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January 4, 2013

Marshall Enquist, Hearing Examiner
Richard Atkins, Hearing Examiner
c/o Docket Services
Railroad Commission of Texas
Oil & Gas Division
1701 N. Congress, Suite 12-123
Austin, Texas 78701

via Hand Delivery

Re: Oil & Gas Docket No. 02-0278952
Application of EOG Resources, Inc. to Drill Klotzman Lease (Allocation) Well No. 1H, Eagleville (EagleFord-2) Field, DeWitt County, Texas Status No. 744730, as an Allocation Well Drilled on Acreage Assigned from Two Leases

Dear Mr. Enquist and Mr. Atkins:

Attached for filing in the above referenced docket, please find the original and 1 copy of Katherine Larson Reilly and Melanie McCollum Klotzman (Protestants or Klotzmans) Closing Brief. We have also enclosed a copy of this Brief on CD.

Please file in your usual manner, and return a file stamped copy to our courier.

Respectfully submitted,

Patrick F. Thompson

PFT/mah
Enclosure
cc: Doug Dashiell
Brian Sullivan
D' Ann Pate
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William Osborn
Jamie Nielson

BEFORE THE

RAILROAD COMMISSION OF TEXAS

OIL & GAS DOCKET NO. 02-0278952
APPLICATION OF EOG RESOURCES, INC.
TO DRILL KLOTZMAN LEASE (ALLOCATION) WELL NO. 1H
EAGLEVILLE (EAGLEFORD-2) FIELD
DEWITT COUNTY, TEXAS
STATUS NO. 744730, AS AN ALLOCATION WELL
DRILLED ON ACREAGE ASSIGNED FROM TWO LEASES

CLOSING BRIEF BY PROTESTANTS KATHERINE LARSON REILLY & MELANIE McCOLLUM KLOTZMAN

This is the closing brief of Katherine Larson Reilly and Melanie McCollum Klotzman (hereinafter "Protestants" or "Klotzmans") regarding EOG Resources, Inc.'s ("EOG") application for a Railroad Commission permit to drill the Klotzman Lease (Allocation) Well 1-H in Dewitt County.

Introduction

EOG proposes to drill a horizontal well that will cross a lease line dividing two leases in which the Klotzmans hold interests. The leases do not allow for pooling for oil production. Tr. at 36. EOG negotiated with the Klotzmans for the right to pool the leases, but EOG was unwilling to give the Klotzmans the commitments they sought from EOG in exchange for the right to pool the leases. Tr. at 123-24. So, when EOG was unable to obtain pooling authority on its terms, EOG went to the Railroad Commission

and applied for a drilling permit anyway. Tr. at 37.[1] When the Klotzmans objected, EOG argued to the Commission that pooling authority was never really necessary to drill and complete the proposed well. EOG calls the well it proposes to drill a "Production Allocation Well." However, "Production Allocation Well" is simply a special label for a well that EOG lacks the necessary legal authority to drill. Attaching a different label to the well does not change the rights held by EOG or the rights reserved by the Klotzmans. Under the circumstances presented in this case, issuance of the requested permit would violate lawfully adopted Commission rules, Commission policy as articulated in prior Commission decisions, and Texas law on the granting and reservation of rights by mineral lessees.

EOG's support at hearing for its asserted "legal right" to complete the well as planned -- a legal conclusion -- was testimony by a landman whom EOG objected to being cross-examined on legal issues because he "is not an attorney." Tr. at 105-06, 108.

EOG presented evidence at hearing that purported to show that issuance of the permit was necessary to prevent waste. But EOG's argument regarding waste was simply silly. The only thing stopping EOG from getting the permits necessary to develop the reservoir as it pleases is its own unwillingness to agree to terms proposed by the mineral owner. EOG could have just as easily come to the Commission and argued that mineral owners' insistence on being paid royalties was causing waste --- or that the hassle and expense of having to obtain a lease from the mineral owner in the first place was causing

[1] "Q. So was the allocation permit applied for after you had attempted unsuccessfully to that point to obtain pooling authority? A. That is correct." Tr. at 37.

waste. EOG's witness on the waste issue specifically stated that the loss of recoverable reserves he calculated assumed that EOG was unable "to arrive at pooling amendments to existing leases." Tr. at 85. In other words, if EOG is unable to obtain pooling authority from mineral owners on the terms it prefers, EOG will come to the Commission and argue that the mineral owners' wishes should be overridden -- in order to prevent "waste."

