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Proration Units: "You keep using that word, I don't think it means what you think it means!"

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I. INTRODUCTION

Two cases recently argued before the Texas Supreme Court on the same day raise the issue of what happens, or can happen, when oil and gas lease provisions refer to external metrics such as proration units adopted by the Texas Railroad Commission to determine rights and obligations under the lease. *See Discovery v. Endeavor* and *XOG v. Chesapeake*. As of the date of this paper's deadline, the Court had not issued opinions in the cases, but they have prompted a renewed focus on how provisions relating to released and/or retained acreage containing such references operate (or fail to operate), and how they might be drafted in the future to achieve the goal of predictable results.[1]

Because, if the two currently pending cases stand for any simple proposition, it is that simply incorporating Railroad Commission concepts into an oil and gas lease will likely not create predictable results. And yet, it seems that the practice has been widespread.

The issue itself is not new. Justice Pope identified the problem succinctly in the seminal case of *Jones v. Killingsworth* in 1965, writing in his dissent, "[t]he fault that I find with our holding in this case is that we are trying to fit the meaning of terms used by private parties to a lease into a supposed technical terminology used by the Railroad Commission in making its rules and orders." *Jones v. Killingsworth*, 403 S.W.2d 325, 333 (Tex. 1965) (Pope, dissenting). To attempt to understand what might happen if a lease references Railroad Commission units for retained acreage or other purposes, and how to construe a lease that does, it seems helpful to consider: (a) what proration units are, exactly; (b) how they came to be in the first place; and (c)

[1] *See, for two recent examples,* Mark Hanna and John Hicks, *Retained Acreage and Depth Issues in Oil and Gas Leases: The Courthouse and Regulatory Perspective*, STATE BAR OF TEXAS OIL AND GAS DISPUTES CONFERENCE, January 26, 2018; Brandon Durrett, *Fun New Ways for Density and Proration Rules to Bust Your Lease*, THE UNIVERSITY OF TEXAS SCHOOL OF LAW 43RD ANNUAL ERNEST E. SMITH OIL, GAS AND MINERAL LAW INSTITUTE, April 14, 2017.

the extent to which their current usage, especially in unconventional reservoirs, differs from their original purpose.

As discussed more fully below, we contend that proration units should not be used as shorthand for "area of lease that has been developed." Railroad Commission proration units are the result of a regulatory framework designed to prevent the drilling of too many wells, and to restrict production from producing wells, but they are used in oil and gas leases in an attempt to require operators to drill more wells. They are a tool being used for the wrong job.

II. PRORATION UNITS AT THE RAILROAD COMMISSION

A. How Did We Get Here

In Texas, an oil and gas lease is a determinable fee. Generally, a lessee of the mineral interest owner is granted the right to develop and produce oil and gas for his own benefit and for the benefit of the owner of the mineral interests, in and under certain geographic areas, until production of oil or gas from the property ceases. This is a broad grant of rights, with very little limitation. For many years, the basic operating provisions included a habendum clause, a clause identifying the primary term, a royalty clause and (perhaps) a pooling clause. One producing well could hold a thousand acres. Over time Lessors sought to ensure that development and production would be steady, consistent and comprehensive. Courts implied certain obligations, such as the implied covenant to reasonably develop the lease and the implied covenant to protect the lease from drainage. Lessees sought to retain the opportunity to develop and produce oil and gas reserves at their discretion, with flexibility to choose when and how to develop and produce the area under lease. Lessors and lessees of oil and gas interests (or more particularly, their counsel) began to modify the terms of basic oil and gas leases in ways each deemed beneficial to its interests.

Title search: Proration Units: "You Keep Using that Word, I Don't Think it Means What You Think it Means!"

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