

THE AGE OF ALLOCATION: THE END OF POOLING AS WE KNOW IT?

*Clifton A. Squibb**

I.	INTRODUCTION	930
II.	BACKGROUND	931
	<i>A. Background: The Klotzman (Allocation) #1H</i>	931
	<i>B. Allocation vs. Pooling</i>	932
III.	ESTABLISHED LEGAL PRINCIPLES FOR HORIZONTAL AND ALLOCATION WELLS	934
	<i>A. Nature of Horizontal Wells</i>	934
	<i>B. Actions Against Allocation-Well Lessees</i>	935
	<i>1. Exceeding the Implied Easement</i>	935
	<i>2. Improper Allocation Under Browning v. Luecke</i>	936
	<i>3. Legality of Allocation Wells</i>	938
IV.	MAY THE RRC ISSUE A PERMIT FOR AN ALLOCATION WELL?	938
	<i>A. Permitting Standard</i>	938
	<i>B. Established Commission Policy</i>	940
	<i>1. Allocation-Well Permits</i>	940
	<i>2. PSA-Well Permits</i>	940
	<i>3. Precedential Value of Prior Policy</i>	941
V.	DOES AN ALLOCATION WELL IMPLY POOLING?	942
	<i>A. Rule 40 Permissiveness</i>	942
	<i>B. Defining “Pooling”</i>	942
	<i>1. Pooling as a Method of Allocation</i>	943
	<i>2. Lease Perpetuation by Pooling</i>	944
	<i>3. Limitation of Pooling to Real-Property Interests</i>	945
	<i>C. Wellbore Pooling</i>	946
	<i>D. Weighing the Merits of the Implied-Pooling Argument</i>	946
VI.	DO COMMINGLING STATUTES PROHIBIT ALLOCATION WELLS? SHOULD THEY?	947
	<i>A. Multi-Completion Commingling</i>	948
	<i>1. Rules 6 & 10</i>	948
	<i>2. Statutory Foundations</i>	949
	<i>3. Applicability to Allocation Wells</i>	949

* Clifton A. Squibb is a founding partner of Hamilton & Squibb, LLP. Board certified in Oil, Gas & Mineral Law by the Texas Board of Legal Specialization, his practice focuses primarily on oil and gas law, including title and transactional matters. He earned a B.A. from the University of Virginia in 2001, an MSc from the London School of Economics & Political Science in 2002, and a J.D. from the Southern Methodist University Dedman School of Law in 2005. The author thanks Matthew E. Comeaux for his assistance in researching the subject matter of this Article.

4. Policy Considerations	949
B. Surface Commingling	950
1. Rules 26 & 27	950
2. Statutory Foundations	951
3. Applicability to Allocation Wells	952
4. Policy Considerations	952
C. Judicial Treatment of Commingling Regulation	954
D. Intra-Lease Allocation	955
E. The Future of Allocation-Well Commingling	956
VII. CONCLUSION	956

I. INTRODUCTION

Before commencing operations for an oil or gas well in Texas, an operator must secure a permit from the Texas Railroad Commission (the Commission or RRC).¹ Operators applying for permits to drill horizontal wells must conform to regulations known as Rules 37, 38, and 86, which set forth spacing and density principles that determine whether a well may be drilled at a given location or along a particular path on the applicant's tract.² Where leases cover smaller tracts of land, operators have historically exercised pooling rights, pooling the leases with other adjoining interests into a larger unit that will support the length needed for a horizontal well under spacing and density requirements.³ Yet, pooling of the royalty interest in a lease requires the express consent of the owner of the royalty interest.⁴ Absent pooling authority granted in a lease or separate agreement, an operator has no basis on which to pool a lease.⁵

In recent years, operators under leases with no pooling authority or stringent pooling provisions have applied for and received permits to drill "allocation wells."⁶ An allocation well is a horizontal well that traverses the boundary between two or more leases that have not been pooled and for which no agreement exists among the royalty owners as to how production will be shared.⁷ Recently, an application by EOG Resources, Inc. to drill an allocation

1. See 16 TEX. ADMIN. CODE § 3.5 (2012).

2. See *id.* §§ 3.37-38, 3.86.

3. See *id.* § 3.40.

4. See *Jones v. Killingsworth*, 403 S.W.2d 325, 327-28 (Tex. 1965).

5. See *id.*

6. See, e.g., Form W-1, Application for Permit to Drill, Recomplete, or Re-enter of EOG Resources, Inc., API No. 42-123-32480, R.R. Comm'n of Tex. (July 16, 2012) [hereinafter EOG Permit Application], available at <http://webapps.rrc.state.tx.us/DP/drillDownQueryAction.do?fromPublicQuery=Y&name=KLOTZMAN%2B%2528ALLOCATION%2529&univDocNo=487207842>.

7. Letter from Colin K. Lineberry, Dir., Hearings Div., R.R. Comm'n of Tex., to Spencer S. Klotzman, Klotzman Law Firm, LLC, and Doug J. Dashiell, Scott Douglass & McConnico, L.L.P. (Oct. 5, 2012) (on file with the Texas Tech Law Review) [hereinafter Lineberry Letter]; see also Closing Statement of Devon Energy Production Co., L.P., Application of EOG Resources, Inc., Oil and Gas Docket No. 02-0278952, (R.R. Comm'n of Tex. Jan. 11, 2013) (on file with the Texas Tech Law Review) [hereinafter Devon Closing].

well across lease lines was protested by royalty owners under the lease, marking the first occasion when the practice was challenged.⁸

Recognition of allocation wells as an appropriate means of drilling horizontal wells would have far-reaching consequences for the pooling landscape in Texas. Rather than being handicapped by the absence of pooling authority or shackled to restrictive pooling provisions, operators would be free to drill horizontally across lease lines. No representation of pooling authority would need to be made to the Commission.

Whether Texas will ultimately countenance allocation wells appears to turn on the answers to two fundamental questions. First, is an allocation well merely an attempt to pool without the requisite authority? Second, should the commingling of production from two or more leases within the wellbore of an allocation well be regulated by the Commission?

Regardless of whether the Commission grants the permit, the subject of allocation wells is likely to receive further attention. The Commission's decision could be appealed to a court of competent jurisdiction if either party is dissatisfied.⁹ The Commission has taken up at least one application for formal rulemaking,¹⁰ and the legislature could attempt to settle the issue through amendments to the Texas Natural Resources Code.¹¹ The ability to commingle and allocate will surely become a point of negotiation in oil and gas leases. And beyond Texas, other regulatory agencies will soon be wrestling with the same issues.

II. BACKGROUND

A. *Background: The Klotzman (Allocation) #1H*

On July 16, 2012, EOG Resources, Inc. submitted to the Commission an application to drill the Klotzman (Allocation) #1H in the Eagleville (Eagle Ford-2) field in DeWitt County, Texas.¹² The application notes that the productive segment of the horizontal drainhole of the proposed well traverses the boundary between a 516.569-acre lease and a 304.97-acre lease.¹³ Because the proposed well would produce from points within each lease, crowding the boundary line of the adjoining lease, the application requests a Rule 37

8. See Lineberry Letter, *supra* note 7, at 2.

9. TEX. GOV'T CODE ANN. § 2001.171 (West 2011).

10. Petition to Initiate Rulemaking Proceedings to Amend Statewide Rule 40 to Regulate the Drilling of Horizontal Wells That Cross Lease or Unit Boundaries (R.R. Comm'n of Tex. Nov. 30, 2012); Memorandum from Gil Bujano, P.E. Dir., Oil & Gas Div., to Barry T. Smitherman, Chairman, David Porter, Comm'r, and Christi Craddick, Comm'r (Jan. 22, 2013) (on file with author) (noting that "while staff agrees that this area of regulation is in need of clarification beyond existing guidance documents, we recommend that rulemaking not be initiated at this time").

11. See TEX. NAT. RES. CODE ANN. §§ 85.001-.389, 86.001-.225 (West 2011).

12. EOG Permit Application, *supra* note 6.

13. *Id.*

exception—an exception to the minimum spacing requirement.¹⁴ Under applicable law, an offset royalty owner, as the holder of a nonpossessory interest, is not entitled to notice; only an offset mineral-interest or working-interest owner is entitled to notice of a requested exception.¹⁵ Accordingly, under normal circumstances, EOG Resources, Inc., as the working-interest owner under each lease, could have simply waived objection to the exception and received an exception permit administratively.¹⁶ Nonetheless, the royalty owners apparently discovered that a permit for an allocation well was filed and sought a hearing on their own initiative.¹⁷

In a letter to the parties dated October 5, 2012, Colin Lineberry, Director of the Hearings Division, stated his conclusion that “the complainants’ assertions cast sufficient doubt on the applicant’s assertion of a good faith claim to preclude the administrative approval of the requested permit at this juncture.”¹⁸ A hearing on the matter was held on December 3, 2012.¹⁹ In addition to EOG Resources, Inc. and the royalty owners under the leases, a number of oil-and-gas operators and the Texas General Land Office entered appearances.²⁰ EOG Resources, Inc., Devon Energy Production Company, L.P., the Texas General Land Office, and the protestants filed written closing statements and responses with the presiding examiners at the Commission.²¹

B. Allocation vs. Pooling

If allowed by the Commission, the ability to drill an allocation well will serve as a valuable alternative to pooling. Allocation wells allow an operator to drill not only when no pooling authority exists, as in the Klotzman matter, but

14. *Id.*; see also 16 TEX. ADMIN. CODE § 3.37 (2012) (explaining the procedure for requesting an exception to the minimum spacing requirement).

15. *H.G. Sledge, Inc. v. Prospective Inv. & Trading Co.*, 36 S.W.3d 597, 599 (Tex. App.—Austin 2000, pet. denied).

16. See ADMIN. § 3.37(h)(2)(B).

17. Letter from David Gross, Att’y at Law, Gross & Nelson, to Lorenzo Garza, Manager, Drilling Permit Unit, R.R. Comm’n of Tex. (July 20, 2012).

18. See Lineberry Letter, *supra* note 7.

19. Notice of Hearing on the Application of EOG Resources, Inc., Oil and Gas Docket No. 02-0278952 (R.R. Comm’n of Tex. Nov. 6, 2012).

