells will have on an operator's drilling program should be considered in the calculus of the extent to which (or whether) these wells will be economic.

G. Conclusion

As the use of horizontal wells and other innovative drilling techniques continues, there will be a greater importance placed the ability of operators and their advisors to understand how to effectively navigate the issues associated with pooling, unitization and the alternative methods of development discussed above.