OG Energy Education Series

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OLIVA GIBBS LLP

New Solutions for Old Units: How to Navigate Drilling Longer Laterals in Texas and Louisiana

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Topics for Discussion

I. A quick discussion of differences between Texas and Louisiana oil and gas law

II. Background of Pooling in Texas and Louisiana

III. What are Allocation Wells and Production Sharing Agreements?

IV. What are Cross-Unit Wells?

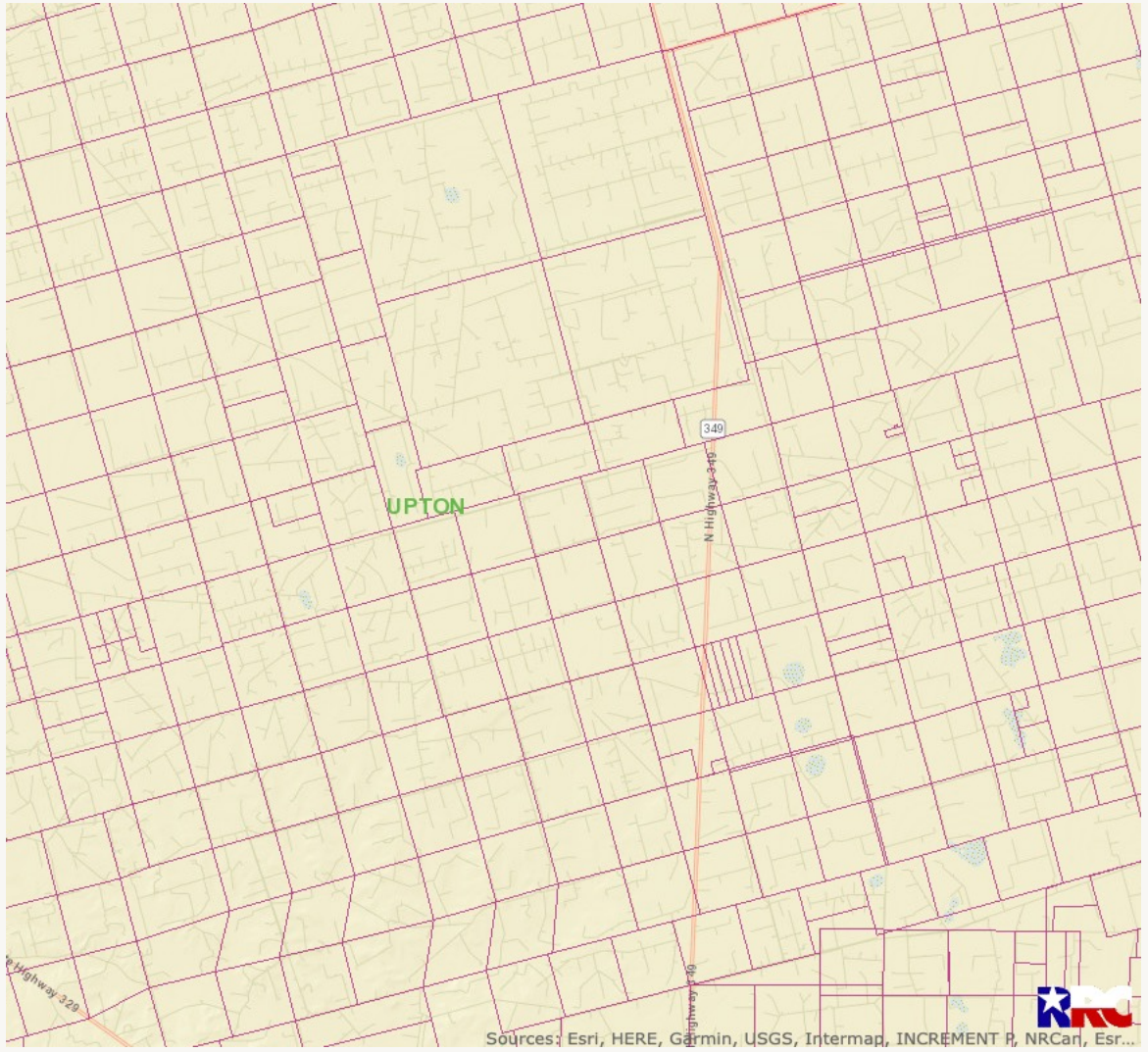
V. Impact of Allocation Wells and Cross-Unit Wells on Horizontal Drilling

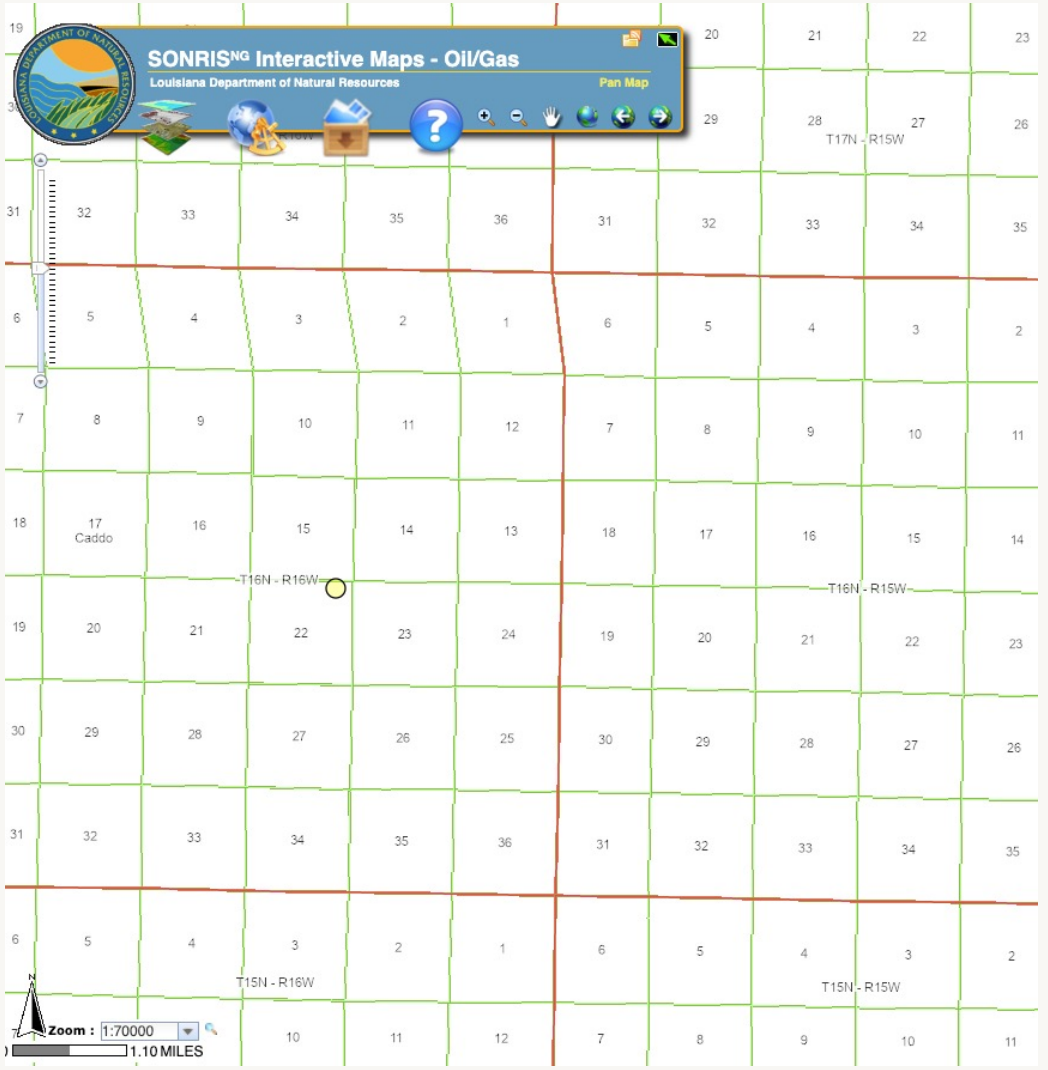
VI. Allocating Production for Allocation Wells and Cross-Unit Wells

Terminology Differences

- County vs. Parish
- Mineral Estate vs. Mineral Servitude
- Common Law vs. Civil Law
- Real property and personal property vs. Immovable/movable and corporeal/incorporeal
- Deed of Trust vs. Mortgage
- Life estate vs. Usufruct
- Probate vs. Succession

Differences Between Texas and Louisiana





Pooling, Generally

- Addresses the situation where an owner's tract is not large enough to be individually developed (absent a spacing or density "exception")
- Allows owners of contiguous tracts to combine acreage (voluntarily or involuntarily) to form "spacing" units that meet states acreage requirements
  - **Drilling/Spacing Unit** = the minimum acreage necessary to drill a single well
  - **Proration Unit** = acreage determined by regulatory authority that can be efficiently and economically drained by a well at a particular depth or horizon
  - **Pooled Unit** = multiple tracts combined to meet state spacing requirements

Pooling vs. Unitization vs. Communitization

- The terms “pooling” and “unitization” are often used interchangeably.
- **Pooling** = bringing together of small tracts sufficient for the granting of a well permit under applicable spacing rules
- **Unitization** = joint operation of all or some part of a producing reservoir (secondary or enhanced recovery units). Compulsory unitization may require a minimum ownership percentage.
- **Communitization** = federal equivalent of pooling
- **Community Lease** = a single lease covering two or more tracts executed by separate owners as if they were joint owners.
  - “Pooled as a matter of law.”