Granting the Permit Would Violate Commission Policy
As Articulated in Orders Adopted by the Commissioners

EOG cited no Commission order or decision and Protestants are unable to find any decision or order signed by the Commissioners that authorizes the practice advocated by EOG here – the granting of a drilling permit for a horizontal well that will cross lease lines, in the absence of pooling authority or the agreement of mineral owners. In fact, the Commission orders that address the practice have either explicitly rejected it or adopted a different and incompatible practice.

In Oil & Gas Docket No. 06-026200[2], Devon Energy Production Co., L.P. sought the adoption of field rules for the Carthage (Haynesville) Field in Panola County. One of the rules sought by Devon would have allowed operators to drill horizontal wells that cross lease or unit boundaries "as long as that operator has a lease or other mineral ownership right to produce from each such unit or lease." See PFD, Attachment 1 at p.6.[3]

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[2] The Examiners took official notice of this file and Proposal for Decision. Tr. at 13.

[3] Counsel for EOG and Devon argued at the hearing that the rule proposed by Devon in Docket 06-026200 "was about how to allocate, not the permitting of wells" (Tr. at 103), but that is not correct. The first sentence of the proposed rule was: "Operators shall be permitted to drill and complete horizontal wells that traverse one or more units and/or leases as long as that operator has a lease or other mineral ownership right to produce from each such unit or lease." PFD at 6.

Devon's proposal was soundly rejected in a very thorough discussion in the Proposal for Decision, which included the following:

> Devon is not the owner of minerals under the various tracts it operates in the area of the proposed Carthage (Haynesville Shale) Field. It is the lessee and its rights are controlled by the terms of the leases it took from the owners of the minerals. Devon itself acknowledges that those lease terms do not authorize it to pool the tracts as it desires. Devon is seeking a Commission field rule that would endorse its desires to effectively amend the terms of its agreements with the mineral owners, authorize it to combine the tracts and direct that the mineral owners be paid in a manner different than is provided in the lease contracts. Such a field rule would be unprecedented in Commission practice and would far exceed the Commission's statutory authority.

PFD, p. 14.

The Proposal for Decision also carefully analyzed the July 23, 2009 letter from Prof. Ernest Smith, which was offered by Devon as support for its proposal. The Examiners found that the letter did not provide "any substantial support for Devon's position." PFD, p. 12.

On December 15, 2009, the Commissioners voted unanimously to approve the Examiners' recommendation in Docket 06-0262000. Railroad Commission Minutes of Formal Commission Actions, December 15, 2009. The Commissioners subsequently voted two to one to approve the Examiners' recommendation to overrule Devon's Motion for Rehearing and Request for Oral Argument. Railroad Commission Minutes of Formal Commission Actions, January 26, 2010.

On another occasion, in a decision on an application by Devon to drill a well in the Newark, East (Barnett Shale) Field, the Commissioners appeared to formally endorse the

policy of granting permits to production sharing agreement wells --- but only when the operator could represent that at least 65% of the ownership in each tract had signed on. The minutes reflecting the Commissioners' decision noted that Devon filed the application with less than 90% agreement from mineral interest owners, but went on to state: "Commissioners Jones and Carrillo voted to approve, directing staff that wells that are permitted based on a production sharing agreement should be approved 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. Chairman Williams voted no." Railroad Commission Minutes of Formal Commission Actions, September 9, 2008.

On August 23, 2011, the Commission formally adopted the Form PSA-12, the "Production Sharing Agreement Code Sheet." 36 TexReg 5835, September 9, 2011. The stated purpose of the form was to provide a means for an operator to supply information "electronically or in hard copy in support of an application for a well on a tract covered by a production sharing agreement." 36 TexReg 5837. The form as adopted did not set forth a minimum level of participation by mineral owners necessary before a well being drilled pursuant to a Production Sharing Agreement would be approved. The adoption of the form however, is inconsistent with EOG's implicit contention that the percentage is irrelevant. If, as EOG contends, an operator is entitled to a permit regardless of whether he has obtained *any* participation in a Production Sharing Agreement, a form stating the percentage participation achieved by the operator would be completely unnecessary.