20. See EOG Permit Application, *supra* note 6.

21. See Devon Closing, *supra* note 7; Closing Brief by Protestants Katherine Larson Riley and Melanie McCollum Klotzman, Oil and Gas Docket No. 02-0278952 (R.R. Comm’n of Tex. Jan. 4, 2013) (on file with the Texas Tech Law Review) [hereinafter Klotzman Closing]; Closing Statement of the Texas General Land Office, Oil and Gas Docket No. 02-0278952 (R.R. Comm’n of Tex. Jan. 4, 2013) (on file with the Texas Tech Law Review); Closing Statement of EOG Resources, Inc., Oil and Gas Docket No. 02-0278952 (R.R. Comm’n of Tex. Jan. 4, 2013) (on file with the Texas Tech Law Review) [hereinafter EOG Closing]; Protestants’ Response to Closing Statements, Oil and Gas Docket No. 02-0278952 (R.R. Comm’n of Tex. Jan. 11, 2013) (on file with the Texas Tech Law Review) [hereinafter Klotzman Reply]; EOG Resources Inc.’s Reply Closing Statement, Oil and Gas Docket No. 02-0278952 (R.R. Comm’n of Tex. Jan. 11, 2013) (on file with the Texas Tech Law Review) [hereinafter EOG Reply]; Reply Closing Statement of Devon Energy Productions Co., L.P., Oil and Gas Docket No. 02-0278952 (R.R. Comm’n of Tex. Jan. 11, 2013) (on file with the Texas Tech Law Review); EOG Permit Application, *supra* note 6.

also when restrictive pooling provisions make pooling difficult or overly burdensome.²²

Drilling an allocation well in lieu of a pooled-unit well has disadvantages. First, pooling affords a lessee greater operational flexibility. When all interests in a unit are pooled, an operator may drill, and the division of interests will be equal from well to well.²³ By contrast, payment obligations under allocation wells must be calculated on a well-by-well basis. Second, without a pooling provision or other agreement, lessors do not bind themselves to a specific formula under which production will be allocated.²⁴ The absence of an agreed-upon formula creates room for disputes over the operator's allocation method.²⁵ Finally, without pooling, an allocation well cannot maintain non-drill-site leases in force.²⁶ Operations on and production from an allocation well hold only those leases in force that are traversed by the well.²⁷

An operator's election to drill an allocation well instead of a pooled-unit well has implications for nonconsenting mineral and royalty interest owners as well. Unleased, undivided mineral interests and nonparticipating royalty interests within the boundaries of pooled units are frequently situated within non-drill-site tracts or in tracts that are underrepresented by the wellbore relative to their share of surface acreage in a unit.²⁸ In those situations, an unleased mineral owner may ratify the lease executed by a mineral cotenant.²⁹ Likewise, a nonparticipating royalty-interest owner will typically ratify the lease signed by the owner of the executive rights corresponding to the interest and begin participating in production.³⁰ But, in the absence of the actual pooling of the cotenant's mineral interest or the mineral interest from which the nonparticipating royalty was carved, there has been no pooling that can be ratified.³¹ Therefore, if an allocation well is drilled, an undivided mineral-interest owner or nonparticipating royalty-interest owner in a non-drill-site tract is excluded from participation in the well.³²

22. See sources cited *supra* note 21.

23. See 2 ERNEST E. SMITH & JACQUELINE LANG WEAVER, TEXAS LAW OF OIL & GAS § 11.1(B), at 11-2 to -4 (2d ed. 2000).

24. See *Browning Oil Co. v. Luecke*, 38 S.W.3d 625, 634 (Tex. App.—Austin 2000, pet. denied).

25. See *id.*

26. See *id.*

27. See *id.* at 634-35.

28. See *Montgomery v. Rittersbacher*, 424 S.W.2d 210, 214-15 (Tex. 1968); *Superior Oil Co. v. Roberts*, 398 S.W.2d 276, 276-77 (Tex. 1966); *Ruiz v. Martin*, 559 S.W.2d 839, 840 (Tex. App.—San Antonio 1977, writ ref'd n.r.e.).

29. *Roberts*, 398 S.W.2d at 279.

30. *Montgomery*, 424 S.W.2d at 214-15; *Ruiz*, 559 S.W.2d at 843.

31. See *Ruiz*, 559 S.W.2d at 843.

32. See *Montgomery*, 424 S.W.2d at 213.

III. ESTABLISHED LEGAL PRINCIPLES FOR HORIZONTAL AND ALLOCATION WELLS

The legislature has delegated authority to the Commission to regulate oil-and-gas activity within the framework of existing Texas law.³³ Understanding the regulatory aspects of the allocation-well debate requires an examination of the posture of Texas law governing horizontal wells drilled across boundaries between unpooled interests.

A. Nature of Horizontal Wells

Under Texas law, each tract penetrated by a horizontal wellbore is considered a drill-site tract.³⁴ Absent a pooling or an allocation agreement, production is allocated to the owners of the mineral estate in the tract where minerals are captured by the wellbore.³⁵ Additionally, under recently adopted field rules regulating where horizontal wells are drilled, the Commission has adopted a “take point” rule.³⁶ Under the rule, take points—points of production along a horizontal drainhole—must comply with spacing requirements, though segments of the wellbore containing no perforations (called NPZs or non-perf zones) do not require exceptions.³⁷

33. TEX. NAT. RES. CODE ANN. § 85.201 (West 2011); *Texaco, Inc. v. R.R. Comm’n*, 583 S.W.2d 307, 310 (Tex. 1979).

34. See *Browning Oil Co. v. Luecke*, 38 S.W.3d 625, 634 (Tex. App.—Austin 2000, pet. denied).

35. See *Japhet v. McRae*, 276 S.W. 669, 670 (Tex. Comm’n App. 1925, judgm’t adopted).

36. See R.R. Comm’n of Tex., *Application of EOG Resources, Inc. to Amend and Make Permanent the Field Rules for the Eagleville (Eagle Ford-2) Field, De Witt, Karnes, Lavaca and Live Oak Counties, Texas*, Oil and Gas Docket No. 02-0274324 (Apr. 5, 2012) (proposal for decision), available at <http://www.rrc.state.tx.us/meetings/ogpfd/ogpofldrules/1-743232-7432413609pfd.pdf>; R.R. Comm’n of Tex., *Application of EOG Resources, Inc. to Amend and Make Permanent the Field Rules for the Eagleville (Eagle Ford-1) Field, Atascosa, Dimmit, Gonzales, La Salle, McMullen, Wilson and Zavala Counties, Texas*, Oil and Gas Docket No. 01-0274323 (Apr. 5, 2012) (proposal for decision), available at <http://www.rrc.state.tx.us/meetings/ogpfd/ogpofldrules/1-743232-7432413609pfd.pdf>; R.R. Comm’n of Tex., *Application of Murphy Expl. & Prod. Co.-USA to Adopt Temporary Field Rule Nos. 5 and 6 for the Eagleville (Eagle Ford-2) Field, De Witt and Karnes Counties, Texas*, Oil and Gas Docket No. 02-0271345 (July 21, 2011) (proposal for decision), available at <http://www.rrc.state.tx.us/meetings/ogpfd/ogpofldrules/2-71345pfd.pdf>; R.R. Comm’n of Tex., *Application of EOG Resources, Inc. to Establish the Eagleville (Eagle Ford-1) Field and to Adopt Temporary Field Rules for the Proposed Eagleville (Eagle Ford-1) Field, Atascosa, Gonzales, La Salle, McMullen and Wilson Counties, Texas*, Oil and Gas Docket No. 01-0266450, (Oct. 5, 2010) (proposal for decision), available at <http://www.rrc.state.tx.us/meetings/ogpfd/ogpofldrules/1-66450.75.77.pdf>; R.R. Comm’n of Tex., *Application of EOG Resources, Inc. to Establish the Eagleville (Eagle Ford-2) Field and to Adopt Temporary Field Rules for the Proposed Eagleville (Eagle Ford-2) Field, De Witt and Karnes Counties, Texas*, Oil and Gas Docket No. 02-0266475 (Oct. 5, 2010) (proposal for decision), available at <http://www.rrc.state.tx.us/meetings/ogpfd/ogpofldrules/1-66450.75.77.pdf>; R.R. Comm’n of Tex., *Application of EOG Resources, Inc. to Consider a New Field Designation for the Eagleville (Eagle Ford-1 Sour) Field and to Adopt Temporary Field Rules for the Proposed Eagleville (Eagle Ford-1 Sour) Field, Atascosa and McMullen Counties, Texas*, Oil and Gas Docket No. 01-0266477 (Oct. 5, 2010) (proposal for decision), available at <http://www.rrc.state.tx.us/meetings/ogpfd/ogpofldrules/1-66450.75.77.pdf>.

37. *Id.*

For regulatory purposes, therefore, a horizontal well is tantamount to a series of vertical wells drilled along the linear path of the horizontal wellbore with each take point being the equivalent of the production point at the bottomhole of a vertical well.³⁸ In theory, the two scenarios generate identical results with respect to production beneath the surface. If perforations and fracturing treatments at the take points yield identical contact with the formation, production will be the same under each scenario.³⁹ Likewise, separate horizontal wells could be drilled on adjacent tracts to establish identical exposure to the formation as the single horizontal well.⁴⁰

Under typical circumstances, a lessor would have no basis for objecting to either the series of vertical wells or the pair of horizontal wells.⁴¹ If both leases are developed, neither lessor will hold a claim for breach of a duty to protect the leasehold by drilling an offset well.⁴² Texas law is now settled that fractures from the offset wells extending beneath the lease are protected under the rule of capture.⁴³ As such, neither scenario gives rise to an actionable trespass claim.⁴⁴ Because allocation wells are protected under the rule of capture,⁴⁵ the universe of possible claims by an opponent of an allocation well is small. The basis for any such claim arises from the distinction between an allocation well and an aggregation of wells that achieve identical results—namely, the fact that production from all take points is captured within a single drainhole.⁴⁶

B. Actions Against Allocation-Well Lessees

1. Exceeding the Implied Easement

One possible claim against an allocation-well lessee is that the use of the surface and subsurface of a lease to drill and operate an allocation well exceeds the implied easement granted under the lease.⁴⁷ Under Texas law, the

38. *Luecke*, 38 S.W.3d at 634 (equating a take point with a drill site).

