Pooling: The Unintended Consequences

Although the days of lease wells have not ridden into the sunset quite yet, due to changes in drilling technology - in particular, the rise of the horizontal wells - the necessity for the lessee/operator to employ multiple tracts in the production of oil and gas has risen in importance. The landman faces the challenge of marrying the often-competing needs of the leases covering the lands necessary to drill the well, while still complying with the rules of the Texas Railroad Commission, particularly Rule 37 and Rule 38. The particular methods employed most frequently are voluntary pooling, allocation wells, and production sharing agreements.

Pooling executed by virtue of the pooling clause in an oil and gas lease is the most common form of voluntary pooling and results in a cross-conveyance of interests in land by agreement among the participating parties for so long as the pool and leases remain in effect. A typical pooling clause performs three (3) integral functions: (1) it grants the lessee the power to pool the lessor's interests, and in some instances, revise, reform, expand and/or contract the pooled unit; (2) it provides that all operations occurring anywhere within the pooled area have the same effect as if it were conducted on the lease itself; and (3) it supplies a method by which the lessors agree to accept a proportionate share of the royalty produced from the pooled unit, often based upon the percentage of acreage contributed to the pooled unit.

A lessee has no power to pool the lessor's interest without express authority, including non-executive owners (NPRI and NEMI). However, a lessee may still be able to pool the interest of lessors by a separate instrument such as a pooling agreement or by the execution and joinder of the lessors, and non-executive owners, in a Unit Designation.

Disputes often arise about whether a lessee has properly exercised the pooling authority created by the lease pooling clause. The lessee is not a fiduciary to the lessor and is only held to a standard of good faith when exercising its pooling authority. Whether an exercise of the pooling power is in good faith is a question of fact, not a legal issue. While determining what constitutes "good faith" is not a clear cut rule, there are a number of factors that can determine a bad faith exercise of pooling. Examples include, gerrymandering boundaries to perpetuate multiple leases, ignoring geological or seismic data, and pooling known unproductive acreage. However, no single factor is determinative as long as the lessee acted as a reasonably prudent operator.

The pooling clause creates great value to the lessee and may even be necessary for the lessor to prevent drainage; however, there are ways lessors try to limit the broad benefits the pooling clause grants to lessees by negotiating other clauses into the lease agreement. There are several methods lessors may utilize to limit the effect of pooling, including the Pugh clause, acreage limitations on the pooled unit size, and anti-dilution provisions. The Pugh clause acts to release acreage (and possibly depths) from the lease, and retains only those lands within pooled units. Acreage limitations as to the pooled unit size can be expressly stated in the pooling provision included in the lease, as well as governmental restrictions prescribing acreage limitations based upon field rules or statewide rules. Anti-dilution provisions require lessees to include a certain percentage of the lessor's acreage within a tract to be included in the pooled unit.

Several problems may arise after the formation of pooled units, due to the lessee's need to expand or contract the unit's geographical boundaries. At least one Texas court has held that an existing pooled unit may be enlarged, provided the lessee exercises the pooling authority in good faith, without express approval in the pooling provision of the lease. However, Texas case law has been interpreted as precluding operators from reducing the size of an existing pooled unit unless: (1) all leases in the unit expressly authorize the reduction; or (2) all lessors consent to such reduction (including NPRIs and NEMIs). Such an analysis could also be applicable to the removal of strata from a pooled unit.

Existing pooled units may also be affected by allocation wells. An allocation well is a horizontal well that transverses the boundary between two or more leases that are not pooled (or two or more pooled units) and for which no agreement exists among the royalty owners as to how production will be shared. As no agreement exists on the sharing of production, payment obligations for allocation wells must be calculated on a well-by-well basis as the parties have not bound themselves by any particular method. However, determining the method has been problematic, as each tract owner is entitled to their fair share of production from their particular tract of land, and there is an inability to precisely measure the amount of production from each tract because production has been commingled within the wellbore. Thus, it is possible that some interest owners may not be allocated production based on the actual amounts produced from their individual tracts.

Production Sharing Agreement (PSA) wells are an alternative to allocation wells are. A PSA well is a well permitted by the Texas Railroad Commission based upon a contractual agreement between the lessors and lessees, which specifies the manner in which production and royalties will be allocated, and is executed by at least 65% of all mineral and working interest owners in each lease, tract, or unit. PSA's recognize that drilling wells across lease and unit lines will encourage further development, prevent waste, prevent the drilling of unnecessary wells, increase the ultimate recovery of hydrocarbons, and protect correlative rights. Furthermore, PSA's specifically describe the method by which interest owners will share production; similar to a pooled unit. However, for any interest owners who do not execute the PSA, the lessee must demonstrate: (1) the quantum of production attributable to each unit or tract transversed by the well's productive drainhole with reasonable probability; and (2) such production is paid to the lessors in compliance with the lessor's royalty and pooling clause.

Whether a lessee opts to utilize an allocation well or PSA well, potential liability to lessors who do not execute the PSA always exists. First and foremost, there are no legal or statutory definitions for an allocation well or PSA well and the practice of permitting either with the Texas Railroad Commission is in its infancy. However, two recent developments have shed some light on the issue. First, the Texas Railroad Commission has granted EOG Resources, Inc.'s application for an allocation well which transversed two tracts in which EOG Resources, Inc. was unable to pool due to the lack of authority in the individual leases. The Commissioners specifically set forth that, "EOG Resources, Inc. has a sufficient good faith claim to drill its proposed Klotzman (Allocation) Well." Second, the Texas Railroad Commission granted an exception to Statewide Rule 40(d) (prohibiting the double assignment of acreage to a well for drilling and development, or for allocation of allowable, in the same reservoir) to Pioneer Natural Resources, Inc. The Texas Railroad Commission concluded that "Pioneer'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."

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.

The above does not constitute legal advice and should only be utilized as a general guide.

M. Ryan Kirby is a partner with Kirby, Mathews & Walrath, PLLC, as well as an adjunct professor of the Texas Oil, Gas and Land Titles class at South Texas College of Law.