The only Commission document cited by EOG in support of its argument that the requested permit should be granted was an April 21, 2010 letter from Director Colin Lineberry. The April 2010 letter does not cite any action by the Commissioners in support of the apparent change in policy. EOG's witness was not able to identify any. Tr. at 102. Neither does it make any attempt to reconcile its position with the orders adopted by the Commission in Docket 06-0262000 or in the Newark, East (Barnett Shale) case. The letter is, in any case, irrelevant to this proceeding because Director Lineberry has authored a more recent letter addressing *this specific application*, concluding that EOG's claim to be a working interest owner in leases covering 100 % of the mineral estate for both tracts is not necessarily sufficient to establish a good faith claim to drill the well. October 5, 2012 Letter of Colin Lineberry, EOG Exh. 7.

In sum, issuance of the requested drilling permit would be inconsistent with Commission policy as articulated in Commission orders. In addition, the sole Commission authority cited by EOG as support for issuance of the permit has been implicitly distinguished or revoked by its author.

Granting the Permit Would Be Inconsistent with Commission Rules

Granting EOG's requested permit would be inconsistent with lawfully adopted and long-established Commission rules intended to protect the interests of mineral owners.

Statewide Rule 40 provides that an operator seeking to combine acreage from separate leases or units to create a drilling unit or proration unit must file a "certified plat delineating the pooled unit and a Certificate of Pooling Authority, Form P-12." 16 Tex. Admin. Code §3.40(a). The P-12 is required to be filed "with the drilling permit

application when two or more tracts are joined to form a pooled unit for Commission purposes to obtain a drilling permit." §3.40(a)(5)(A). On the form, the operator is directed to "separately list each tract committed to the pooled unit by *authority granted to the operator*." §3.40(a)(2)(A)(emphasis added). The rule also contains other provisions intended to protect the interests of mineral owners "for which pooling authority does not exist." §3.40(b)&(c).

Pursuant to Statewide Rule 40, an operator seeking to combine acreage from separate leases must represent to the Commission that it has the authority to pool the tracts. EOG has a simple, but invalid plan for how to deal with Statewide Rule 40: It will not call what it proposes to do "pooling." But application of a Commission rule cannot be evaded simply by putting a different label on the prohibited activity. The effects of what EOG proposes to do are the same as the activity regulated by Rule 40. Minerals from one lease will be commingled with minerals from a separate lease and produced through a single well. When performed pursuant to a claimed right to produce from both tracts, that is pooling.

EOG has argued that, because the well is completed on both tracts, the result is not "pooling." It is, they argue, as if there were a well completed on each tract. That, however, is not true. Production from separate leases through a horizontal well that crosses the lease line cannot be separately measured. It can only be allocated by some formula that is either entirely arbitrary or, at best, an attempt to approximate the volume of hydrocarbons produced from each lease. That would not be true if there were separate wells completed on each lease.

A lessor's right to actual measurement of the hydrocarbons produced from his lease is protected by Statewide Rule 26. Even if it were proper to regard EOG's proposed horizontal well as "a well on each tract," the way EOG proposes to operate the wells would violate Rule 26.

Rule 26 requires all "oil and other liquid hydrocarbons" to be measured "before the same leaves the lease from which they are produced." 16 Tex. Admin. Code §3.26(a)(2). Obviously, production from the non-surface-location lease will leave that lease without being measured. EOG's witness was not even able to address whether what EOG proposes to do violates the prohibition against downhole commingling. Tr. at 115. Rule 26 provides for exceptions when the two tracts "have identical working interest and royalty interest ownership in identical percentages" or when no protest to the proposed commingling is received after 21 days' notice to all working and royalty interest owners and other specified conditions are met. §3.26(b)(1)(C). These exceptions do not apply to EOG's requested permit. Tr. at 51. The Klotzmans are therefore entitled to the protections afforded by Rule 26.

In sum, issuance of EOG's requested permit would violate Statewide Rule 40 and would inevitably result in a violation of Statewide Rule 26. See Tr. at 131.

Granting the Permit Would Violate Texas Law Governing Issuance of Commission Permits

EOG has argued, and Protestants will certainly concede, that the Railroad Commission does not have the power to determine title to property. However, the application of that principle to regulatory permitting is frequently misunderstood. Texas

courts have not held that the Commission cannot adjudicate disputes that are based, in part, on property or contractual rights. The power the Commission lacks, because it is reserved to the courts, is the power to actually establish property rights with a binding decision. When the courts say that the Commission does not have the authority to "determine" property rights, they mean that the Commission lacks the authority to make binding determinations of property rights --- not that the Commission lacks the authority to examine and evaluate property rights in the performance of its regulatory duties.