39. *Id.* at 635.

40. *Id.* at 634-35.

41. *See, e.g.*, *Natural Gas Pipeline Co. of Am. v. Pool*, 124 S.W.3d 188, 192-93 (Tex. 2003) (stating that a lessor grants a lessee a fee simple determinable in the minerals so the lessee owns the minerals in place, while the lessor gives up his right to the minerals).

42. *Tex. Pac. Coal & Oil Co. v. Barker*, 6 S.W.2d 1031, 1035 (Tex. 1928).

43. *See Coastal Oil & Gas Corp. v. Garza Energy Trust*, 268 S.W.3d 1, 17 (Tex. 2008).

44. *Id.* at 12-13.

45. *Id.* at 13.

46. *Id.* at 29.

47. *See, e.g.*, *Robinson v. Robbins Petrol. Corp., Inc.*, 501 S.W.2d 865, 867 (Tex. 1973) (declaring that an operator cannot use water from one tract of land for the benefit of production on another tract); *Cole v. Anadarko Petrol. Corp.*, 331 S.W.3d 30, 36 (Tex. App.—Eastland 2010, pet. denied) (stating that a lessor must ratify a unitization agreement for a lessee to include those minerals in a unit); *Delhi Gas Pipeline Corp. v. Dixon*, 737 S.W.2d 96, 97-98 (Tex. App.—Eastland 1987, writ denied) (holding that a lessee has an implied easement to use the surface only as is reasonably necessary for production); *TDC Eng'g, Inc. v. Dunlap*, 686 S.W.2d 346, 348 (Tex. App.—Eastland 1985, writ ref'd n.r.e.) (holding that an operator did not have “the right to inject salt water into [a] nonproductive well”).

determinable fee in the mineral estate granted under a lease is dominant to the surface estate.⁴⁸ Therefore, a lessee may use so much of the servient surface estate as is reasonably necessary to develop its minerals.⁴⁹ In an allocation well, the segment of the horizontal wellbore within the lease is being used to benefit not only the lease but also the tracts traversed by the well that are outside the lease (with which the mineral estate has not been pooled).⁵⁰

Unfortunately for many lessors, in the absence of interference with or injury to, the mineral estate, a mineral-interest owner has no actionable claim that an operator has exceeded his easement under a lease.⁵¹ Consequently, this argument is likely unavailing if the mineral owner holds no corresponding interest in the surface estate. Moreover, according to one court examining the legality of a pipeline that benefitted lands beyond a pooled unit, “[T]he mere fact that incidental non-unit activities have taken place does not establish a cause of action absent evidence that these activities caused damage.”⁵² In all likelihood, the segment of the wellbore within the lease will be identical to a wellbore that terminates at the lease boundary. Unless the wellbore or surface facilities are configured in a manner that increases the burden of the use on the surface estate, proving damages will be difficult.⁵³

2. *Improper Allocation Under Browning v. Luecke*

The principal case addressing the consequences of drilling horizontal wells across unpooled interests is *Browning Oil Co. v. Luecke*.⁵⁴ In that case, a lessee was bound by an anti-dilution provision restricting the quantity of lease acreage that could be pooled with the lease.⁵⁵ Unable to secure an amendment, the lessee, nonetheless, filed a pooling instrument purporting to designate a pooled unit that failed to comply with the anti-dilution provision and proceeded to drill horizontal wells across the unit.⁵⁶

The court of appeals acknowledged the rule that a lessee must strictly comply with the pooling provisions in the lease⁵⁷ and held that it must account to the lessor for production on an unpooled basis.⁵⁸ Rejecting the lessors’ argument that the “confusion of goods” doctrine required payment of royalty on all production from the well, the court held that the operator owed damages

48. Warren Petrol. Corp. v. Martin, 271 S.W.2d 410, 413 (Tex. 1954).

49. *Id.*

50. *See supra* text accompanying notes 6-7.

51. *See, e.g.*, Coastal Oil & Gas Corp. v. Garza Energy Trust, 268 S.W.3d 1, 12-13 n.31 (Tex. 2008).

52. *Cole*, 331 S.W.3d at 37.

53. *See Vest v. Exxon Corp.*, 752 F.2d 959, 961-63 (5th Cir. 1985); Warren Petrol. Corp. v. Monzingo, 304 S.W.2d 362, 363 (Tex. 1957).

54. *Browning Oil Co. v. Luecke*, 38 S.W.3d 625, 632 (Tex. App.—Austin 2000, pet. denied).

55. *Id.* at 637.

56. *Id.* at 638-39.

57. *Id.* at 640; *see also* Se. Pipe Line Co. v. Tichacek, 997 S.W.2d 166, 170 (Tex. 1999); Jones v. Killingsworth, 403 S.W.2d 325, 327-28 (Tex. 1965).

58. *Luecke*, 38 S.W.3d at 644-47.

based upon “a determination of what production can be attributed to their tracts with *reasonable probability*.”⁵⁹ The Supreme Court of Texas has not addressed what standard governs damages for production from unpooled interests along a horizontal well. Until it does, it appears that, under *Luecke*, a lessee may allocate production on an unpooled basis, without liability under the confusion-of-goods theory, provided it can establish with reasonable probability what production originates from the segment or segments of the drainhole within the unpooled lease.⁶⁰

The decision generated a variety of formulae employed by operators who must account to unpooled interests hosting a portion of a horizontal well. Typically, these consist of calculating either (1) the length of a horizontal drainhole within a tract relative to total length within the correlative interval or (2) the number of take points within a tract relative to the total number along the entire horizontal drainhole.⁶¹ These ratios may be altered to reflect engineering factors such as variances in the strength of fracturing treatments along the wellbore and geological considerations such as variances in porosity and permeability and differences in the number of acre-feet in the reservoir surrounding different spans of the wellbore.⁶²

A lessee has an implied duty to manage and administer a lease.⁶³ To do so, it must account to the lessor as would a reasonably prudent operator acting for the mutual advantage of both parties.⁶⁴ This implied contractual obligation is brought to bear in the standard announced in *Luecke*.⁶⁵ Accordingly, if an operator’s method does not establish with reasonable probability what production is attributable to a lease, the lessor may claim damages.⁶⁶ Naturally, failure by an operator to narrowly tailor allocation to the geological and engineering conditions surrounding a well can result in liability.⁶⁷

59. *Id.* at 647 (emphasis added); *see also* *Humble Oil & Ref. Co. v. West*, 508 S.W.2d 812, 818 (Tex. 1974) (“[T]he confusion of goods theory attaches only when the commingled goods of different parties are so confused that the property of each cannot be distinguished.”).

60. *See Luecke*, 38 S.W.3d at 650; *cf. Humble Oil*, 508 S.W.2d at 818 (“[I]f goods are so confused as to render the mixture incapable of proper division according to the pre-existing rights of the parties, the loss must fall on the one who occasioned the mixture.”). *But see* Terry E. Hogwood, *Horizontal Wells and Commingling*, U. TEX. SCH. L. 39TH ANN. ERNEST E. SMITH OIL, GAS & MIN. L. INST. 4 (2013) (opining that the *Luecke* court ignored the law of commingling in adopting the reasonable-probability standard).

61. Walter H. Walne, III & Heather D. Person, *Pooling—Planning and Pitfalls in Preparation for a Horizontal Well 6* (Mar. 21, 2012) (unpublished manuscript), *available at* http://walne.net/practiceimages/Pooling_Horizontal_Wells_WalneLawPLLC.pdf.

62. *See id.* at 3; *see also* Hogwood, *supra* note 60, at 14-15.

63. *Bowden v. Phillips Petrol. Co.*, 247 S.W.3d 690, 708 (Tex. 2008); *Amoco Prod. Co. v. Alexander*, 622 S.W.2d 563, 567 (Tex. 1981).

64. *Bowden*, 247 S.W.3d at 699-702; 1 SMITH & WEAVER, *supra* note 23, § 5.1(B), at 5-5 to -6.

65. *Luecke*, 38 S.W.3d 641-42.

66. *Id.* at 647.

67. *See supra* text accompanying notes 59-62.

3. Legality of Allocation Wells

Presumably, an applicant for an allocation well intends to adopt an allocation formula under which unpooled royalty owners will be paid for production on an unpooled basis. The *Luecke* case, however, governs *damages* occasioned by the production from a horizontal well drilled across unpooled tracts.⁶⁸ It fails to address whether regulatory authority to drill such a well exists in the first place.⁶⁹

Indeed, at the most basic level, opponents object to the very drilling of allocation wells because production will be commingled within the drainhole. This commingling of production, they allege, amounts to an unlawful pooling and should be regulated or prohibited.⁷⁰ Operators disagree, asserting that such objections are merely cover for an attempt to extract more favorable lease terms in exchange for pooling authority.⁷¹ These arguments—the core of the debate over the Klotzman (Allocation) Well No. 1H—center on the question of whether the operator holds the right to drill the proposed well at all, rather than on what basis a lessee must account to unpooled royalty owners after a well has been drilled.⁷² If no such right exists, a lessor may be able to prevent issuance of a permit or secure an order from the Commission voiding a permit that has already been issued.⁷³

IV. MAY THE RRC ISSUE A PERMIT FOR AN ALLOCATION WELL?

Under Texas law, “all property is held subject to the valid exercise of the police power.”⁷⁴ In the exercise of the police power, the legislature delegated rulemaking authority to the Commission to prevent waste, conserve natural resources, and protect correlative rights.⁷⁵ All Commission authority, including the issuance of permits, flows from this delegation of authority.

A. Permitting Standard

The case of *Magnolia Petroleum Co. v. Railroad Commission* established that the Commission may not grant a drilling permit to an operator who cannot, in good faith, claim the right to drill the well for which the permit is sought.⁷⁶

68. See *Luecke*, 38 S.W.3d at 643-47 (emphasis added).

69. See *id.*

70. Klotzman Closing, *supra* note 21, at 7-8.

71. See EOG Reply, *supra* note 21, at 1-2.

72. *Id.* at 2.

