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Chapter 28
ALLOCATION WELLS IN THE PERMIAN BASIN

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Recent Developments

Following the paper is a copy of a lawsuit filed against the Railroad Commission of Texas challenging the Commission's Order which dismissed a Lessors' complaint as an unnecessary duplication of proceedings and moot because the Commission has previously decided that pooling authority is not required to show a good faith claim to a permit for an allocation well.

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Chapter 28

ALLOCATION WELLS IN THE PERMIAN BASIN

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§ 28.01 Introduction* ¹

Given the commotion surrounding the decision of the Railroad Commission of Texas (Railroad Commission) in the *Klotzman* case² one might believe that it represented the first time the Railroad Commission had granted a drilling permit to an operator planning to drill what has now become known as an “allocation” well. Horizontal wells have been drilled across the boundary lines of separate tracts without pooling pursuant to permits issued by the Railroad Commission for more than 20 years. The first such wells were drilled in Texas before the terms “allocation” well and “production sharing agreement” (PSA) well were first introduced.

*Cite as Michael E. McElroy, “Allocation Wells in the Permian Basin,” 63 *Rocky Mt. Min. L. Inst.* 28-1 (2017).

¹Special thanks to Eno Peters and Mike Paluso for their assistance with this chapter and the conference presentation.

²See Final Order, *In re* Application of EOG Res., Inc., Klotzman Lease (Allocation) Well No. 1H, No. 02-0278952 (R.R. Comm'n of Tex. Sept. 24, 2013), *appeal dismissed*, *Reilly v. R.R. Comm'n of Tex.*, No. D-1-GN-13-004306 (Tex. Dist. Ct. Travis Cnty. Apr. 1, 2014). The author's law firm intervened in this Railroad Commission proceeding in support of EOG Resources, Inc.'s claim of a right to drill its proposed well without pooling.

An allocation well is a horizontal well drilled across multiple tracts without the formation of a pooled unit and without a production sharing formula between the owners of interests in the tracts traversed by the horizontal well.³ A PSA well is a well drilled across multiple tracts without formation of a pooled unit but where the owners of interests in the tracts traversed by the horizontal well have agreed to a production sharing formula.⁴

Since the *Klotzman* case, the debate concerning allocation wells and whether they are authorized by a typical oil and gas lease has continued in three subsequent law review articles.⁵ When placed in the context of applicable Texas property law, it is easy to follow the evolution that brought about “allocation” and “PSA” wells. This author agrees with Professor Ernest Smith that, where the lessee holds leases on all tracts traversed by the horizontal well, the rights conveyed to the lessee under a typical oil and gas lease include the right to drill across separate leaseholds without pooling because it is not prohibited by the typical lease.⁶ This chapter will discuss the basics of Texas oil and gas property law that lead to this conclusion.

This chapter will also discuss Railroad Commission matters involving these horizontal wells and review the applications of property law and regulatory rules to horizontal oil and gas activity today.

³See Ernest E. Smith, “Applying Familiar Concepts to New Technology: Under the Traditional Oil and Gas Lease, a Lessee Does Not Need Pooling Authority to Drill a Horizontal Well that Crosses Lease Lines,” 12 *Tex. J. of Oil, Gas, & Energy Law* 1, 3 (2015); see also John Hicks, “Pooling and Unitization Methods Across Shale Basins (or Lack Thereof): Texas (Eagle Ford and Barnett),” *Development Issues in Major Shale Plays* 8C-1, 8C-36 (Rocky Mt. Min. L. Fdn. 2014); Robert. C. Grable, “Royalty Payments and Other Current Issues from Horizontal Wells,” *Horizontal Oil & Gas Development* 13A-1, 13A-10 (Rocky Mt. Min. L. Fdn. 2012).

⁴Smith, *supra* note 3, at 11. For a sample production sharing agreement, see Barry D. Thomas, “Pooling Issues for Horizontal Development in Texas,” *Horizontal Oil & Gas Development* 6C-1, 6C-13 (Rocky Mt. Min. L. Fdn. 2012).

⁵See Clifton A. Squibb, “The Age of Allocation: The End of Pooling as We Know It?” 45 *Tex. Tech L. Rev.* 929 (2013); Bret Wells, “Allocation Wells, Unauthorized Pooling, and the Lessor’s Remedies,” 68 *Baylor L. Rev.* 1 (2016); Smith, *supra* note 3.

⁶See Smith, *supra* note 3, at 8–9.

§ 28.02 Basics of Texas Oil and Gas Property Law

[1] Ownership in Place

Under Texas law, “gas and oil in place are minerals and realty, subject to ownership, severance, and sale, while embedded in the sands or rocks beneath the earth’s surface”⁷

This property right is held subject to the valid exercise of the police power of the state.⁸ In Texas, this police power has been delegated to the Railroad Commission.⁹ The power of the Railroad Commission to regulate oil and gas operations is valid only when exercised within the limits of its statutory authority.¹⁰ The Railroad Commission is obligated to grant a drilling permit where necessary to prevent waste or to protect vested property rights.¹¹ Under the Texas regulatory system “[e]ach person still owns the oil and gas in place under his land, and each still has the right to possession, use, enjoyment, and ownership of the oil and gas produced through wells located on his land, regardless of its origin.”¹²

[2] Waste and Confiscation

Under Texas law, “waste” is defined as the failure to recover and put to beneficial use oil or gas that might otherwise be recovered in a validly permitted well.¹³ If evidence establishes that the applicant for the permit has a good-faith claim of title and that waste will occur unless a well is drilled, the Railroad Commission is obligated to grant the permit.

The term “confiscation” can refer to either drainage or the deprivation of an owner’s or lessee’s right to “a fair chance to recover the oil and gas in or under his land, or their equivalent in kind.”¹⁴ If evidence establishes that confiscation will occur unless a well is drilled, the Railroad Commission is obligated to grant the permit.¹⁵

⁷Stephens Cnty. v. Mid-Kan. Oil & Gas Co., 254 S.W. 290, 292 (Tex. 1923); *see also* Texas Co. v. Daugherty, 176 S.W. 717, 718–20 (Tex. 1915).

⁸Brown v. Humble Oil & Ref. Co., 83 S.W.2d 935, 940 (Tex. 1935).

⁹*Id.* at 941 (“the Railroad Commission, acting under valid laws, has ample authority, under both the Constitution and the police power, to prevent waste and conserve the mineral interests of the state”).

¹⁰*Id.*

¹¹*Id.* at 944.

¹²*Id.*

¹³Gulf Land Co. v. Atl. Ref. Co., 131 S.W.2d 73, 80 (Tex. 1939).

¹⁴*Id.*

¹⁵*Id.*

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