Forced Pooling in Louisiana

- 2 Common Types of Units in Louisiana
  1. Compulsory Units (Forced Pooling)
     - Drilling units
  2. Conventional Units
     - Declared units
     - Voluntary units

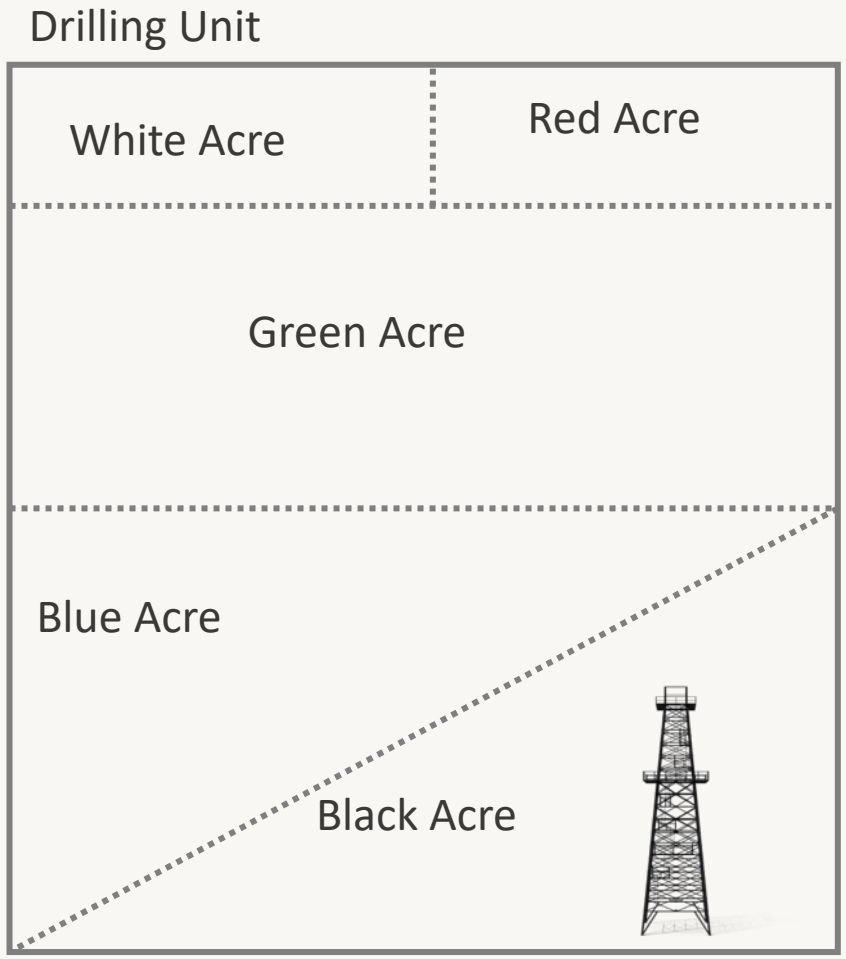
Forced Pooling (Cont.)

- Drilling Unit:
  - For the prevention of waste and to avoid the drilling of unnecessary wells, the commissioner shall establish a drilling unit or units for each pool, except for those pools which, prior to July 31, 1940, had been developed to an extent and where conditions exist making it impracticable or unreasonable to use a drilling unit at the present stage of development. A drilling unit, as contemplated herein, means the maximum area which may be efficiently and economically drained by one well. This unit shall constitute a developed area as long as a well is located thereon which is capable of producing oil or gas in paying quantities.
    - La. R.S. §30.9(B)

Forced Pooling (Cont.)

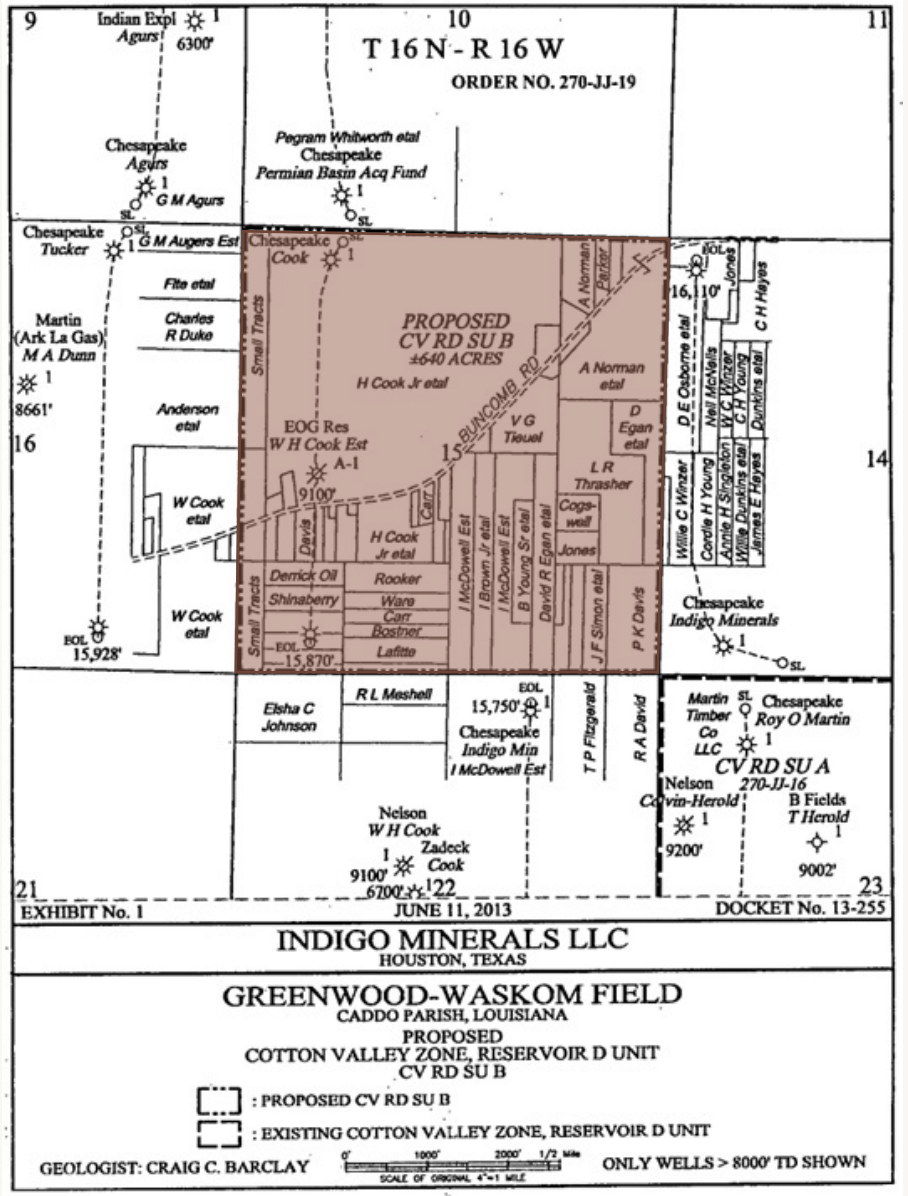
- Where the owners have not agreed to pool their interests, the commissioner shall require them to do so and to develop their lands as a drilling unit, if he finds it to be necessary to prevent waste or to avoid drilling unnecessary wells.
  - La. R.S. §30:10(A)(1)
- Creation of the drilling unit can be done prior to drilling the proposed unit well, while drilling, or after the drilling has been completed.
- Once a unit has been established, the Commissioner may appoint an operator to extract oil and gas from a reservoir.
  - *Hunt Oil Co. v. Batchelor*, 644 So. 2d 191, 196 (La. 1994)

Forced Pooling (Cont.)



- The portion of the production allocated to the owner of each tract included in a drilling unit formed by a pooling order shall, when produced be considered as if it had been produced from his tract by a well drilled thereon.
  - La. R.S. §30:10(A)(1)(b)

Forced Pooling (Cont.)