73. Brian R. Sullivan, *Rule 37: Any Well Drilled in Violation of This Rule Shall Be Plugged*, 22 ST. B. TEX. ANN. ADVANCED OIL, GAS & ENERGY RES. L. COURSE 4-5 (2004).

74. *City of College Station v. Turtle Rock Corp.*, 680 S.W.2d 802, 804 (Tex. 1984) (citing *Lombardo v. City of Dall.*, 73 S.W.2d 475, 478 (Tex. 1934)).

75. TEX. NAT. RES. CODE ANN. § 85.201 (West 2011); *Texaco, Inc. v. R.R. Comm'n*, 583 S.W.2d 307, 310 (Tex. 1979).

76. *Magnolia Petrol. Co. v. R.R. Comm'n*, 170 S.W.2d 189, 191 (Tex. 1943).

To gain permission for an allocation well, it must “reasonably appear . . . that the applicant has a good-faith claim in the property” so as to drill a well traversing multiple unpooled leases.⁷⁷ The function of the Commission is not to “undertake to adjudicate questions of title or rights of possession.”⁷⁸ In that sense, a permit issued by the Commission “merely removes the conservation laws and regulations as a bar to drilling.”⁷⁹

The protestants in the Klotzman matter allege that the act of drilling across lease lines and producing from multiple tracts and leases is pooling, despite the label attached to the permit application.⁸⁰ Because the leases that authorize drilling do not authorize pooling, the protestants argue that EOG Resources, Inc. has no good-faith claim to the right to drill the well.⁸¹ Furthermore, the protestants point out that such a well necessarily requires the removal of captured minerals from the lease prior to measurement.⁸² In their view, the inescapable prospect of downhole commingling breaks down the above-described analogy between an allocation well and a collection of wells isolating each lease.⁸³ In the latter, production can be measured at the surface of each well, and no disputes will arise over what production is attributable to a particular lease.⁸⁴ The protestants argue that the plain language of Rule 26 requires measurement prior to removal of production from a lease.⁸⁵

By contrast, proponents of allocation wells insist that no pooling results from the drilling of an allocation well.⁸⁶ Additionally, Rule 26, they assert, has no applicability or relevance to downhole commingling.⁸⁷ On the narrow question of whether they hold a good-faith claim to the right to drill, proponents point to the leases, which indisputably grant the right to drill on and through the lands described in the leases.⁸⁸ Because the rights and duties under a lease are a matter of contract between a lessor and lessee, they maintain that interpretation of contractual rights is the province of courts rather than the Commission.⁸⁹

Accordingly, the Commission must decide whether the practice of drilling a horizontal well across lease lines constitutes pooling.⁹⁰ And because such a

77. *Id.* at 191.

78. *Id.*

79. *Id.*

80. Klotzman Closing, *supra* note 21, at 7.

81. *Id.* at 12.

82. *Id.* at 8.

83. *See id.* at 7-8.

84. *Id.* at 7.

85. *Id.* at 8.

86. *See* EOG Closing, *supra* note 21, at 3.

87. *See* EOG Reply, *supra* note 21, at 6.

88. *See* EOG Closing, *supra* note 21, at 4-6.

89. Devon Closing, *supra* note 7, at 5; *Magnolia Petrol. Co. v. R.R. Comm'n*, 170 S.W.2d 189, 191 (Tex. 1943).

90. *See* Devon Closing, *supra* note 7, at 8-10.

well necessarily commingles production, it also must determine whether existing rules governing commingling apply in an allocation-well context.⁹¹

B. Established Commission Policy

1. Allocation-Well Permits

In the Klotzman dispute, EOG Resources, Inc. points to sixty-seven allocation-well permits granted by the Commission from 2010 through 2012.⁹² On one occasion, the Commission expressly notified an allocation-well applicant that, based on the representation that it held leases covering each tract crossed by the well, it had “made a sufficient showing of a good faith claim to the right to produce the minerals under the proposed unit such that the good faith claim issue [did] not bar issuance of a [drilling] permit.”⁹³

2. PSA-Well Permits

The Commission’s policy toward wells drilled pursuant to Production Sharing Agreements (PSA Wells) also reflects a tolerance for wells crossing boundary lines between tracts containing unpooled interests. Operators have utilized PSA Wells in recent years to drill horizontal wells in areas where older leases are maintained by older vertical wells.⁹⁴ Handicapped by the configurations of smaller, irregularly shaped pooled units surrounding the older, vertical wells, operators sought to combine multiple pooled units that would accommodate horizontal wells.⁹⁵ To do so, they entered into production-sharing agreements with royalty and working-interest owners in the leases committed to each pooled unit.⁹⁶

In 2008, the Commission established a policy of granting permits for PSA Wells “when the usual criteria are met and the operator certifies that at least 65% of the working and royalty interest owners in each component tract have signed the production sharing agreement.”⁹⁷ Implementing this policy, the Commission adopted Form PSA-12, titled “Production Sharing Agreement Code Sheet.”⁹⁸

91. See Klotzman Closing, *supra* note 21, at 7-8.

92. EOG Closing, *supra* note 21, at 1.

93. Devon Closing, *supra* note 7, at 4.

94. See H. Phillip Whitworth & D. Davin McGinnis, *Square Pegs, Round Holes: The Application and Evolution of Traditional Legal and Regulatory Concepts for Horizontal Wells*, 7 TEX. J. OIL, GAS & ENERGY L. 177, 210-13 (2012); H. Martin Gibson, *Modifying Oil & Gas Documents for Horizontal Drilling*, 19 TEX. WESLEYAN L. REV. 77, 113 (2012).

95. See Whitworth & McGinnis, *supra* note 94, at 210-13.

96. *Id.*

97. Klotzman Closing, *supra* note 21, at 5.

98. *Adopted Rules*, 36 TEX. REG. 5753, 5835 (Sept. 9, 2011).

Under the foregoing policy, a lessee may drill across the boundary line between pooled units even when 35% of working-interest and royalty owners have not consented to a contractual method by which to share in production.⁹⁹ Yet their nonconsent does not preclude the issuance of a permit.¹⁰⁰ Apparently, the Commission determined that the operator has a good-faith claim to the right to drill even when a lessor has not authorized the pooling of its interest into a separate unit supporting a horizontal well or has not otherwise consented to production sharing.¹⁰¹ If consent is not required, then by extrapolation, the Commission should not object to a horizontal well crossing boundaries between unpooled leases.

3. *Precedential Value of Prior Policy*

The foregoing evidence suggests that the Commission has, in practice, permitted the drilling of horizontal wells across lease lines without a showing of pooling. The precedential value of that policy, however, is debatable. In none of those cases was the Commission asked to evaluate whether the leases would preclude the drilling of a well traversing lease boundaries in the absence of pooling.¹⁰² On a more fundamental level, agencies are charged with administering law within the framework of existing law and statutory authority.¹⁰³ It follows that an agency may abandon a policy that it believes is based on a misinterpretation of that law.¹⁰⁴

Whatever the status of current Commission policy, the Klotzman dispute provokes a discussion of what Commission policy *should* be when considering the rights and interests of the parties.¹⁰⁵ In formulating policy, the Commission must operate within the framework provided by judicial and statutory authority.¹⁰⁶ If the legislature takes action to resolve this uncertainty, its efforts may center on the fundamental question of whether—and if so, how—the Commission should regulate downhole commingling in horizontal wells that traverse unpooled leases.

99. See Whitworth & McGinnis, *supra* note 94, at 212-13.

100. *Id.*

101. *Id.*

102. Lineberry Letter, *supra* note 7, at 2. This letter from Colin Lineberry, Director of the Hearings Division, acknowledged, “This is the first case of which I am aware in which a mineral owner has asserted, prior to the permitting of the well, that the specific terms of its leases bar an operator from having even a good faith claim to the right to drill a horizontal well”

103. Pruet v. Harris Cnty. Bail Bond Bd., 249 S.W.3d 447, 452 (Tex. 2008).

104. See Phillips Petrol. Co. v. Tex. Comm’n on Env’tl. Quality, 121 S.W.3d 502, 507 (Tex. App.—Austin 2003, no pet.) (noting that, generally, “[an] agency’s construction of its rule is controlling”).

105. TEX. GOV’T CODE ANN. § 2001.038 (West 2011) (subjecting an agency rule to review “if it is alleged that the rule or its threatened application interferes with or impairs, or threatens to interfere with or impair, a legal right or privilege of the plaintiff”).

106. See *id.*

V. DOES AN ALLOCATION WELL IMPLY POOLING?

A. Rule 40 Permissiveness

Rule 40(a) provides as follows: “An operator may pool acreage, in accordance with appropriate contractual authority and applicable field rules, for the purpose of creating a drilling unit or proration unit by filing an original certified plat delineating the pooled unit and a Certificate of Pooling Authority, Form P-12”¹⁰⁷ Under the plain language of the rule, an operator *may* pool—pooling is permissive, not required.¹⁰⁸ Obviously, if a single lease is of sufficient size to host a well at a regular location, no pooling is required.¹⁰⁹ Yet neither Rule 40 nor any other rule expressly mandates the pooling of acreage when more than one lease is needed for a horizontal well drilled across multiple tracts.¹¹⁰

B. Defining “Pooling”

Whether pooling is *required* to combine acreage for purposes of forming a drilling or proration unit depends on the definition of pooling. If pooling is defined such that drilling a horizontal well across lease lines amounts to pooling, as argued by the protestants in the Klotzman dispute, then the absence of pooling authority poses an insurmountable problem for an applicant seeking a permit for an allocation well. Absent express authority, a lessee has no authority to pool.¹¹¹ When authority exists, pooling must be accomplished in strict compliance with the terms under which consent is granted.¹¹² Therefore, if drilling and producing from a well traversing lease lines implies pooling, an operator seeking to drill such a well must strictly comply with a lessor’s grant of pooling authority.¹¹³ If no such authority exists, the well cannot be drilled, and the lessee cannot satisfy the *Magnolia* standard because it has no good-faith claim to the right to drill the well.¹¹⁴ On the other hand, if pooling is more narrowly defined, then under the plain language of Rule 40, pooling can be construed as a sufficient, but not necessary, means by which to secure a permit for a drilling or proration unit consisting of multiple leases.¹¹⁵

107. 16 TEX. ADMIN. CODE § 3.40(a) (2012).