This has been well-established law in Texas since at least 1943. In *Magnolia Petroleum Co. v. Railroad Commission*, 170 S.W.2d 189 (Tex. 1943), a suit to invalidate two oil well permits issued by the Commission, the Court declared "the Railroad Commission should not do the useless thing of granting a permit to one who does not claim the property in good faith. The Commission should deny the permit if it does not reasonably appear to it that the applicant has a good faith claim in the property." *Id.* at 191. The mere fact that a party asserts a property or contractual right to drill a well, as EOG does here, is not sufficient grounds for the Commission to issue the requested permit. The Court in *Magnolia* recognized that the Commission has the power, and in instances such as these, the duty to examine that claim for reasonableness.

More specifically, the courts have ruled that the Commission can and should consider the legal authority of the operator to *pool* when deciding whether to grant a permit. *Cheesman v. Amerada Petroleum Corporation*, 227 S.W.2d 829 (Tex. Civ. App. – Austin 1950, *no writ*).

EOG has admitted that it does not have the authority to pool the two tracts that will be traversed by its proposed horizontal well. Tr. at 36. EOG has also admitted that it has not separately obtained an agreement from affected mineral owners to complete and produce the proposed well. Tr. at 36. EOG nonetheless asserts, at hearing and in the attachments to its Form W-1, the right to drill and produce the well. EOG makes the claim, but EOG does not and cannot establish the reasonableness of that claim.

When an operator's assertion of its right to drill is inherently contradictory, it is not reasonable, and cannot serve as the basis for a permit. EOG both admits that it lacks the right to pool these tracts for oil, and asserts the right to produce oil from both tracts through a single well, relying on a formula, rather than actual measurement, to allocate the production to the two tracts and to the respective royalty owners. EOG both disclaims and asserts the right to pool. That does not meet any definition of "reasonable."

Though the hearing in this docket was specifically called for the purpose of determining whether EOG was capable of making a good faith claim to a right to drill the proposed well, remarkably little of EOG's case was devoted to that issue. EOG presented a landman, not a lawyer, to present all of its testimony on that subject. (Tr. at 32) That landman was not able to reconcile his position with the opinion of the Third Court of Appeals in *Browning Oil Company, Inc. v. Luecke,* 38 S.W.3d 625 (Tex. App. -- Austin 2000, *writ denied*), and EOG's lawyer objected to him even being asked such questions. Tr. at 105, 108. EOG presented no one to explain about how EOG could assert in good faith the right to drill the proposed well, despite its inability to cite *any* Commission rule or

decision authorizing it, and despite prior Commission decisions and court cases which appeared to forbid it.

Granting the Permit Would Violate Texas Law
On the Granting and Reservation of Mineral Rights

Lessees in Texas have no power to pool without the lessor's express authorization. *Southeastern Pipeline Company, Inc. v. Tichacek,* 997 S.W.2d 166 (Tex. 1999). The right to pool is not implied. If it is not expressly granted to the lessee, it is a right reserved by the mineral owner. *See: Jones v. Killingsworth*, 403 S.W.2d 325 (Tex. 1966). Under the policy advocated by EOG, the Commission would essentially infer an operator's power to effectively pool separate leases based on the fact that the operator proposes to drill a horizontal well. The Commission has no such authority. "[T]he acts of the Railroad Commission cannot be said to operate effectively to extend the restrictive terms of a lease. The orders of the Railroad Commission cannot compel pooling agreements that the parties themselves do not agree upon." *Killingsworth* at 328.

The Austin Court of Appeals relied on *Killingsworth* in deciding the case most closely on point to the issues presented here. In *Browning Oil Company, Inc. v. Luecke,* 38 S.W.3d 625 (Tex. App. -- Austin 2000, *writ denied*), the court found that an operator's completion of a horizontal well across lease lines violated the terms of the leases. In *Luecke*, the operator argued, as EOG has argued here, that the drilling of the well does not violate the leases, and the only issue is the proper determination of the royalties due to the lessors on production from the well. The court rejected that argument. "To allow Lessees to drill any size well and then attempt to comply with the leases after the well has

been drilled would defeat the intention of the parties to limit pooled units to the smallest unit allowed by the rules. *See Killingsworth*, 403 S.W.2d at 328. In contravention of this intent, Lessees drilled wells they knew would not fit within the eighty acre spacing requirement and exceeded the authority granted in the pooling provisions. *See id.* (Railroad Commission rules cannot extend restrictive terms of a lease.) We hold that the trial court did not err in ruling that Lessees failed to comply with the pooling provisions in the lease." *Id.* at 642. If the drilling of a well will violate the terms of an operator's lease, the operator obviously cannot in good faith claim a right to drill the well.[4]