Louisiana Risk Fee Statute

- The Louisiana Risk Fee Statute (La. R.S. §30:10) seeks to allocate the risk of drilling certain wells as between “drilling” owners and "non-drilling" owners.
- Under the Risk Fee Statute, the drilling owner has the option to give all other owners in the unit, statutory notice and an opportunity to elect to participate in the risk and expense of the unit well by advancing their pro rata share of the total anticipated costs of the proposed well.

Louisiana Risk Fee Statute (Cont.)

- La. R.S. § 30:10(A)(2)(b)(i) provides for the following risk charge attributable to those parties electing not to participate or deemed a non-participating owner:
  - The owner paying for a nonparticipating owner's share of drilling and operating costs can recover a risk charge of two hundred percent (200%) of the carried nonparticipating owners share of drilling, testing and completing the well costs if the nonparticipating owner's interest is derived from a unit well, substitute unit well, or a cross-unit well that serves as a unit well or substitute well.
  - If the carried nonparticipating owner's interest is derived from an alternate well or a cross-unit well that serves as an alternate well, a risk charge of one hundred percent (100%) of drilling, testing and completing the well costs may be recovered. (emphasis added)
- If the owner of an interest in a unit elects not to participate in the risk and cost of drilling a well, the owner paying for the nonparticipating owner's share of the drilling and operation of a well may recover a risk charge *only if* the paying owner has made an unsuccessful, good-faith attempt to have the other owners in the unit join in and participate in the risk and cost of drilling the well.
- Proper notice is required before a risk charge can be imposed.

Louisiana Risk Fee Statute (Cont.)

- However, La. R.S. § 30:10(A)(2)(e)(i) provides for the following:
  - The provisions of Subparagraph (b) of this Paragraph with respect to the risk charge shall not apply to any unleased interest not subject to an oil, gas, and mineral lease. (emphasis added)

Texas Approach to Forced Pooling - MIPA

- Compulsory pooling is uncommon in Texas, but it is available under the Mineral Interest Pooling Act ("MIPA"). **Tex. Nat. Res. Code Ann. §§ 102.001, *et seq*.**
- You might call it "compulsory voluntary" pooling. This is because there is a high threshold for a "fair and reasonable" offer prior to pooling. Generally, if a true fair and reasonable offer is made, it will be accepted voluntarily
- **Procedure:**
  - Application to pool
  - RRC Examiner issues a Proposal for Decision (PFD) after hearing
  - Commissioner adopts or rejects Examiner's recommendation and issues an order

MIPA – Requirements, *inter alia*

- Separately owned tracts embraced in a common reservoir with field rules
- Two or more separately owned interests in the proration unit
- No voluntary pooling
- Action by commission will prevent economic and physical waste
- The reservoir was discovered *after* March 8, 1961
- **Fair and reasonable** offer to voluntarily pool has been made

MIPA Type 1 – "Standard" Application

- Used to "force" unleased mineral interest owners to participate. **Tex. Nat. Res. Code Ann. § 102.011 & § 1-2.013**
- **Requires:** (i) fair and reasonable offer to pool; (ii) proof the MIPA unit will prevent waste and protect correlative rights; and (iii) prevent drilling unnecessary wells
- **Fair and Reasonable Offer**
  - A no surface use lease with at least the average royalty in the proposed unit, with average bonus and a primary term no more than three years
  - An option to participate as a working interest owner subject to a JOA with a risk penalty no greater than 100%
  - A farm-out option whereby the unleased owner retains a 20% ORRI convertible to a 25% working interest at payout

MIPA Type 2 – "Muscle In" Application

- Used by small tract owners adjacent to existing or proposed" wells in an effort to "force" their tracts into the unit. **Tex. Nat. Res. Code Ann. § 102.014**
- In addition to the requirements of a Standard Application, must prove **actual drainage** of your tract and/or whether your minerals will be "stranded"
- Recently used for riverbed tracts (*Ammonite Oil and Gas* Applications)

MIPA Type 2 – "Muscle In" Application (Cont.)

❖ Fair and Reasonable Offer

1. No change in operatorship
2. Inclusion of applicant's tract will not significantly dilute other tracts on pro rata basis
3. A proposed oil and gas lease
4. Applicant agrees to be treated as a WI owner subject to a JOA with risk penalty no more than 100%
5. Accurate survey (difficult for river tracts)
6. Applicant must obtain a benefit that outweighs burden to operator (e.g., drainage vs. equipment)

MIPA – Risk Penalties

- Treatment has been wildly inconsistent and seemingly arbitrary. Statute only says "not to exceed 100%"
- Risk penalties in recent decisions have been 0%, 10%, 50%, 100%, *etc.*
- Some evidence that has been given weight:
  - Number of wells in a five-mile radius not expected to reach payout
  - The actual chance of successful completion
  - The likelihood of the proposed well reaching payout
  - The standard risk penalty in JOAs for the area
  - How many nearby wells are considered to be uneconomic
  - Other economic risks including market prices or regulatory challenges

Substitutes for Pooling in Texas

- Substitutes for pooling have arisen in Texas because MIPA lacks teeth
  - May be used to drill across tracts, units, or leases with no pooling authority
  - Very little authority for PSA and allocation wells other than production must be allocated with some "reasonable probability." ***Browning Oil Co. v. Luecke*, 38 S.W.3d 625 (Tex. App.-–Austin 2000).**
  - Common standard would be amount of productive lateral on each tract from first take point to last take point. Others may include surface acreage or number of take points.

Substitutes for Pooling in Texas – PSA Wells

Production Sharing Agreement (PSA) Well

- A creation of the Railroad Commission ("RRC") to combine multiple tracts in absence of pooling
- Allows an operator to form a production-sharing agreement by obtaining consent of at least 65% of the working interest and 65% of the royalty interest
- If the requisite consent is obtained, then the RRC will permit the operator to treat the production-sharing agreement as a single drillsite tract
- A PSA will require a Rule 37 lease line exception (but if the operator owns 100% of the working interest it can waive the notice and hearing under Rule 37 as an "own-offset waiver")

Substitutes for Pooling in Texas – Allocation Wells

- A horizontal well that traverses **multiple tracts** which are **not pooled** and for which there is **no separate agreement** allocating production
- May traverse unpooled leases or separate units
- Two Main Issues:
  1. What is the "reasonable probability" basis for allocation?
  2. Does the RRC even have authority to permit them?
- Can cause additional issues with spacing and setback requirements such as Rule 37 Exceptions
- **Bottom Line:** Still a good idea to get as many owners as possible to sign a PSA, even if it is under the 65% requisite for a PSA Well

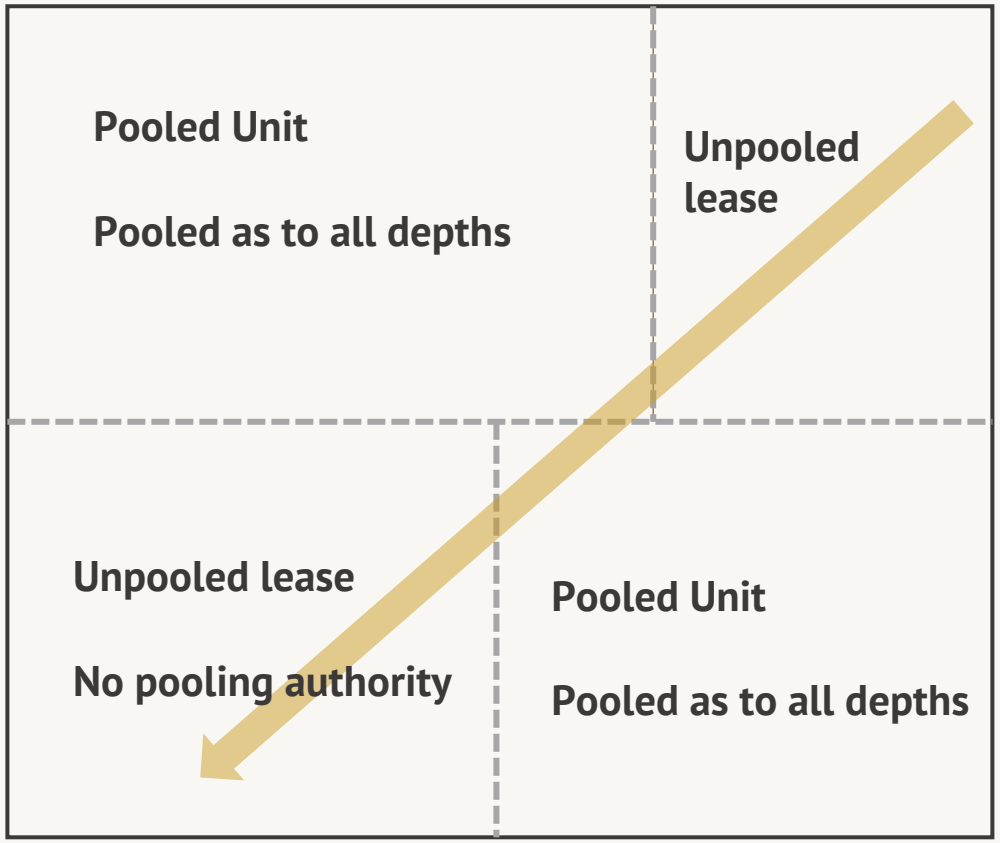
Authority for Allocation Wells

- There is no Texas statute or regulation addressing production-sharing agreements or allocation wells
- *Cockrell v. Texas Gulf Sulphur Co.*, 299 S.W.2d 672, 675 (Tex. 1956)
  - Explaining the doctrine of the greatest possible estate granted, which permits the lessee to drill anywhere on the lease, including border to border, unless expressly prohibited by the lease
- *Magnolia Petroleum Co. v. Railroad Comm'n of Texas*, 170 S.W.2d 189 (Tex. 1943)
  - Explaining that a "reasonably satisfactory showing of good-faith claim of ownership in the property" is what is required to obtain a drilling permit