108. *See id.*

109. *See id.*

110. *Id.*

111. *Tittizer v. Union Gas Corp.*, 171 S.W.3d 857, 860 (Tex. 2005); *Se. Pipe Line Co. v. Tichacek*, 997 S.W.2d 166, 170 (Tex. 1999).

112. *See Tichacek*, 997 S.W.2d at 170; *Jones v. Killingsworth*, 403 S.W.2d 325, 327-28 (Tex. 1965); *Browning Oil Co. v. Luecke*, 38 S.W.3d 625, 640 (Tex. App.—Austin 2000, pet. denied).

113. *See Tichacek*, 997 S.W.2d at 170; *Killingsworth*, 403 S.W.2d at 327-28; *Luecke*, 38 S.W.3d at 640.

114. *Magnolia Petrol. Co. v. R.R. Comm’n*, 170 S.W.2d 189, 191 (Tex. 1943).

115. 16 TEX. ADMIN. CODE § 3.40(a) (2012).

As evidenced by the rich body of case law addressing it, pooling is an esoteric, nuanced concept—one that defies simple definition. Pooling has been defined as “the constructive joining of at least two separately owned tracts of land so that they are treated as one tract for oil and gas production purposes.”¹¹⁶ According to the Amarillo Court of Appeals in *Circle Dot Ranch v. Sidwell Oil and Gas, Inc.*, “Pooling means the bringing together of small tracts sufficient for the granting of a well permit under applicable spacing rules.”¹¹⁷ However, this statement arguably fails to capture the fullness of the meaning of pooling.

First, the statement in *Circle Dot Ranch* appears as part of an explanation of the technical difference between pooling and unitization.¹¹⁸ In a more recent case, the supreme court declined to equate pooling with the combining of smaller tracts for the purpose of securing a well permit.¹¹⁹ Rather, the court held only that “[p]ooling *allows* a lessee to join land from two or more leases into a single unit”—a statement not in dispute by proponents of allocation wells.¹²⁰

Second, few would argue that a group of small tracts is incapable of being pooled together when doing so would form a unit that falls short of the size required for a well. The failure of those tracts to aggregate to a size required for a drilling unit does not render a pooling ineffective unless reaching the unit size is a condition of the pooling provision.

Third, and more importantly, this simple definition of pooling ignores important and, perhaps, essential features of pooling. Specifically, pooling (1) provides a basis on which production from a pooled unit is allocated and (2) assures that operations within the unit will constructively serve as operations on each pooled tract so that a pooled lease may be perpetuated.¹²¹ Furthermore, the association of pooling with real-property interests, as opposed to produced minerals, poses conceptual obstacles to the notion that allocation wells entail pooling.

1. Pooling as a Method of Allocation

A leading treatise on Texas oil and gas law, after describing pooling as the process of combining tracts for the formation of a drilling unit, explains by way of example that the parties who pool their interests into the unit may “share the

116. Brady Paul Behrens, Comment, *Rule 37 Exceptions and Small Mineral Tracts in Urban Areas: An Argument for Incorporating Compulsory Pooling into Special Field Rules in Texas*, 44 TEX. TECH L. REV. 1053, 1066 (2012).

117. *Circle Dot Ranch, Inc. v. Sidwell Oil & Gas, Inc.*, 891 S.W.2d 342, 347 (Tex. App.—Amarillo 1995, writ denied) (alteration in original) (quoting 6 H. WILLIAMS & C. MEYERS, OIL & GAS LAW § 901 (1994)) (internal quotation marks omitted).

118. *See id.*

119. *Browning Oil Co. v. Luecke*, 38 S.W.3d 625, 634 (Tex. App.—Austin 2000, pet. denied) (emphasis added).

120. *Luecke*, 38 S.W.3d at 634 (emphasis added).

121. *Id.*

costs and proceeds of the drilling and production operation equally.”¹²² Indeed, an important, if not essential, feature of pooling is that it generally establishes a method or means by which the tracts pooled will share in production.¹²³ Texas courts have historically held that pooling accomplishes a cross-conveyance of interests.¹²⁴ As stated by the supreme court, “[P]ooling effects a cross-conveyance among the owners of minerals under the various tracts of royalty or minerals in a pool so that they all own undivided interests under the unitized tract in the proportion their contribution bears to the unitized tract.”¹²⁵ Therefore, the cross-conveyance concept necessarily establishes a method by which ownership of production is shared proportionately on an undivided basis within the pooled area.¹²⁶

The pooling provisions of many leases today expressly provide that pooling shall not result in a cross-conveyance of interests.¹²⁷ Texas courts have yet to fully address the significance of such language.¹²⁸ Some commentators believe that the cross-conveyance principle is an inextricable feature of pooling that cannot be negated by a contract term in a lease.¹²⁹ To the extent the principle can be negated, pooling provisions that attempt to do so invariably include provisions governing the method by which production from a pooled unit will be shared, typically providing for production on a surface-acreage basis.¹³⁰ Accordingly, whether pooling is brought about through a cross-conveyance or by contract, a method by which production will be shared accompanies the act of pooling.¹³¹

2. Lease Perpetuation by Pooling

According to a leading treatise, “The principal effect of pooling on the oil and gas lease is that production and operations anywhere on the pooled unit are treated as if they have taken place on each tract within the unit.”¹³² As explained by the Texas Supreme Court,

122. 2 SMITH & WEAVER, *supra* note 23, § 11.1(B), 11-3 to -4.

123. *Id.*

124. *Montgomery v. Rittersbacher*, 424 S.W.2d 210, 213 (Tex. 1968); *Veal v. Thomason*, 159 S.W.2d 472, 475 (Tex. 1942).

125. *Montgomery*, 424 S.W.2d at 213 (citing *Veal*, 159 S.W.2d at 475).

126. *See id.*

127. Jeffrey L. Hart & J. Bruce Bennett, *Selected Pooling Issues*, 27 ST. B. TEX. ANN. ADVANCED OIL, GAS & ENERGY RES. L. COURSE 12 (2009).

128. *Id.*; *see also* *Wagner & Brown, Ltd. v. Sheppard*, 198 S.W.3d 369, 376 (Tex. App.—Texarkana 2006), *rev'd*, 282 S.W.3d 419 (Tex. 2008).

129. *See* Hart & Bennett, *supra* note 127, at 12.

130. 8 PATRICK H. MARTIN & BRUCE M. KRAMER, *WILLIAMS & MEYERS OIL AND GAS LAW* 805 (2002).

131. *See* Hart & Bennett, *supra* note 127, at 12-13.

132. 1 SMITH & WEAVER, *supra* note 23, § 4.8, at 4-121.

The *primary* legal consequence of pooling is that production and operations anywhere on the pooled unit are treated as if they have taken place on each tract within the unit. If the lessee pools in good faith, the lessee is relieved of the obligation to reasonably develop each tract separately, or to drill off-set wells on other tracts included in the unit to prevent drainage by a well on one or more of such tracts.¹³³

Absent the application of this consequence of pooling to a leased tract, operations and production cannot maintain a lease in force unless such operations and production occur within, or for the benefit of, the leased acreage.¹³⁴

3. *Limitation of Pooling to Real-Property Interests*

A final point about the nature of pooling requires an appreciation of the property-law distinction between oil and gas before and after production. To the extent pooling is a cross-conveyance of interests, it changes, conveys, and disposes of the affected interests.¹³⁵ As discussed above, an interest may not be pooled absent express consent.¹³⁶ This limitation is grounded in real-property law. A royalty interest is a real-property interest entitling its owner to a share of production or the proceeds thereof.¹³⁷ As an interest in land, it may not be changed, altered, conveyed, or in any way disposed of without consent.¹³⁸ Once consent is granted, the royalty interest, as a real-property interest, is a candidate for pooling.¹³⁹ Produced oil and gas, by contrast, is not an interest in real property. Actual production occurs once minerals are severed from the formation.¹⁴⁰ Accordingly, when oil or gas flows into the wellbore, it has been severed from the formation and is no longer owned as oil and gas in place.¹⁴¹ The right to oil and gas in place “does not extend to specific oil and gas beneath the property.”¹⁴²

A well that penetrates the subsurface of leased property—even one configured and engineered to produce minerals—is merely a hole in the earth.¹⁴³ In the absence of production, nothing about the physical existence of a

133. See *Pipe Line Co. v. Tichacek*, 997 S.W.2d 166, 170 (Tex. 1999) (emphasis added) (citation omitted) (citing *Southland Royalty Co. v. Humble Oil & Ref. Co.*, 249 S.W.2d 914, 916 (Tex. 1952)).

134. See *id.*

135. See *Veal v. Thomason*, 159 S.W.2d 472, 476 (Tex. 1942).

136. See *Tittizer v. Union Gas Corp.*, 171 S.W.3d 857, 860 (Tex. 2005); *Tichacek*, 997 S.W.2d at 170.

137. See 8 MARTIN & KRAMER, *supra* note 130, at 952; 1 SMITH & WEAVER, *supra* note 23, § 2.4[A], at 2-61 to -62.

138. *Brown v. Smith*, 174 S.W.2d 43, 46 (Tex. 1943).

139. See *id.*

140. See *Killam Oil Co. v. Bruni*, 806 S.W.2d 264, 267 (Tex. App.—San Antonio 1991, writ denied) (citing *Diamond Shamrock Exploration Corp. v. Hodel*, 853 F.2d 1159, 1165 (5th Cir. 1988)).

141. See *Petro Pro, Ltd. v. Upland Res., Inc.*, 279 S.W.3d 743, 750-53 (Tex. App.—Amarillo 2007, pet. denied) (discussing Texas’s oil and gas ownership doctrine).

142. *Seagull Energy E & P, Inc. v. R.R. Comm’n*, 226 S.W.3d 383, 388-89 (Tex. 2007).

