Pooling:
The Unintended Consequences & Alternatives

M. Ryan Kirby & Andrew Potts
Kirby, Mathews & Walrath, PLLC

Pooling is an integral part of the development of oil and gas, but it is not without pitfalls and unforeseen consequences. Understanding how pooling operates is vital to utilizing it properly, in order to maximize potential production. So what is pooling? Pooling is the method by which two or more adjacent tracts covered by separate oil and gas leases are joined into a single drilling unit. Leases are pooled to obtain sufficient acreage to meet the Texas Railroad Commission's spacing and density requirements for a well, which are governed by Rules 37 and 38.

A "pooled unit" is different from other types of oil and gas units. A "drilling unit," also called a spacing or development unit, is the acreage assigned to a well for drilling purposes pursuant to Rule 38. The Railroad Commission regulation of spacing units does not change property rights, which remain governed by the common law rule of non-apportionment. A "proration unit" is the acreage assigned to a well for the purpose of determining the amount of production that will be permitted by the Railroad Commission; it does not pool the lands covered by the proration unit. Finally, unitization is the coordinated development of all or most of a particular reservoir. It involves secondary recovery efforts which usually require much more to accomplish than a single pooled unit.

Most commonly, the authority to pool is expressly granted in the "pooling clause" of each lease, and typically includes three important provisions: 1) the Lessee is given the power to combine or "pool" the Lessor's interests with interests covered by other leases; 2) any operations or production occurring within the pooled area have the same effect as if it the operations or production occurred on the leased lands; and 3) the Lessor agrees to accept royalty payments in proportion to the percentage of acreage contributed to the pooled area.

When pooling is accomplished through the pooling clause in an oil and gas lease, it is called voluntary pooling. In extremely limited circumstances, forced pooling may be accomplished through the Texas Mineral Interest Pooling Act, but because its use is so infrequent, further discussion is unwarranted. As a general rule, unless each oil and gas lease includes a pooling clause, the Lessee has no authority to pool. If the oil and gas leases do not contain a pooling clause, the Lessee may subsequently obtain pooling authority by a separate instrument, such as a pooling agreement, or by having all interest owners, including non-excutive and non-participating interest owners, execute a Unit Designation.

Even if each lease contains a pooling clause, the Lessee must be careful to properly exercise the pooling authority granted. Although the Lessee is not a fiduciary for the Lessor, the Lessee must act in "good faith," a standard that is sometimes difficult to define. Whether pooling was exercised in "good faith" is a fact specific question, and no single factor is determinative. However, courts are likely to find pooling was in "bad faith" when a Lessee 1) gerrymanders boundaries to perpetuate multiple leases, 2) ignores geological or seismic data, or 3) pools acreage known to be unproductive.

Because of the broad power given to the Lessee by the pooling clause in a lease, Lessors may attempt to limit the scope of the pooling authority granted by including one or more of the following: 1) a Pugh clause, which releases non-drillsite acreage that is not included in a pooled unit after the termination of the primary term, or as otherwise specified by the lease; 2) acreage limitations in the pooling clause, placing a cap on the maximum amount of acreage included in a lease that can be pooled with other leases; and 3) anti-dilution provisions, placing a cap on the minimum amount of acreage included in a lease that can be pooled with other leases.

While pooling provides many benefits to both Lessors and Lessees, it can also result in unintended and unforeseen consequences, as further illustrated by the following three scenarios:

Scenario 1: Changing the Size of the Pooled Unit.

Oil Co. operates Unit A, which is a gas unit pooled to all depths, and is currently producing from a shallow depth. Also, Oil Co. has leased the acreage bordering Unit A. Oil Co now wants to create Unit B, an oil unit producing from a deeper strata. Can Oil Co. develop the leased acreage adjoining a portion of Unit A's acreage to create Unit B?

This would require the already existing Unit A to be reduced in size in order for Unit B to include that portion of Unit A's acreage in Unit B's Pooled Unit. In order to reduce a unit size, it must be authorized by the provisions of each lease within the unit, or other instrument(s) executed by all parties having executive rights within the unit. Ladd Petroleum Corp. v. Eagle Oil & Gas Co. Also, the authority to reduce must be expressly stated. Even if the provision permitted the Lessee to enlarge or "change" the shape, the court in Estate of Grimes v. Dorchester Gas Prod. Co., held that authority to "change" is not express authority to reduce the size.

Unless the leases included in Unit A permit the reduction in size of a producing pooled unit, Oil Co. will be unable to develop the acreage adjacent to the Unit A, as proposed, and form Unit B. Oil Co. should obtain an Amendment of Unit A and ratifications of same from all mineral, royalty, and working interest owners included in the current Unit A, said ratifications to include present words of grant of the authority to reform and reduce the size of the Unit A.

Scenario 2: The "Allocation" Well Dilemma

Oil Co. intends to drill a horizontal well that will traverse the boundaries of two (2) adjacent units, each of which already contain a horizontal well and are pooled to all depths. Oil Co. owns all working interest in both units, but does not have express pooling authority to reduce the depths of the two units in order to drill the proposed well in a new formation, and is contemplating whether to apply for either a Production Sharing Agreement (PSA) well or an "allocation" well.