The RRC's Position

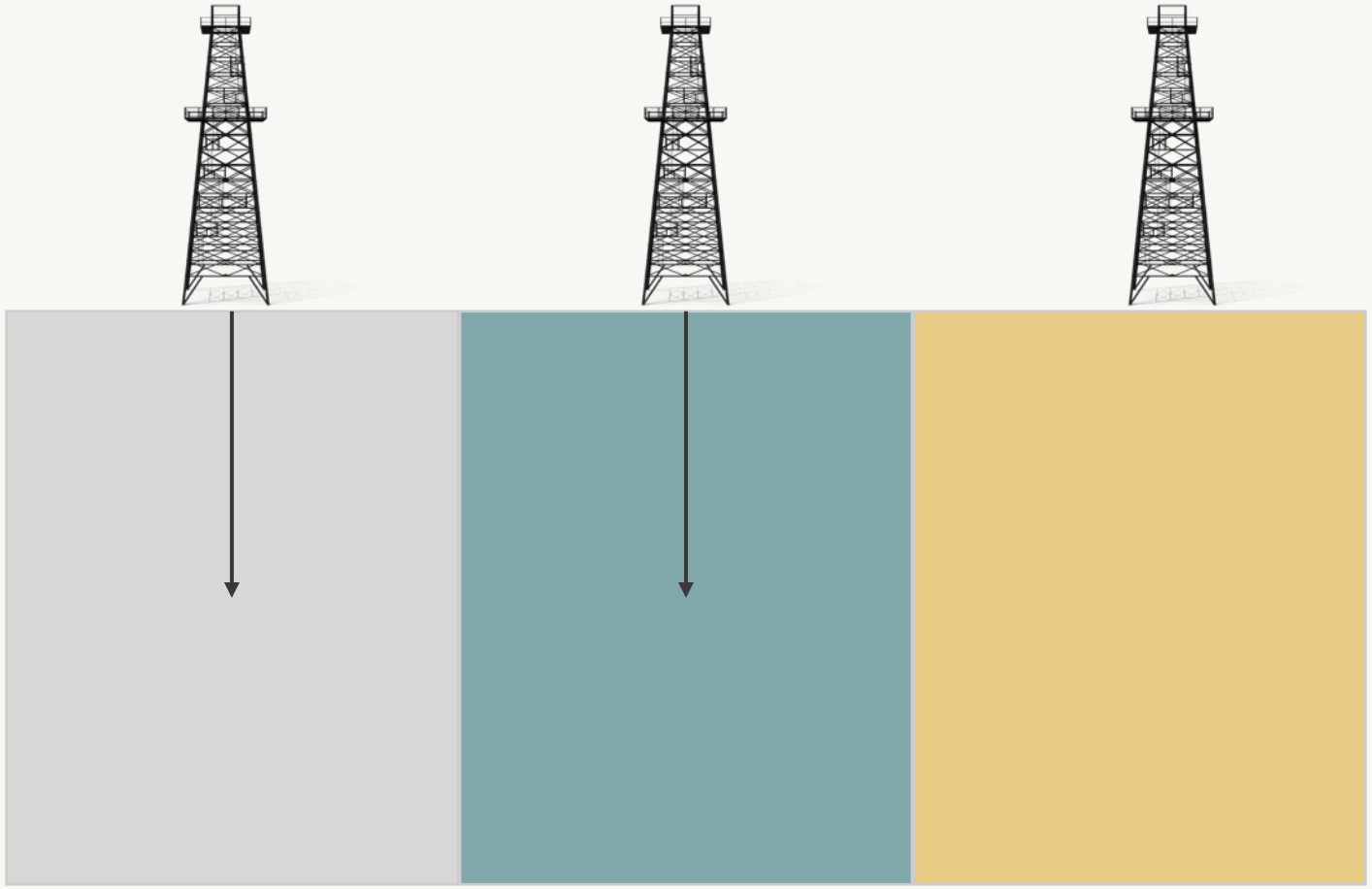
- The RRC has authority to permit commingling
- Developed as a response to combine multiple tracts in the absence of pooling authority or the consent of the working interest or royalty owners
- The RRC will issue a permit to drill a horizontal allocation well where the applicant shows a good-faith claim of a right to drill, which is satisfied by holding leasehold or mineral rights
- The RRC includes a disclaimer on allocation well permits that includes:
  - "Issuance of the permit is not an endorsement or approval of the applicant's stated method of allocating production proceeds among component leases or units."
  - "Payment of royalties is a contractual matter between the lessor and lessee."

Why Do Allocation Wells Exist?

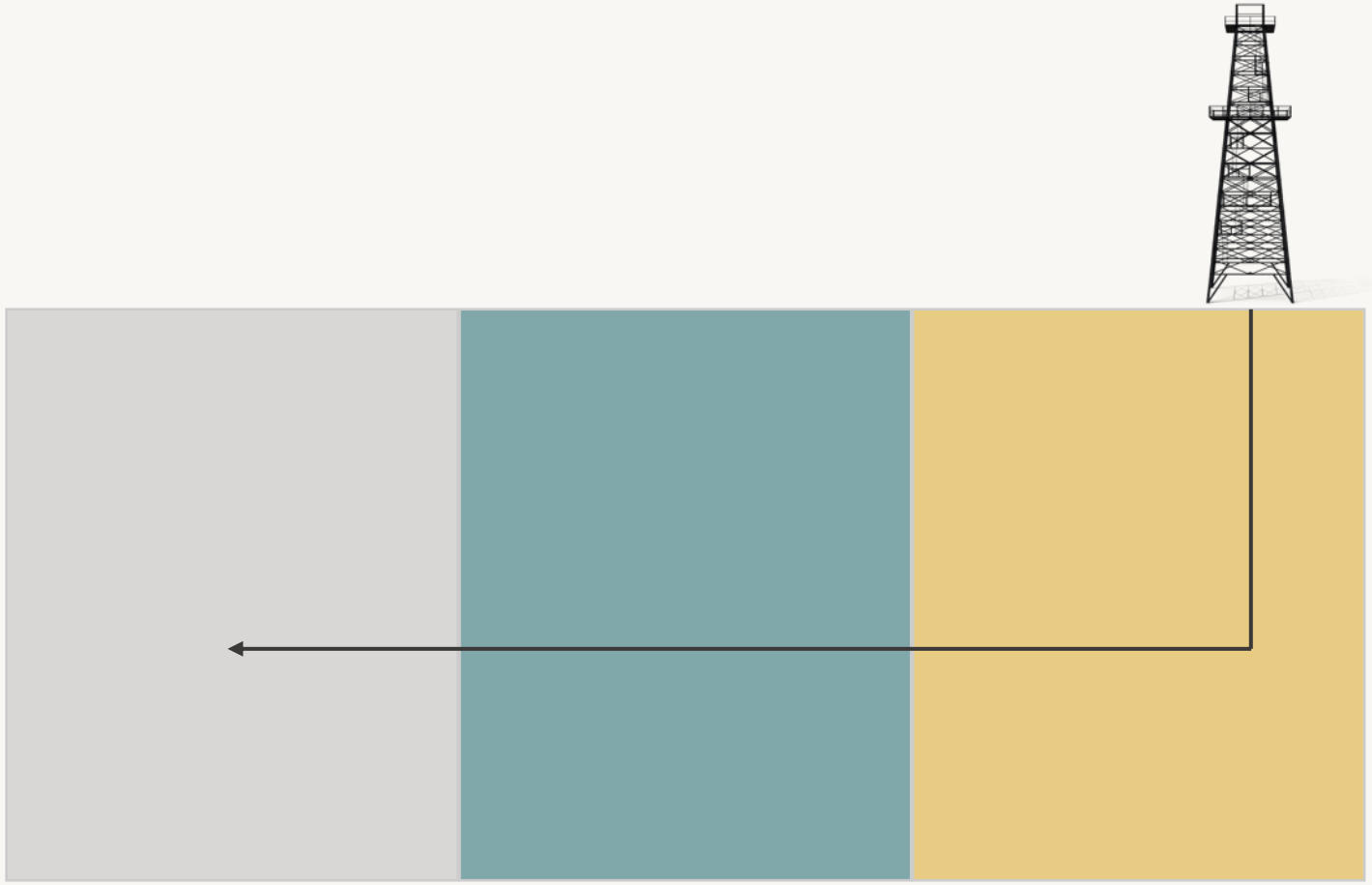


- Restrictive pooling provisions
- Lack of pooling authority
- Existing pooled units