143. 8 MARTIN & KRAMER, *supra* note 130, at 1205.

well can transform the nature and ownership of real property. Rather, the pooling argument advanced by the protestants in the Klotzman dispute is apparently based on the fact that the operator intends to actually produce the minerals through take points along the wellbore, commingle them within the drainhole, and draw them to the wellhead.¹⁴⁴ Thus, the premise of the pooling argument is the existence of actual production from the well.¹⁴⁵ Yet a lessor's interest in produced minerals is not a real-property interest capable of being pooled.

C. Wellbore Pooling

Opponents might argue that the pooling attempted by the drilling of an allocation well is not necessarily the pooling of acreage but rather the pooling of the wellbore. In the case of *Petro Pro, Ltd. v. Upland Resources, Inc.*, a Texas court recognized the right of a working-interest owner to assign a leasehold interest in a wellbore.¹⁴⁶ If a wellbore may be assigned, it stands to reason that it may likewise be pooled.¹⁴⁷ A wellbore pooling, as an extension of *Petro Pro*, would consist of a pooling of the mineral interests in the tracts traversed by the well that can be developed through the wellbore.¹⁴⁸

Again, however, whether the drilling of an allocation well implies a pooling of the wellbore depends on the definition of pooling. The existence of an allocation well does not deliver a method of allocation and does not maintain a lease if land covered by the lease does not host any portion of the wellbore.¹⁴⁹ Furthermore, as discussed above, actual production is the fundamental premise of the pooling argument.¹⁵⁰ But pooling of a wellbore, like an assignment of a wellbore, would constitute a conveyance or disposition of minerals in place that may be produced through that wellbore, rather than minerals that are no longer owned in place as real property.¹⁵¹

D. Weighing the Merits of the Implied-Pooling Argument

Pooling serves important functions for an operator. First, it furnishes a method by which production is allocated.¹⁵² Second, it enables production or

144. See Klotzman Closing, *supra* note 21, at 1-3.

145. See *id.*

146. *Petro Pro, Ltd.*, 279 S.W.3d at 745.

147. See *Montgomery v. Rittersbacher*, 424 S.W.2d 210, 213 (Tex. 1968) (discussing the nature of pooling as a conveyance); *Veal v. Thomason*, 159 S.W.2d 472, 476 (Tex. 1942).

148. *Petro Pro, Ltd.*, 279 S.W.3d at 751-52.

149. See, e.g., *Coastal Oil & Gas Corp. v. Garza Energy Trust*, 268 S.W.3d 1, 17 (Tex. 2008) (holding that the rule of capture applies to hydraulically fractured wells); *Browning Oil Co. v. Luecke*, 38 S.W.3d 625, 646 (Tex. App.—Austin 2000, pet. denied) (holding that, absent pooling, production does not accrue to the benefit of owners of a non-drill-site tract).

150. See *supra* text accompanying note 145.

151. See *Petro Pro, Ltd.*, 279 S.W.3d at 750.

152. See 1 SMITH & WEAVER, *supra* note 23, § 4.8, at 4-121 to -129.

operations anywhere on the pooled unit to be deemed production or operations on each tract within the unit.¹⁵³ Significantly, an allocation well carries neither of these features. The drilling of an allocation well across lease lines certainly involves the combination of a series of contiguous tracts along and surrounding the horizontal path of the well.¹⁵⁴ But in contrast to a typical pooling, an allocation well is not accompanied by a cross-conveyance of interests or any contractual agreement among the parties by which production is allocated.¹⁵⁵ Rather, by electing to drill an allocation well, the operator implies that no surface-acreage formula associated with pooling is necessary.¹⁵⁶ Instead, each lessor simply receives royalty based on production from each lease.¹⁵⁷ And the rule that operations anywhere on a unit are considered operations on a tract does not hold when tracts are combined for an allocation well; a lessee cannot maintain a lease in force unless the well produces directly from the tract covered by the lease.¹⁵⁸ These differences remain whether the allocation well is alleged to effect a pooling of acreage or a wellbore pooling.

A lessor who has deliberately withheld pooling authority may consider the drilling of an allocation well as an attempt to circumvent the terms of the lease.¹⁵⁹ But the availability of allocation does not render a lessor's withholding of pooling authority meaningless. Pooling generally establishes a method of production allocation and deems operations on one tract operations on another. The drilling of an allocation well captures neither of these benefits for the lessee. If either of these effects of pooling is an essential attribute of pooling, then the argument that an allocation well is a pooling fails.

The legal principles underpinning pooling as a real-property concept present further difficulties for the argument. The existence of a well crossing lease boundaries cannot be construed as pooling independent of production.¹⁶⁰ And once production occurs, the produced minerals are no longer part of a real-property interest for which pooling consent must be granted.¹⁶¹

VI. DO COMMINGLING STATUTES PROHIBIT ALLOCATION WELLS? SHOULD THEY?

Under the umbrella of statutory authority in the Texas Natural Resources Code, the Texas Administrative Code includes a small handful of rules

153. *Id.*

154. *See* Lineberry Letter, *supra* note 7; *supra* text accompanying note 7.

155. *See id.*

156. *Contra* 1 SMITH & WEAVER, *supra* note 23, § 1.1(D)(1), at 1-12 to -14.

157. *See* Robert C. Grable, *Royalty Payments & Other Current Issues from Horizontal Wells*, 2012 ROCKY MTN. MIN. L. FOUND., no. 4, Paper No. 13A, at 13A-19.

158. *See* Coastal Oil & Gas Corp. v. Garza Energy Trust, 268 S.W.3d 1, 17 (Tex. 2008); Browning Oil Co. v. Luecke, 38 S.W.3d 625, 646 (Tex. App.—Austin 2000, pet. denied).

159. *See* Behrens, *supra* note 116, at 1067 (noting that, usually, a lessee must get permission from the lessor to pool).

160. *See supra* notes 148-49 and accompanying text.

161. *See* Amoco Prod. Co. v. Wood, 113 S.W.3d 462, 466 (Tex. App.—Texarkana 2003, pet. denied).

regulating commingling of oil and gas. As discussed below, the applicability of these rules to allocation wells is questionable. Regardless of their applicability, however, if extending them to allocation wells would achieve the policy objectives for which the rules were adopted, a strong argument can be made that the rules should apply. In any event, the novelty of allocation wells prompts consideration of the question of whether rules or statutes should be adopted to expressly regulate commingling within allocation wells.

A. Multi-Completion Commingling

1. Rules 6 & 10

Rule 6 provides that the Commission will grant authority “to multicomplete a well in separate reservoirs that are not in communication without the necessity of notice and hearing on each separate application”¹⁶² provided certain technical well requirements are satisfied.¹⁶³ The counterpart to Rule 6 is Rule 10, which establishes exceptions to Rule 6. Rule 10 provides that “[o]il or gas shall not be produced from different strata through the same string of tubulars except as provided in this section.”¹⁶⁴ These rules recognize and acknowledge that requiring an operator to drill a separate well to each mineral-bearing stratum would result in a substantial waste of resources.¹⁶⁵ The purpose of these rules is to allow operators to use a single well to produce from a variety of depths and reservoirs while preventing commingling of production from the various deposits.¹⁶⁶

To comply with the rule, tubulars within a well travel to different depths, and packers are set between the producing zones.¹⁶⁷ Minerals from the deepest horizon are captured and brought to the opening in the deepest tubular string but cannot migrate within the well above the packer separating the deepest zone from shallower zones.¹⁶⁸ Likewise, minerals from uphole zones can escape into the tubular string bottomed in the zone but are prevented by a packer from traveling upwell to shallower tubulars.¹⁶⁹

162. 16 TEX. ADMIN. CODE § 3.6(a) (2012).

163. ADMIN. § 3.6(d).

164. *Id.* § 3.10(a).

165. *See* R.R. Comm’n v. Pend Oreille Oil & Gas Co., 817 S.W.2d 36, 45 (Tex. 1991).

166. *Id.*

167. *See* ADMIN. § 3.6.

168. *See* Form W-4A, Sketch of Multiple Completion Installation with Tubing Inside Casing, R.R. Comm’n of Tex. (last revised Aug. 27, 1969), available at <http://www.rrc.state.tx.us/forms/og/pdf/Form W4Ap.pdf>.

169. *See id.*

2. Statutory Foundations

The case of *Railroad Commission v. Pend Oreille Oil & Gas Co.* offers insight on the development of the statutes and rules governing downhole commingling of production from multiple strata.¹⁷⁰ The origins of the statutes addressing downhole commingling of minerals from multiple strata are traceable to the longstanding law that the Commission may prorate production only from a common reservoir.¹⁷¹ In reaction to judicial scrutiny of the Commission's findings that consolidated multiple reservoirs for administrative convenience, the Commission began denying all commingling requests to maintain the integrity of the prorationing system.¹⁷² As a result, operators could not economically access minerals in separate deposits beneath the same tracts of land.¹⁷³

Responding to that predicament, the legislature enacted § 85.046 and § 86.012,¹⁷⁴ expressly allowing for commingling when the Commission finds it will “prevent waste, . . . promote conservation, or . . . protect correlative rights.”¹⁷⁵ Later, the legislature enacted § 86.081(b),¹⁷⁶ which authorizes the Commission to regulate and prorate production from commingled separate accumulations “as if they were a single common reservoir.”¹⁷⁷

3. Applicability to Allocation Wells

The commingling that takes place within an allocation well occurs within a well producing from a single reservoir.¹⁷⁸ By contrast, the downhole commingling regulated in Rules 6 and 10 results from production from multiple reservoirs or accumulations.¹⁷⁹ Plainly, therefore, the rules have no direct applicability to allocation wells.

4. Policy Considerations

Despite their nonapplicability, do the policy justifications for regulating multiple-strata commingling apply to allocation-well commingling? As discussed in *Pend Oreille*, the primary policy purpose of Rules 6 and 10 is the

170. See *Pend Oreille*, 817 S.W.2d at 46-47.

171. *Id.* at 45.

172. *Id.* The Commission apparently feared that production from multiple strata would result in overproduction of the common source of supply if the strata were judged to be a common reservoir.

173. *Id.*

174. *Id.*

175. TEX. NAT. RES. CODE ANN. §§ 85.046(b), 86.012(b) (West 2011).

176. *Pend Oreille*, 817 S.W.2d at 46; *Seagull Energy E & P, Inc. v. R.R. Comm'n*, 226 S.W.3d 383, 386 (Tex. 2007).