An allocation well is a horizontal well that traverses the boundary between two or more leases that are not pooled and for which no agreement exists among the royalty owners as to how production will be shared, or between adjacent existing pooled units since pooling eliminates lease lines.

While there is no legal or statutory definition of an "allocation" well, the working definition in the field is a horizontal well that traverses the boundary between two or more leases that are not pooled and for which no agreement exists among the royalty owners as to how production will be shared, or between adjacent existing pooled units since pooling eliminates lease lines. It must be granted by the RRC following an operator's

assertion that the operator has a good faith claim to drill the well. The practice is not formalized by any rule or regulation. However, progress in the area is increasing. There has been repeated emphasis by Texas courts on avoiding policies that would hamper or discourage the use of new technology, and the Railroad Commission has since disagreed that an allocation well constitutes unauthorized pooling. However, since the production from an allocation well is not pooled, the Lessee is vulnerable to suits brought by Lessors on the theory production is not being properly allocated among the parties to the lease. Additionally, only the drillsite tracts of an allocation well are held by production.

A Production Sharing Agreement ("PSA") Well is similar to an allocation well, but is permitted by the Railroad Commission based upon a contractual agreement between the Lessors and Lessees, which specifies the manner in which production and royalties will be allocated. Currently, the Railroad Commission requires at least 65% of all mineral and working interest owners in each lease, tract, or unit to join in the PSA. The purpose of a PSA Well is to bypass the need for express pooling authority, instead contracting as to the method by which interest owners will share in production. PSA wells recognize that drilling wells across lease and unit lines will encourage further development, prevent waste, prevent the drilling of unnecessary wells, increase ultimate recovery of hydrocarbons, and protect correlative rights. Another benefit of a PSA well is that it potentially allows for development on tracts that are already pooled, and would otherwise not allow for a horizontal well. However, since a PSA well is not pooled, production only holds the drillsite tracts; royalties are calculated on a well-by-well basis; and the Lessee remains vulnerable to suits brought by Lessors that did not execute the PSA.

Scenario 3: The Proration Unit Dilemma

Oil Co. owns the working interest in Lease A, covering a 40 acre tract, which contains the Oil Co. "A1" Well, a vertical well in a 40 acre proration unit. Gas Co. owns the working interest is Lease B, covering a 40 acre tract located adjacent to Lease A, with no producing wells. Oil Co. and Gas Co. want to execute a JOA and drill a horizontal well traversing Lease A and Lease B.

Under Railroad Commission Rule 40(d), the acreage assigned to a well for drilling and development, or for allocation of allowable, cannot be assigned to any other well or wells completed in the same reservoir. This rule has been around for 30 years despite the growth of information in the oil and gas field, and so there have been recent attempts to amend Rule 40(d) to be more current. For example, one oil company recently requested the Texas Railroad Commission to amend the field rules for the Spraberry Field to permit duplicate assignment of acreage into separate pooled units when the mineral rights in a tract are horizontally severed. Although the Railroad Commission Examiners initially denied the request, a Final Order was entered in late 2013, with the following conclusion: "Oil Co.'s application to amend the field rules in the Spraberry (Trend Area) Field will prevent confiscation, protect correlative rights, and will allow tracts with severed mineral rights to be developed."

Although the above example is limited to the Spraberry Field, the Commission has established precedent for exceptions to the Statewide Rule 40(d) through the multiple drainhole provision of Statewide Rule 86(e) and by field rules for stacked lateral wells. The Commission will grant exceptions to permit drilling with shorter distances and drilling more wells than prescribed when such exceptions are necessary either to prevent confiscation or waste. This is a granted exception to Rule 38 for fractional units less than 80 acres, but not less than 20 acres.

In sum, it is important to recognize that this is an evolving area, and that traditional pooling by declaration may not be sufficient by itself to efficiently develop all of the oil and gas resources within the State of Texas, particularly in existing fields where the presence of older vertical wells may impede the development of the

assets by horizontal drilling. Allocation wells and Production Sharing Agreements hold promise, but are not a complete solution at this time. Going forward, it will be important to continue to revisit the issue as Texas Railroad Commission decisions and the decisions of the Texas appellate courts are published. Only then will we be able to regard pooling, allocation wells, and Production Sharing Agreements as discrete, but useful tools of multi-tract development.

M. Ryan Kirby is a founding Partner and Andrew Potts is an Associate Attorney with Kirby, Mathews & Walrath, PLLC; a firm founded on the idea that oil and gas operators are best served by individuals that understand the needs of the industry, as well as fulfilling those needs in an efficient, cost-effective and timely manner, all the while establishing a relationship and a dialogue with the client. Prior to the formation of Kirby, Mathews & Walrath, Mr. Kirby and Mr. Potts worked closely together for a large Houston-based oil and gas firm. In addition to his legal practice, M. Ryan Kirby is also a frequent speaker at seminars for various Landmen's organizations; he also serves as an Adjunct Professor at South Texas College of Law, where he teaches the Texas Oil, Gas and Land Titles course. Andrew Potts is an attorney licensed and practicing in Texas and New Mexico.

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