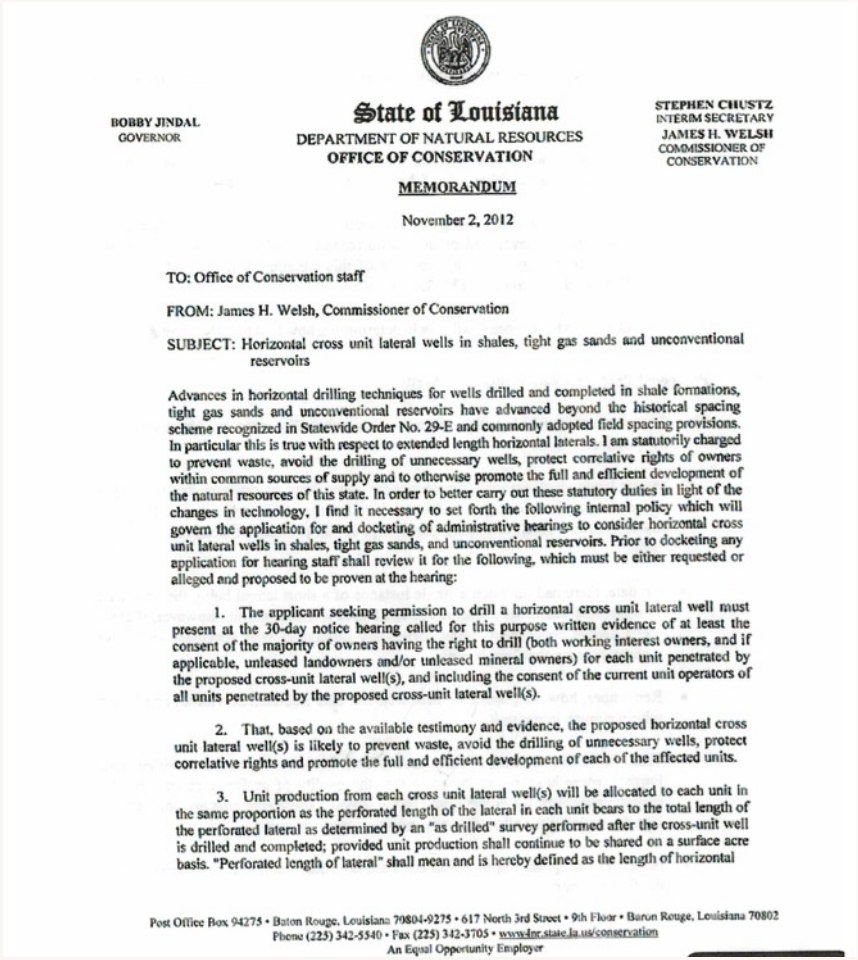
Why Allocation Wells?



Why Allocation Wells? (Cont.)



Louisiana Response to Changes in Drilling Technology



BOBBY JINDAL
GOVERNOR

State of Louisiana
DEPARTMENT OF NATURAL RESOURCES
OFFICE OF CONSERVATION

STEPHEN CHUSTZ
INTERIM SECRETARY
JAMES H. WELSH
COMMISSIONER OF
CONSERVATION

MEMORANDUM

November 2, 2012

TO: Office of Conservation staff

FROM: James H. Welsh, Commissioner of Conservation

SUBJECT: Horizontal cross unit lateral wells in shales, tight gas sands and unconventional reservoirs

Advances in horizontal drilling techniques for wells drilled and completed in shale formations, tight gas sands and unconventional reservoirs have advanced beyond the historical spacing scheme recognized in Statewide Order No. 29-E and commonly adopted field spacing provisions. In particular this is true with respect to extended length horizontal laterals. I am statutorily charged to prevent waste, avoid the drilling of unnecessary wells, protect correlative rights of owners within common sources of supply and to otherwise promote the full and efficient development of the natural resources of this state. In order to better carry out these statutory duties in light of the changes in technology, I find it necessary to set forth the following internal policy which will govern the application for and docketing of administrative hearings to consider horizontal cross unit lateral wells in shales, tight gas sands, and unconventional reservoirs. Prior to docketing any application for hearing staff shall review it for the following, which must be either requested or alleged and proposed to be proven at the hearing:

1. The applicant seeking permission to drill a horizontal cross unit lateral well must present at the 30-day notice hearing called for this purpose written evidence of at least the consent of the majority of owners having the right to drill (both working interest owners, and if applicable, unleased landowners and/or unleased mineral owners) for each unit penetrated by the proposed cross-unit lateral well(s), and including the consent of the current unit operators of all units penetrated by the proposed cross-unit lateral well(s).

2. That, based on the available testimony and evidence, the proposed horizontal cross unit lateral well(s) is likely to prevent waste, avoid the drilling of unnecessary wells, protect correlative rights and promote the full and efficient development of each of the affected units.

3. Unit production from each cross unit lateral well(s) will be allocated to each unit in the same proportion as the perforated length of the lateral in each unit bears to the total length of the perforated lateral as determined by an "as drilled" survey performed after the cross-unit well is drilled and completed; provided unit production shall continue to be shared on a surface acre basis. "Perforated length of lateral" shall mean and is hereby defined as the length of horizontal

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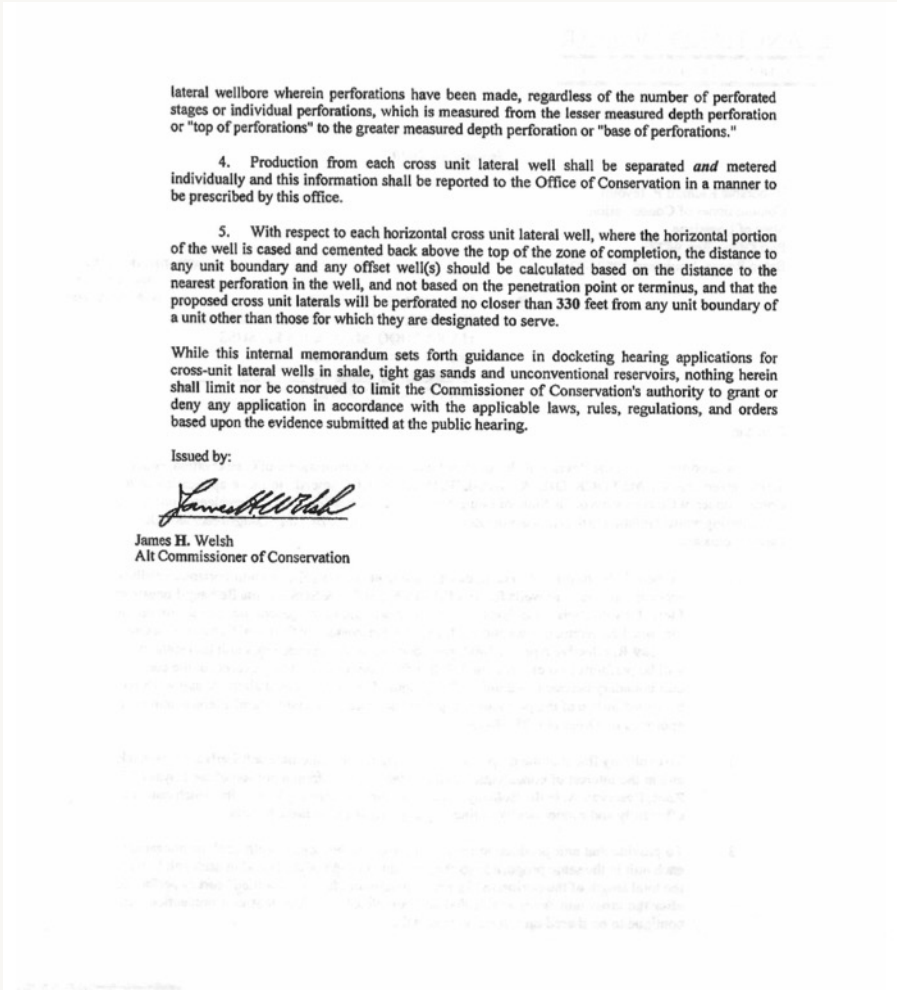


lateral wellbore wherein perforations have been made, regardless of the number of perforated stages or individual perforations, which is measured from the lesser measured depth perforation or "top of perforations" to the greater measured depth perforation or "base of perforations."