177. TEX. NAT. RES. CODE ANN. § 86.081(b) (West 2011).

178. See *Pend Oreille*, 817 S.W.2d at 43-44.

179. 16 TEX. ADMIN. CODE §§ 3.6, 3.10 (2012).

protection of the Commission's prorationing system.¹⁸⁰ By generally requiring measurement of production from each reservoir, the Commission removes the danger that an operator of a well will mask overproduction from a particular reservoir through commingling.¹⁸¹ The rules, therefore, protect correlative rights by assuring that each well produces no more than its fair share of minerals from a particular reservoir.¹⁸² But unlike production from the wells at issue in Rules 6 and 10, production from an allocation well occurs from a single reservoir.¹⁸³ Consequently, allocation-well production presents no danger that commingling will disguise production greater than the well's allowable.

In certain situations, ownership of minerals may be vertically severed, with ownership varying from one depth to another.¹⁸⁴ In those cases, prevention of commingling between strata may also protect correlative rights by ensuring that the production allocated to the owner of the minerals at a given depth is based upon actual measurement. However, as discussed in *Pend Oreille*, prorationing was the primary policy reason for the statutes that gave birth to regulations of multiple-strata commingling.¹⁸⁵

B. Surface Commingling

1. Rules 26 & 27

Rule 26 is titled "Separating Devices, Tanks, and Surface Commingling of Oil."¹⁸⁶ Subsection (a)(2) of the rule specifies that "[a]ll oil and any other liquid hydrocarbons as and when produced shall be adequately measured according to the pipeline rules and regulations of the commission before the same leaves the lease from which they are produced."¹⁸⁷ Subsection (b) provides as follows: "In order to prevent waste, to promote conservation or to protect correlative rights, the commission may approve surface commingling of oil, gas, or oil and gas production from two or more tracts of land producing from the same commission-designated reservoir. . . ."¹⁸⁸ The counterpart rule applicable to gas is found in Rule 27, which, under subsection (a), generally requires gas production to be measured separately as to each completion before the gas leaves the lease.¹⁸⁹ Subsection (e) allows for "surface commingling of gas or oil and gas . . . in accordance with § 3.26(b)."¹⁹⁰

180. *Pend Oreille*, 817 S.W.2d at 44-46.

181. *See id.*

182. *Id.* at 44.

183. *Id.* at 45.

184. *See* 1 SMITH & WEAVER, *supra* note 23, § 1.2(B), at 1-17 to -19.

185. *Pend Orielle*, 817 S.W.2d at 44-46.

186. 16 TEX. ADMIN. CODE § 3.26 (2012).

187. ADMIN. § 3.26(a)(2).

188. ADMIN. § 3.26(b).

189. *Id.* § 3.27(a).

190. ADMIN. § 3.27(e).

Approval for Rule 26(b) surface commingling is available administratively without a hearing in the following situations: (1) the tracts have identical working and royalty interests in identical percentages such that there is no commingling of separate interests;¹⁹¹ (2) production from each tract is separately measured prior to commingling;¹⁹² and (3) after notice, no protest is made by affected owners of working or royalty interests¹⁹³ and the applicant provides “a method of allocating production to ensure the protection of correlative rights.”¹⁹⁴ If the application is protested, the permit will nevertheless be granted upon a showing that commingling will prevent waste, promote conservation, or protect correlative rights.¹⁹⁵ The allocation method is presumed to protect correlative rights if based upon daily production rates calculated using results from semi-annual tests for each well.¹⁹⁶

2. Statutory Foundations

The statutory basis for Rules 26 and 27 is found in § 85.046(c) of the Texas Natural Resources Code.¹⁹⁷ Under the statute,

The commission, after notice and opportunity for hearing, may permit surface commingling of production of oil or gas or oil and gas from two or more tracts of land producing from the same reservoir . . . if the commission finds that the commingling will prevent waste, promote conservation, or protect correlative rights.¹⁹⁸

It continues, “The commission may permit the commingling regardless of whether the tracts or commission-designated reservoirs have the same working or royalty-interest ownership.”¹⁹⁹ Finally, it provides that the “production attributable to each tract . . . shall be determined in a manner consistent with this title” and specifies that “[t]he commission has broad discretion in administering this subsection.”²⁰⁰

191. ADMIN. § 3.26(b)(1)(A).

192. ADMIN. § 3.26(b)(1)(B).

193. ADMIN. § 3.26(b)(1)(C).

194. ADMIN. § 3.26(b)(1)(C)(i).

195. ADMIN. § 3.26(b)(2).

196. ADMIN. § 3.26(b)(3)-(b)(3)(A). The Commission may approve annual testing of commingled wells on an operator’s written request showing that correlative rights will not be harmed. *See* ADMIN. § 3.26(b)(3)(B).

197. TEX. NAT. RES. CODE ANN. § 85.046(c) (West 2011).

198. *Id.*

199. *Id.*

200. *Id.*

3. *Applicability to Allocation Wells*

Rules 26(a)(2) and 27(a) provide that oil and gas are generally to be measured before leaving the lease from which they are produced.²⁰¹ Read in isolation, these rules could support an inference that commingling within an allocation well—prior to its removal to the surface—is prohibited. Subsection (b) of Rule 26 and subsection (e) of Rule 27 (which refers back to Rule 26(b)) carve out exceptions under which the Commission may approve surface commingling.²⁰² Because the rules do not specifically address the issue of downhole commingling within an allocation well, questions arise as to how the rules affect allocation wells.

Downhole commingling and surface commingling are not mutually exclusive. Production that is commingled downhole within an allocation well remains commingled when removed to the surface. This fact implicates the possibility that downhole commingling, if allowed, must conform to the rule provisions addressing surface commingling. Read in its entirety, however, Rule 26(b) appears to contemplate only commingling of the sort that takes place at the surface, after production is achieved through separate wells.²⁰³ The language prohibiting harm to the interest owners “of any of the wells” and requiring tests to ascertain production rates “for each well” support this conclusion.²⁰⁴ The Rule 26(b) exception consequently offers little guidance on allocation-well commingling.

Allocation wells are designed such that production leaves a lease along the horizontal drainhole.²⁰⁵ Opponents argue that Rule 26(a)(2) and Rule 27(a) generally require measurement before oil or gas leaves the lease through the drainhole of an allocation well.²⁰⁶ But in practice, this general rule is abrogated in a variety of circumstances. For example, the rule is not enforced when leases are pooled or when a well is bottomed beneath a lease from an off-lease surface location.²⁰⁷ Whether non-enforcement extends to allocation wells remains to be seen. Because the rules contain no express rule authorizing commingling in an allocation well, operators are left to wonder whether such commingling is permissible.

4. *Policy Considerations*

Setting aside the applicability of the foregoing rules, to what extent are the policies promoted by those rules relevant to the issue of downhole commingling

201. See 16 TEX. ADMIN. CODE §§ 26(a)(2), 27(a) (2012).

202. See ADMIN. §§ 26(b), 27(e).

203. See ADMIN. § 3.26(b).

204. See ADMIN. § 3.26(b)(3).

205. See *supra* Part I.

206. Klotzman Closing, *supra* note 21, at 7-8; ADMIN. § 3.26(a)(2), (b).

207. See generally 16 TEX. ADMIN. CODE § 3.27 (2012) (stating that the Commission may grant exceptions).

within allocation wells? On one hand, surface-commingling rules promote orderly prorationing from reservoirs. Because the Commission assigns allowables on a per-well basis, the Commission has an interest in measuring and identifying production from each well before it is commingled and can no longer be identified.²⁰⁸ But because an allowable is properly assigned to an entire well, rather than to each lease committed to a well, the policy of protecting the prorationing system is not promoted by regulating commingling with allocation wells.

On the other hand, prohibiting and limiting surface commingling between leases also protects the correlative rights of interest owners by attempting to ensure that an owner of an interest in a lease receives his fair share of production from a well on that lease.²⁰⁹ If such production is commingled without adequate protections in place, the share of commingled production allocated to the owner might underrepresent the true quantity of production obtained from the lease. This concern applies to allocation wells. The inability to measure production of each tract committed to an allocation well prior to commingling of the oil or gas within the wellbore gives rise to the possibility that some interest owners will not be allocated production based on the amounts actually produced from the tracts in which they hold an interest.

Arguably, however, the benefit of separate measurement is merely a by-product of a general rule designed to promote a policy—i.e., protecting correlative rights through even-handed prorationing—that would not be furthered by the regulation of allocation-well commingling. Whether this incidental benefit is substantial enough to justify regulation can be judged in terms of costs and benefits. Requiring measurement at each well prior to surface commingling is, under most circumstances, a small burden and, therefore, a small price to pay for the protection of correlative rights. By contrast, obtaining actual measurements of production from each tract committed to an allocation well is a large burden, if not an impossible one. Measuring actual production from each tract would require a separate string of tubulars for each tract, with impervious packers placed along the well at each tract boundary, similar to the requirements of Rule 6.²¹⁰ The technological viability of such measurement is likely inversely correlated with the length of the horizontal well and the degree to which the well receives fracturing treatments.

Regulation of allocation-well commingling does not necessarily entail actual measurement. A less onerous standard, such as a showing that an allocation method protects correlative rights, would also create a substantial burden—not only on the operator but also on the Commission. Evaluation of

208. *Id.* § 3.38.

209. *See* TEX. NAT. RES. CODE ANN. § 85.046(c) (West 2011).

210. *See* 16 TEX. ADMIN. CODE § 3.6 (2012).

an operator's showing would require extensive geological and engineering analysis on a case-by-case basis.

As discussed above, a lessor questioning an operator's allocation has non-regulatory remedies available.²¹¹ Under the standard announced in *Luecke*, absent pooling, a commingling lessee must allocate based upon determination of what production can be attributed to each tract traversed by a wellbore with reasonable probability.²¹² When commingling occurs, the burden to make a satisfactory allocation belongs to the lessee.²¹³ Moreover, during lease negotiations, lessors are free to insist on lease provisions that not only withhold pooling authority but also expressly prohibit commingling.²¹⁴ These considerations may have some bearing on whether operators should be subjected to the burden of allocation-well commingling regulations.