The obvious exception to the prohibition against forced pooling is the Mineral Interest Pooling Act ("MIPA"). However, EOG is not proposing to invoke the MIPA. Still, the MIPA is instructive as a declaration of Texas law on pooling and mineral owner rights. Texas was late to allow forced pooling and when it was finally permitted, it was subject to severe limitations. It does not apply to reservoirs discovered and produced before 1961 and does not apply at all to land owned by the State of Texas. The potential units are limited in size. Most importantly, the Commission cannot exercise the authority granted under the Act unless the applicant first makes a "fair and reasonable offer" to pool voluntarily, which is rejected by the mineral owner. Texas Natural Resources Code Chapter 102. The MIPA reflects the strong sentiment in Texas that the rights of Texas

[4] To the extent EOG relies on Prof. Ernest Smith's July 23, 2009 letter to argue that such a well is legal to drill, their position is in conflict with the court's holding in *Luecke*. But Protestants agree with the Commission Examiners' assertion in Docket No. 06-0262000 that the operators' reliance on the Smith letter is misplaced. As the Examiners found, Prof. Smith's qualified response to the hypothetical questions posed does not constitute "an unequivocal statement of support."

mineral owners to *separate* production of their oil and gas cannot be ignored or overridden.

The Commission is Not Estopped from Denying EOG's Permit

At hearing, EOG presented evidence that approximately 70 "allocation wells" have been permitted since Mr. Lineberry's April 21, 2010 letter, and that EOG "relied" on the ability to drill "allocation wells" when it acquired assignment of the Klotzman leases. The relevance of these assertions to the issues to be determined in this case was not explained. Presumably, EOG is not arguing that the Railroad Commission is estopped from denying this permit because EOG relied on its ability to override the mineral owners' choice not to grant pooling authority. Estoppel does not run against the state when acting in its regulatory capacity. *State v. Dunham*, 860 S.W.2d 63, 67 (Tex. 1993). In addition, it was not reasonable to assume that the Commission would override the mineral owners' decision on pooling when there is no rule, no statute and no Commission order suggesting that it would.

As for the 70 "allocation wells," all the record reflects is that there are 70 wells with the word "allocation" in the lease name. The record does not reflect whether the affected mineral owners were even aware that "allocation wells" were being completed on their property. The existence of the wells does nothing to establish that EOG has a good faith claim of the right to drill the proposed well. The fact that, of the thousands of horizontal well permits issued since April of 2010, only seventy are classified by their operators as "allocation wells" indicates that, in the vast majority of cases, operators are able to drill the horizontal wells they wish to drill based on their existing lease rights or

rights that they are able to acquire through negotiation. If the number of such wells establishes anything, it is that the power sought by EOG here is both extraordinary and unnecessary.

Conclusion

EOG has not carried its burden of proving that it has the legal and contractual rights necessary to drill and complete the Well 1H as proposed. Protestants respectfully request that the Commission deny the permit sought by EOG. If the Commission denies the requested permit, EOG will remain free to seek permits that are consistent with its rights under the existing leases and will remain free to negotiate amendments to those leases necessary to drill wells such as the 1H across lease lines.

Respectfully submitted,

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By: _____
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Certificate of Service

I certify that on January 4, 2013, a copy of the foregoing Closing Brief of Protestants was sent by **email** to the persons listed below.

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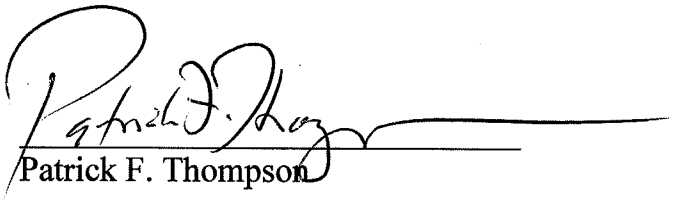

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