4. Production from each cross unit lateral well shall be separated ***and*** metered individually and this information shall be reported to the Office of Conservation in a manner to be prescribed by this office.

5. With respect to each horizontal cross unit lateral well, where the horizontal portion of the well is cased and cemented back above the top of the zone of completion, the distance to any unit boundary and any offset well(s) should be calculated based on the distance to the nearest perforation in the well, and not based on the penetration point or terminus, and that the proposed cross unit laterals will be perforated no closer than 330 feet from any unit boundary of a unit other than those for which they are designated to serve.

While this internal memorandum sets forth guidance in docketing hearing applications for cross-unit lateral wells in shale, tight gas sands and unconventional reservoirs, nothing herein shall limit nor be construed to limit the Commissioner of Conservation's authority to grant or deny any application in accordance with the applicable laws, rules, regulations, and orders based upon the evidence submitted at the public hearing.

Issued by:

James H. Welsh
Alt Commissioner of Conservation

Cross-Unit Wells

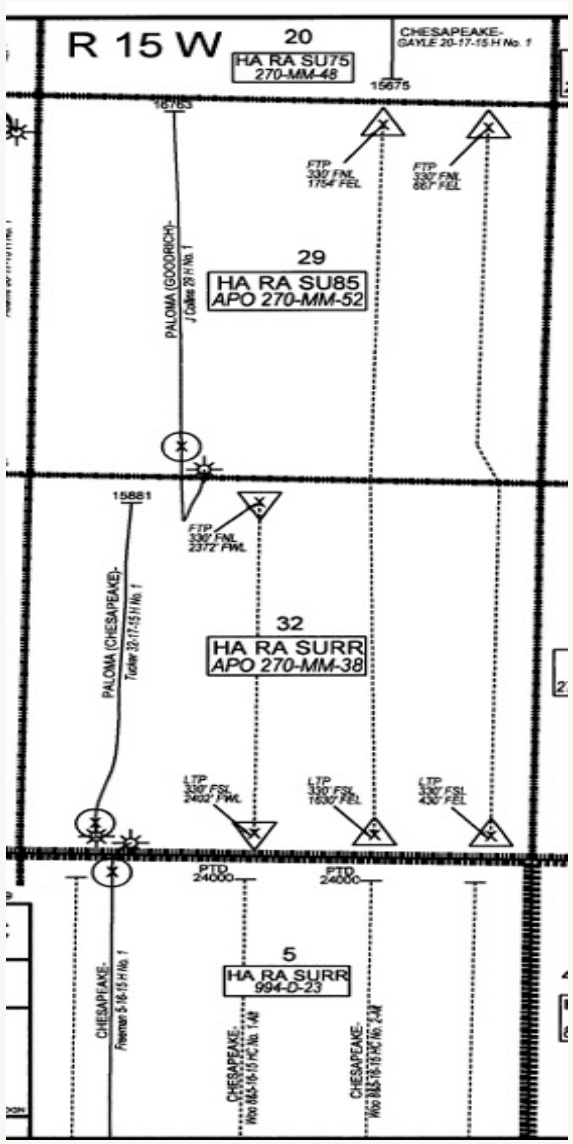
- "Cross-unit well" means a well drilled horizontally and completed under multiple drilling units that is designated by the commissioner after notice and public hearing to serve as a unit well, substitute unit well, or alternate unit well for said units.

- The commissioner shall not authorize or permit a cross-unit well that is proposed to have less than five hundred feet of perforated lateral in any unit to be served by the cross-unit well if one of the following occurs:

    1. The preapplication notice and hearing application do not expressly set forth the cross-unit person's right to object to the application.

    2. A timely objection is filed by a cross-unit person who owns an interest in a short unit and, on the date of the application hearing, the short unit either is not producing or is producing only from one or more horizontal laterals with a combined length of perforated lateral less than five hundred feet.

- -La R.S. 30:9.2

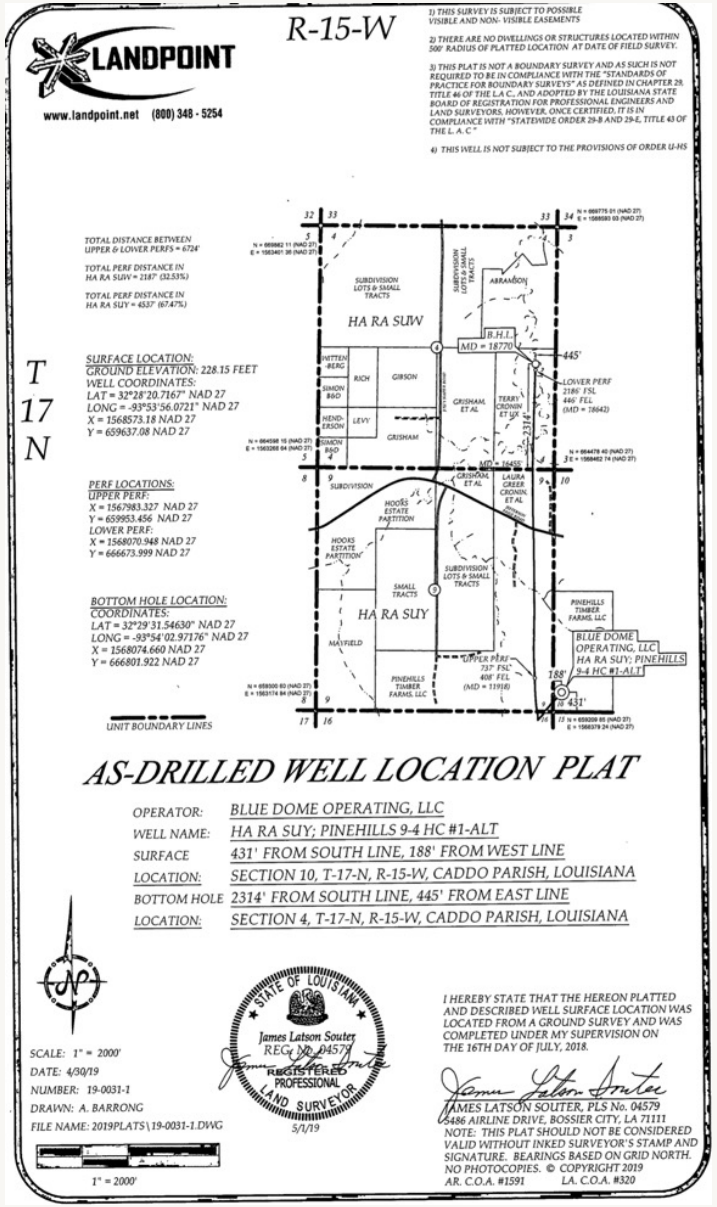


Cross-Unit Wells (Cont.)

- An applicant for a cross-unit well must present evidence that both:
  - (a) the majority of the "owners having the right to drill (both working interest owners and if applicable, unleased mineral owners for each unit penetrated by the proposed cross-unit lateral well(s)" and
  - (b) the operators of each unit penetrated by the proposed cross-unit lateral well, consent to the proposed well

Production from Cross-Unit Wells

- Unit production from each cross-unit lateral well will be allocated to each unit in the same proportion as the perforated length of the lateral in each unit bears to the total length of the perforated lateral as determined by an "as drilled" survey performed after the cross-unit well is drilled and completed
  - "Perforated length of lateral" is defined as the "length of horizontal lateral wellbore wherein perforations have been made, regardless of the number of perforated stages or individual perforations, which is measured from the lesser measured depth perforation or 'base of perforation' to the greater measured depth perforation or 'base of perforation'
  - Production from each cross-unit lateral well shall be separate and metered individually and this information shall be reported to the Office of Conservation in the manner prescribed by this office"
- The production allocated to each unit is then shared between the owners in that unit on a surface acreage basis of participation



As Drilled Survey

- The survey will reflect the length of the lateral between the first perforation and the last perforation = “total perforated length of the lateral”
- The survey will reflect the length of the perforated lateral in each unit. Each unit’s allocation percentage is determined by dividing the perforated length of lateral in that unit by the total perforated length of the lateral