Preventing or overly burdening allocation-well commingling might eliminate or sharply curtail the practice of drilling allocation wells. Proponents argue that doing so would result in enormous waste of resources because wells cannot otherwise be drilled.²¹⁵ The rebuttal to that argument is that the withholding of pooling authority is rarely absolute. In exchange for certain concessions from a lessee, lessors might be willing to grant pooling authority, which would eliminate the bar to accessing those minerals.²¹⁶ These arguments raise the question of whether the Commission's duty to prevent waste requires inquiring into the parties' willingness to negotiate and evaluating the reasonableness of the parties' behavior during negotiations.

C. Judicial Treatment of Commingling Regulation

The case of *Seagull Energy E & P, Inc. v. Railroad Commission* limits the extent to which the correlative-rights doctrine may preclude commingling.²¹⁷ In that case, an operator obtained a permit for a well producing from two of three sands considered by the Commission to be a single, commingled reservoir.²¹⁸ When the operator was denied an exception permit to produce from the third sand through a separate well, it challenged the denial as an unconstitutional taking.²¹⁹ The Supreme Court of Texas held that the operator failed to carry its

211. See *supra* Part III.B.

212. See *Browning Oil Co. v. Luecke*, 38 S.W.3d 625, 647 (Tex. App.—Austin 2000, pet. denied).

213. See *Humble Oil & Ref. Co. v. West*, 508 S.W.2d 812, 818 (Tex. 1974); Linton E. Barbee, *The Lessor's Remedies for Nonpayment of Royalty*, 45 TEX. L. REV. 132, 143 (1966).

214. See *Tittizer v. Union Gas Corp.*, 171 S.W.3d 857, 860 (Tex. 2005) (citing *Se. Pipe Line Co. v. Tichacek*, 997 S.W.2d 166, 170 (Tex. 1999)) (regarding pooling clauses in a lease).

215. See *EOG Closing*, *supra* note 21, at 6-7; TEX. NAT. RES. CODE ANN. § 85.046(a)(6) (West 2011) (defining waste as "physical waste or loss incident to or resulting from drilling, equipping, locating, spacing, or operating a well or wells in a manner that reduces or tends to reduce the total ultimate recovery of oil or gas from any pool").

216. *Klotzman Closing*, *supra* note 21, at 3.

217. *Seagull Energy E & P, Inc. v. R.R. Comm'n*, 226 S.W.3d 383, 384 (Tex. 2007).

218. *Id.* at 385.

219. *Id.* at 387.

burden, agreeing with the Commission that the confiscation “must be shown from the common reservoir as a whole rather than from an individual, commingled sand” when the sands are treated as commingled.²²⁰ Therefore, the court concluded that the Commission’s “authority to regulate the placement and number of wells in fields where commingling is approved” was “within the scope of [the] authority delegated to the Commission by the Legislature.”²²¹

In reaching that decision, the court noted, “Although a mineral owner has a right to its fair share of the minerals on and under its property, this right does not extend to specific oil and gas beneath the property.”²²² Because an owner of an interest in a well has no right to specific molecules of oil and gas, the *Seagull* decision suggests that if the Commission declines to regulate commingling within an allocation well, any challenge of that decision on takings grounds will fail.²²³

D. Intra-Lease Allocation

Under many circumstances, a lease covers interests in more than one tract. If ownership differs from one tract to another at the time the lease is executed, and the lease contains anti-communitization language, royalties will not be communitized among the lessors.²²⁴ Similarly, if ownership is uniform at the time of lease execution but the lessors thereafter subdivide the property, and the lease contains no entireties clause, the nonapportionment rule applies.²²⁵ In both situations, unless the leased interests are affirmatively pooled, the lessee must account to lessors on a noncommunitized basis.²²⁶ Doing so requires either downhole measurement prior to commingling or allocation.

The protestants in the Klotzman dispute were faced with the same situation: royalty ownership differed between tracts within one of the leases.²²⁷ The protestants did not dispute that the lessee was entitled to drill and produce

220. *Id.* at 388.

221. *Id.* at 387.

222. *Id.* at 388-89.

223. *Coastal Oil & Gas Corp. v. Garza Energy Trust*, 268 S.W.3d 1, 15 (Tex. 2008).

224. *See, e.g., Verble v. Coffman*, 680 S.W.2d 69, 70 (Tex. App.—Austin 1984, no writ) (holding that the trial court did not err in holding that the two parties’ “royalty interests had been pooled, communitized and apportioned, within the entire McCurdy tract, and that each of the royalty owners was entitled to one-fourth of all royalties paid under the McCurdy lease”); *London v. Merriman*, 756 S.W.2d 736, 739-40 (Tex. App.—Corpus Christi 1988, writ denied) (holding that a suit against a lessee and assignee effectively ratified the lease to include the nonparticipating royalty interest owner but providing that the interests may be pooled when pooling authority is granted by ratification).

225. *Japhet v. McRae*, 276 S.W. 669, 671-72 (Tex. Comm’n App. 1925, judgment adopted).

226. *Compare Verble*, 680 S.W.2d at 70 (addressing differing ownership between tracts and anti-communitization language in the lease), and *London*, 756 S.W.2d at 739-40 (similarly addressing divided ownership and anti-communitization language), with *Japhet*, 276 S.W. at 671-72 (stating that uniform ownership at the time of lease execution that is later subdivided is subject to the nonapportionment rule).

227. *See Devon Closing*, *supra* note 7, at 7-8.

from a well crossing tract boundaries within a lease.²²⁸ They insisted, however, that the well could not cross a lease boundary absent pooling authority.²²⁹

Conceptually, why production should be measured before commingling between leases, but not between tracts within a lease, is not clear. If the protestants prevail and no basis for the distinction exists, consistency forbids allocation of intra-lease production. To the great alarm of operators, this result would prevent operators from drilling through tracts containing interests that are leased but unpooled, such as nonratifying, nonparticipating royalty interests.

E. The Future of Allocation-Well Commingling

The Commission's duty and ability to regulate are shaped by the policies that regulating would promote. As discussed above, regulating allocation-well commingling fails to promote the policy of protecting the integrity of the prorationing system.²³⁰ Currently, without further regulation, the prorationing system protects the rights of interest owners in an allocation well, as a group, to receive their fair share of production from a reservoir.²³¹ Policing allocation-well commingling would extend protection to *within* that group between the interest owners in a given well.²³²

Taking into consideration the burden it would place upon operators, the resources it would require, and the availability of nonregulatory remedies, the Commission and the legislature must ask whether the interest of holding lessees accountable to lessors is worthy of regulatory attention. Ultimately, the decision is driven by fundamental questions about the role of government. Is a lessor's right to a proper allocation a matter between private parties that can be adequately protected through nonregulatory means? Or should government act as a guarantor of a lessor's rights against mismanagement by a lessee?

VII. CONCLUSION

In today's horizontal-well environment, the inability to secure pooling authority has redirected lessees down a new path. When a compromise on pooling authority is considered impossible or too costly, operators have adopted a strategy of seeking permits to drill allocation wells. For the moment, the debate centers on the narrow legal standard of whether a lessee has a good-faith claim to the right to drill an allocation well. But wide differences of opinion belie this narrow standard, and due to the novelty of the issue, direct guidance from the courts and the legislature is thin.

228. *See id.*

229. *See* Klotzman Reply, *supra* note 21, at 13-14.

230. *See supra* text accompanying note 172; *supra* Part VI.A.4.

231. *See supra* Part VI.A.4.

232. *See supra* note 209 and accompanying text; *supra* Part VI.A.4.

The argument for allocation wells rests on a pair of disputed assumptions: first, that pooling is neither a precondition for nor implied by the drilling of a horizontal well across lease boundaries and, second, that commingling within such a well is not regulated. Therefore, determining the legality of allocation wells will require a close examination of oil and gas law as it pertains to these fundamental concepts.

As discussed above, the argument that an allocation well implies pooling requires isolating important attributes and consequences of pooling from its definition. It also may ignore basic property-law distinctions between in-place and produced minerals. The case for applying or extending commingling regulations to allocation wells has a firmer footing but necessitates a focus on policy issues. Ultimately, policy makers must determine whether protecting the correlative rights of an unpooled lessor justifies actual measurement or other regulatory requirements. This evaluation must consider factors such as the economic and technological feasibility of downhole measurement, the burden that case-by-case analysis of allocation methods and correlative rights would place on the Commission, and whether lessors and royalty owners may be adequately protected through nonregulatory means and remedies.

If the practice of drilling allocation wells attains protected status, it will not supplant pooling. In most instances, pooling will continue to provide the structural framework and flexibility needed to develop blocks of leases. The administrative burden of accounting to royalty owners on a well-by-well basis and an aversion to the risk of liability for improper allocation will encourage most lessees to seek and exercise pooling authority. The allocation-well option may serve as a last resort if commingling regulations are adopted, requiring operators to notify royalty owners at the application stage. Such regulations would increase the probability of protests, which would likely shift the burden to the operator to show that correlative rights are protected. Depending on what kind of standard is applied, the burden of making such a showing might deter operators from seeking allocation-well permits.

Nonetheless, lessors, operators, and practitioners will eagerly monitor whether Texas law will countenance allocation wells. Any result allowing allocation wells would profoundly impact the oil-and-gas industry. At the point of lease negotiation, awareness of allocation wells as a legal alternative to pooling would influence the behavior of the parties. Concerned lessors would seek to supplement pooling provisions with limitations on allocation and commingling, while lessees would attempt to preserve the ability to allocate. Savvy parties willing to bend from these positions would seek favorable terms elsewhere in the lease in return. Operationally, the option of drilling an allocation well would liberate lessees faced with restrictive pooling provisions or no pooling authority at all.

In all likelihood, the allocation-well dispute will reverberate beyond the halls of the Commission to those of the legislature and the courts. Stakeholders throughout Texas will watch closely, and policymakers of other states will

observe intently. With a proper focus on the subtleties of pooling and commingling law and policy, Texas should arrive at a reasoned position on allocation wells grounded in a firm understanding of oil and gas law.