

Presented:
40th Annual Ernest E. Smith
Oil, Gas and Mineral Law

March 28, 2014
Houston, Texas

Production Allocation Issues: Non-Participating Royalty Interest Owners in Vertically and Horizontally Pooled Units

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I. Introduction

The United States and, particularly, Texas, is experiencing an energy boom we haven't seen in over a decade. Advancements in horizontal drilling techniques are making it economical to produce from hydrocarbon-bearing formations once thought too uneconomical to produce. Sophisticated advancements in hydraulic fracturing and horizontal drilling have spurred this energy revolution, causing many oil and gas majors to quickly jump on board or risk getting left behind.

One area having a difficult time adapting to the fast-paced world of horizontal drilling is the law applicable to oil and gas jurisprudence. Advancements in technology have outpaced the legal framework. It is increasingly more difficult to apply old law (often developed in the context of vertical well development) to these cutting-edge concepts for developing hydrocarbon-rich formations utilizing a horizontal wellbore. The skyrocketing use of horizontal well development cannot be ignored and the body of existing oil and gas law must continue to develop and adapt to the issues created by horizontal development. At the forefront is ensuring the law protects property rights.

This paper will focus on the legal concepts that have developed when dealing with a non-participating royalty interest ("NPRI") owner considering ratification within a vertically pooled unit and the challenges of applying these concepts to the NPRI owner within a horizontally pooled unit.

II. Background

A. Definition: Non-Participating Royalty Interest

A non-participating royalty interest is "an interest in the gross production of oil, gas and other minerals carved out of the mineral fee estate as a free royalty, which does not carry with it the right to participate in the execution of, the bonus payable for, or the delay rentals to accrue under oil, gas and mineral leases executed by the owner of the mineral fee estate." *Plainsman Trading Co. v. Crews*, 898 S.W.2d 786, 789-90 (Tex. 1995). Said another way, an NPRI is an expense-free interest in oil or gas, if and when produced. *Id.* The NPRI owner lacks the benefits of the executive owner, having no right to negotiate or execute oil and gas leases, no right to receive bonus payments or delay rentals, and no right to develop and produce the minerals himself. *Id.*

An NPRI can be created by reservation, as when a predecessor in title conveys his mineral interest but reserves a small interest in future profits, or by grant, as when the NPRI is purchased from the mineral interest owner. *See, e.g., In re Bass*, 113 S.W.3d 735, 738 (Tex. 2003) (NPRI created by reservation); *White v. White*, 830 S.W.2d 767, 768 (Tex. App.—Houston [1st Dist.] 1992, writ denied) (NPRI created by grant). For example, an instrument conveying all oil, gas, or other minerals but reserving one-half of all present and future royalties on oil or gas

produced and saved from the land would create a one-half NPRI interest in favor of the grantor.¹ Thus, the interest is not created by an oil and gas lease, rather, it is carved out of the mineral owner's interest. Further, unlike a mineral interest owner, who is typically entitled to his proportionate share of production, less any costs of production, NPRIs are due a portion of the gross revenue from the proceeds of production and do not incur deductions for expenses associated with production. *Schlittler v. Smith*, 101 S.W.2d 543 (1937).

B. Distinction Between Ratification and Revivor:

The doctrines of revivor and ratification are often confused and frequently used interchangeably. *Bradley v. Avery*, 746 S.W.2d 341, 344 (Tex. App.—Austin 1988, no writ); *Sun-Key Oil Co., Inc. v. Whealy*, No. 2-06-198-CV, 2006 WL 3114466, at *4 (Tex. App.—Fort Worth Nov. 2, 2006, no pet.) (mem. op.) Revivor has the effect of reviving a lifeless lease by subsequent execution of a document that clearly recognizes the validity of the lifeless lease. *Cannon v. Sun-Key Oil Co., Inc.*, 117 S.W.3d 416, 419-20 (Tex. App.—Eastland 2003, pet. denied). The execution of the subsequent document must make sufficient reference to the terminated lease in order to revive it. *Westbrook v. Atl. Richfield Co.*, 502 S.W.2d 551 (Tex. 1973). Ratification, on the other hand, applies to conveyances like an oil and gas lease that is inoperative, rather than terminated. *Whealy*, 2006 WL 3114466 at *4. Ratification, like revivor, also requires execution of a formal document clearly recognizing the validity of the inoperative conveyance. *Id.*; *Hastings v. Pichinson*, 370 S.W.2d 1, 4 (Tex. Civ. App.—San Antonio 1963, no writ).

III. NPRIs Considering Ratification in a Vertically Pooled Unit: A Powerful Position

Typically, oil and gas companies approach royalty and non-executive mineral interest owners to ratify an oil and gas lease covering the lands in which they own their interest because they seek the right to pool their interests covered by the oil and gas lease. Pooling allows lessees to join tracts from one or more leases to form a single unit where a single tract is often insufficient in size to meet the Texas density or spacing requirements. *Browning Oil Co., Inc. v. Luecke*, 38 S.W.3d 625 (Tex. App.—Austin 2000, pet. denied); *see also* 2 Ernest E. Smith & Jacqueline Lang Weaver, *Texas Law of Oil and Gas* § 11.1[B] (2d ed. 2012) (stating purpose of pooling is to allow an operator to combine separately owned smaller tracts of land in order to drill a well in compliance with the Texas Railroad Commission's spacing requirements). Operations anywhere within the unit are treated as though they occurred on all land within the unit, and production from a well within the pooled unit is treated as though it is producing on all tracts pooled into the unit. *Southland Royalty Co. v. Humble Oil & Refining Co.*, 249 S.W.2d

¹ Compare this with an instrument conveying one-half of all oil, gas, or other minerals in or under the [described] land, reserving the exclusive right to execute oil and gas leases on the land forever. This would create a one-half non-executive mineral interest in favor of the grantee as the grantee owns a one-half interest in oil, gas, or other minerals but lacks the right to join in the execution of a lease.