Production from Allocation Wells

- Method to allocate production
  - The Texas Supreme Court has not specified a formula for allocation of production (other than allocation to each tract with reasonable certainty)
- *Humble v. West*, 508 S.W.2d 812 (Tex. 1974)
  - Explaining that the burden of proof is on the commingler of gas to prove each party's share with "reasonable certainty" by expert testimony
- *Springer Ranch v. Jones*, 421 S.W.3d 273 (Tex. App.–San Antonio 2013)
  - Concluding that an expert's opinion that production from multiple tracts allocated on the basis of the horizontal well's distance between first and last take points within the correlative interval was reasonable
- Contrast: When tracts are pooled, production from any tract in the pooled unit is treated as production from every tract in the pooled unit and is allocated to every tract in the pooled unit

Types of Production Sharing Agreements

Designated Area PSA

- Signed by owners within two or more pooled units or leases
- Agreement applies to one or more wells

Single Well PSA

- Signed by owners within two or more pooled units or leases
- Agreement is limited to the identified well

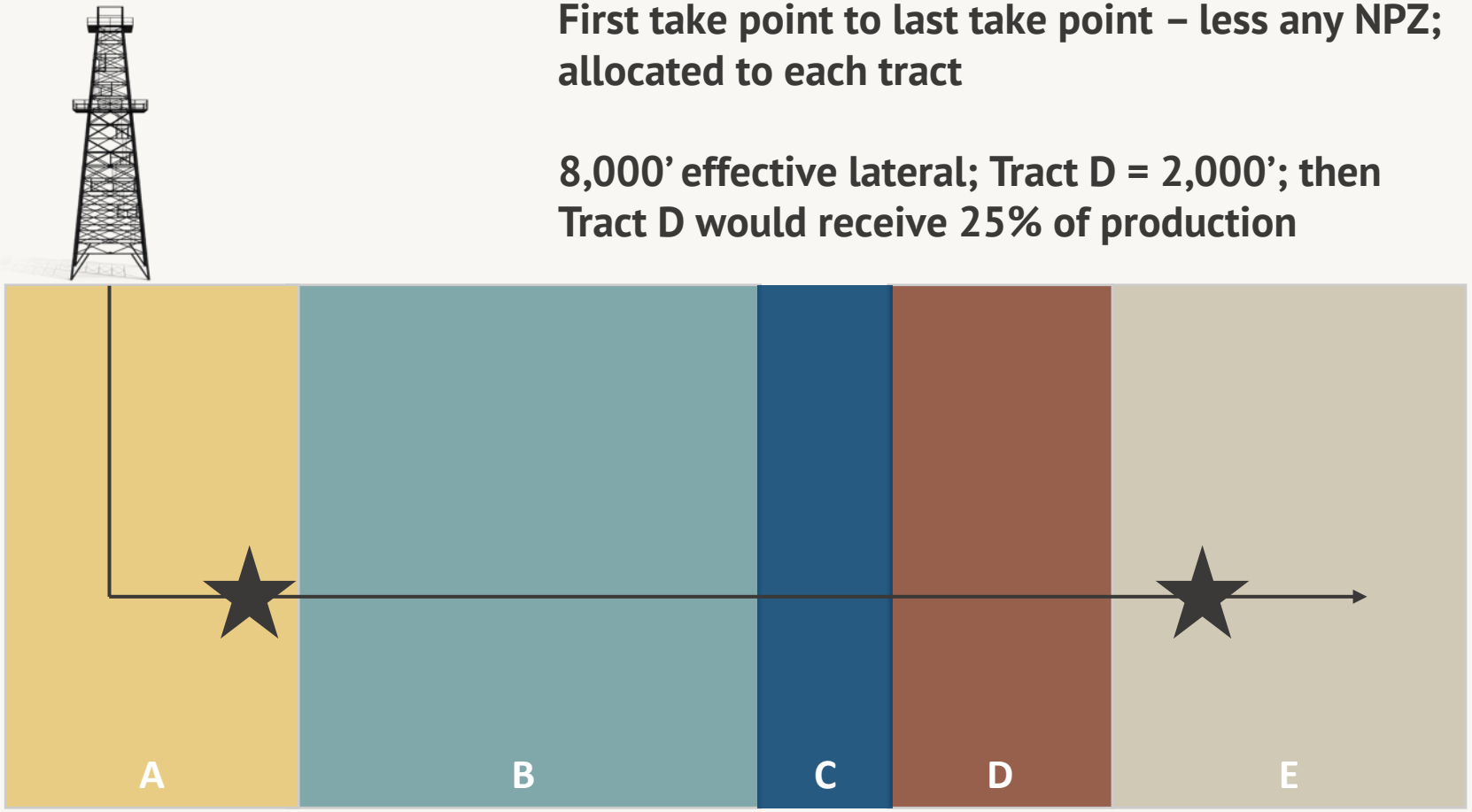
Sharing Well PSA

- Signed by lessors of a lease that may or may not be within an existing pooled unit authorizing the lessees/operator to allocate production from a “sharing well” (one or more horizontal wells that traverse lease or pooled unit or other lands)
- Lessee may include the lease/pooled unit in more than one shared well
- No specific acreage is designated in the agreement

Methods for Calculating Interests in Texas

- Productive lateral length
- Percentage of horizontal lateral
- The number of take points within a tract compared to the total number of take points along the lateral
- Surface acreage

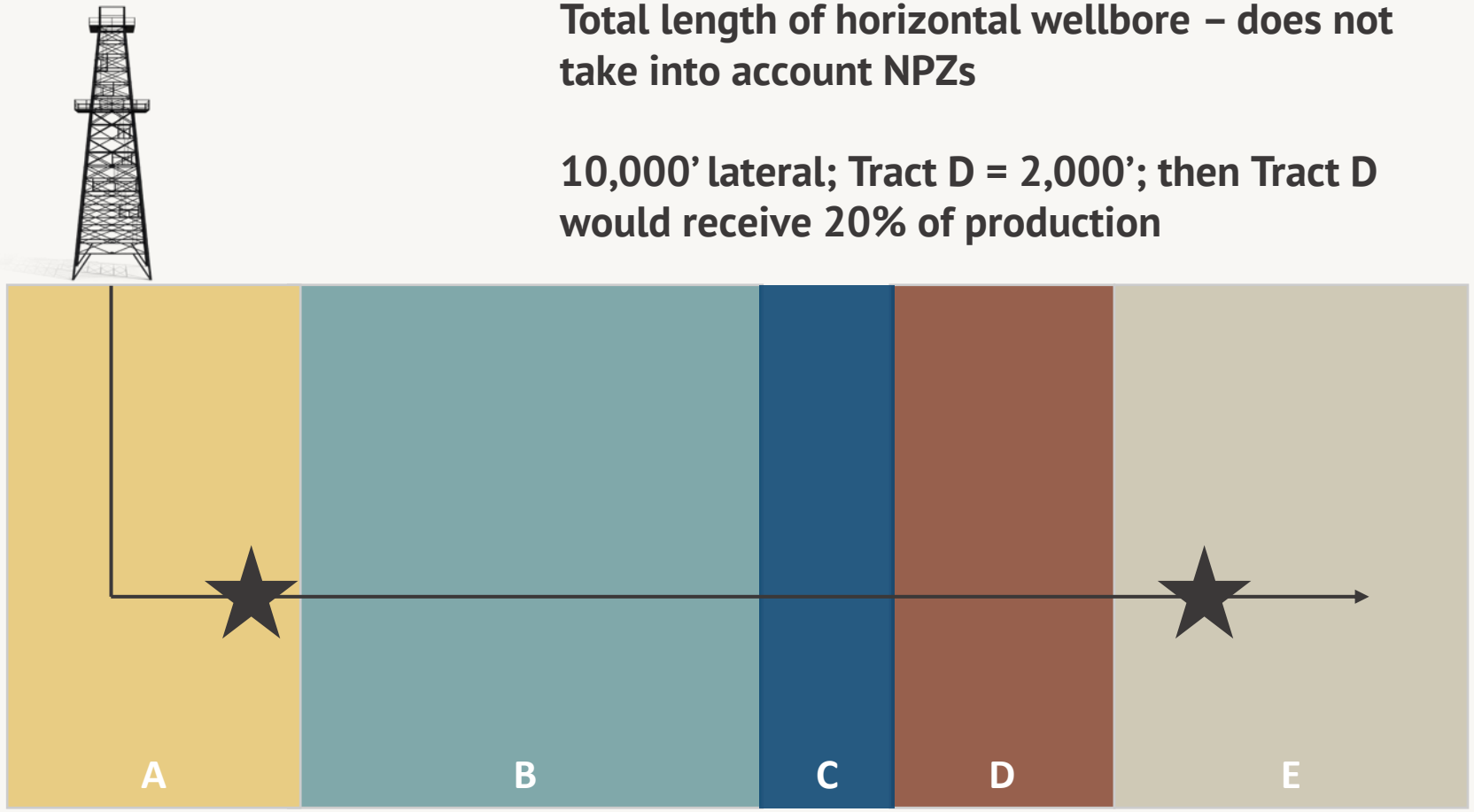
Productive/Effective Lateral Length



First take point to last take point – less any NPZ; allocated to each tract

8,000' effective lateral; Tract D = 2,000'; then Tract D would receive 25% of production

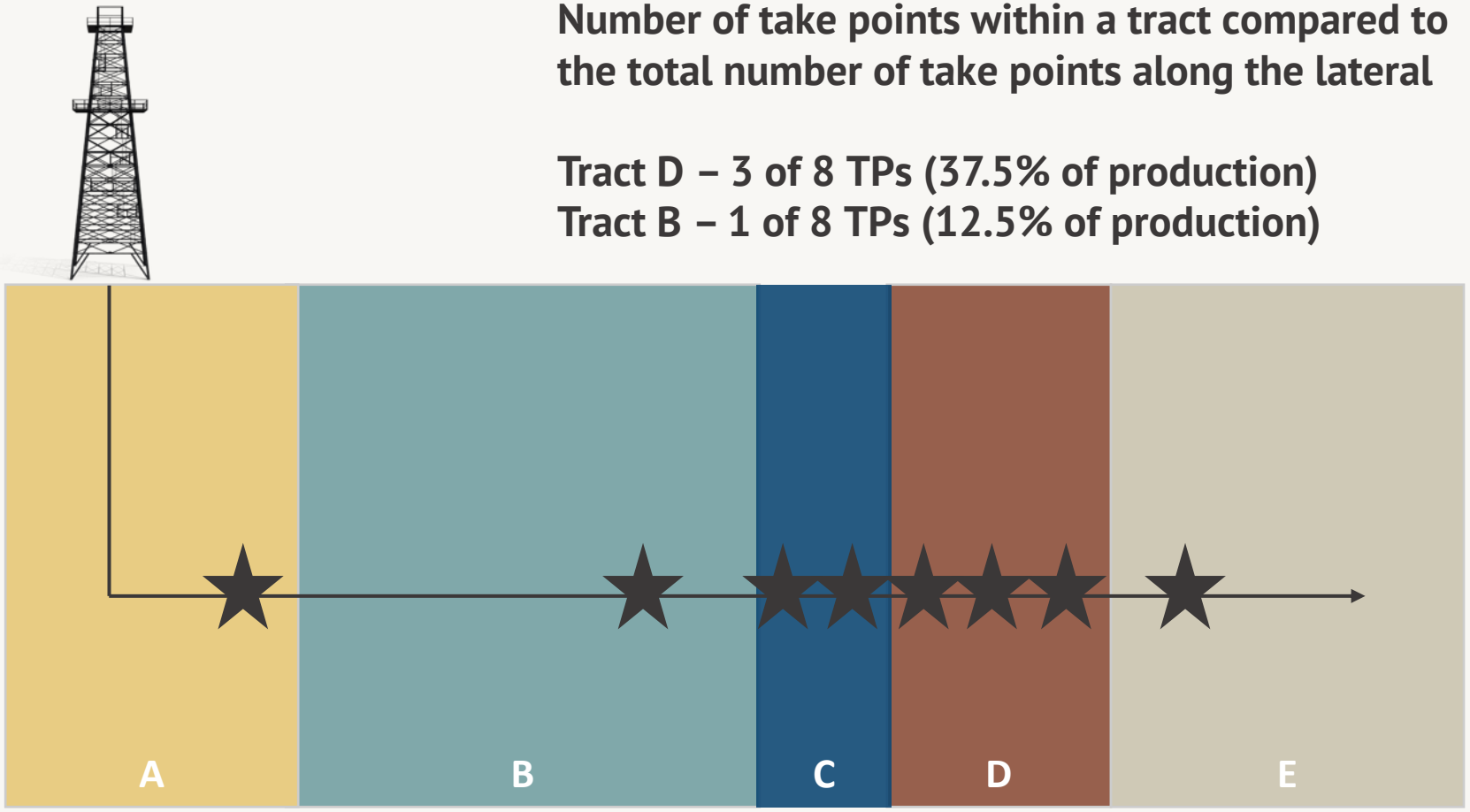
Percentage of Horizontal Lateral



Total length of horizontal wellbore – does not take into account NPZs

10,000' lateral; Tract D = 2,000'; then Tract D would receive 20% of production

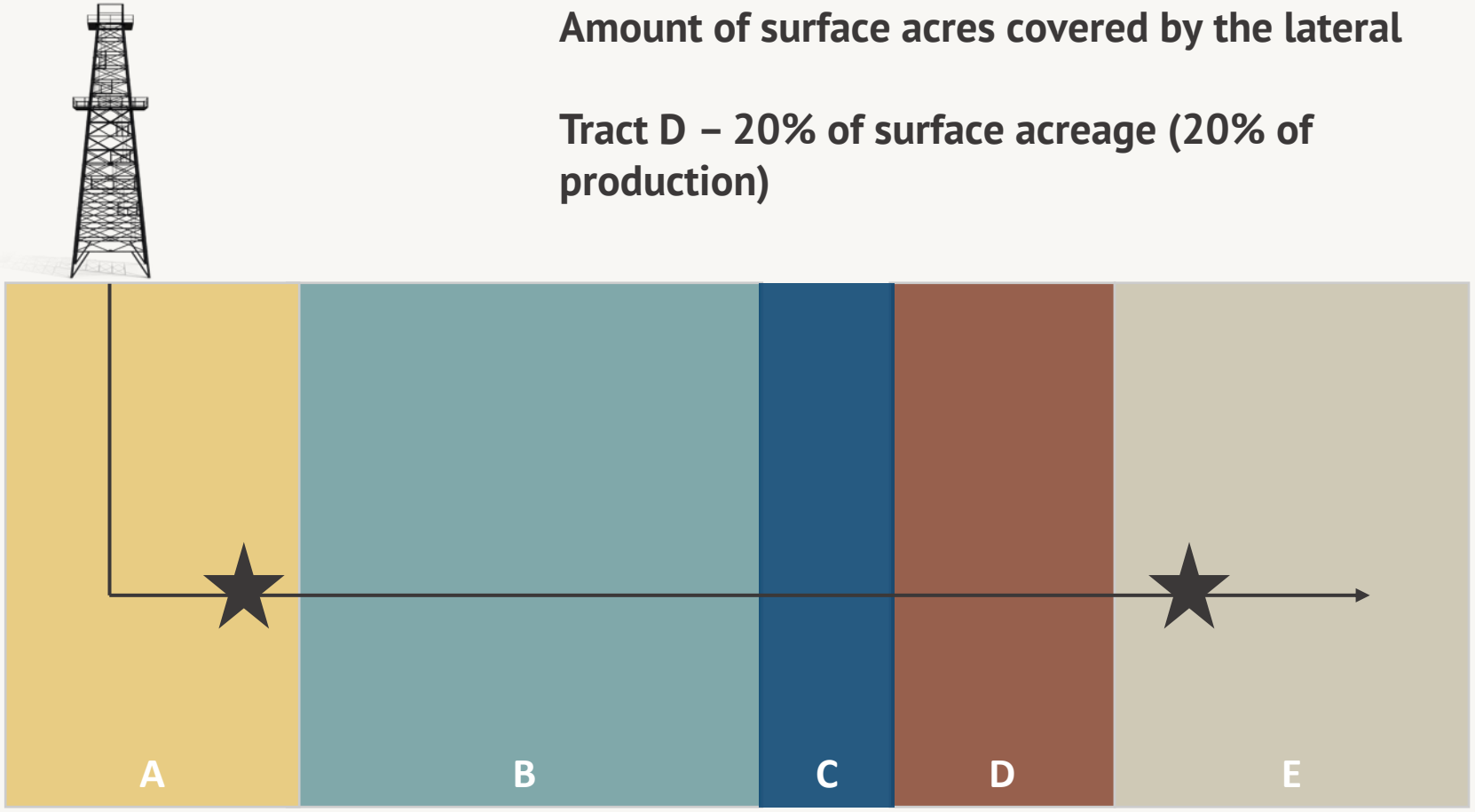
Take Points



Number of take points within a tract compared to the total number of take points along the lateral

Tract D – 3 of 8 TPs (37.5% of production)
Tract B – 1 of 8 TPs (12.5% of production)

Surface Acreage



Amount of surface acres covered by the lateral

Tract D – 20% of surface acreage (20% of production)

Patrick Schenkel

Partner, Oliva Gibbs LLP

I focus my practice on **due diligence, complex mineral titles, pooling issues, lease analysis, joint operating agreements, surface use issues, title curative, regulatory, and general upstream matters.**

LOCATION

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BAR ADMISSIONS

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EDUCATION

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J.D., Loyola University New Orleans College of Law

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