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

MOTION FOR REHEARING
OF
KATHERINE LARSON REILLY AND MELANIE MCCOLLUM KLOTZMAN

ORAL ARGUMENT REQUESTED

On September 24, 2013 the Commissioners signed an order in this case that rejected all but three of the fifteen Findings of Fact proposed by the Examiners who heard the case and examined the evidence. The order also rejected all but two of the Examiners' proposed Conclusions of Law. In their place, the Commissioners substituted a Finding of Fact that is directly contradicted by the Applicant's own evidence in the record and a Conclusion of Law that lacks justification, explanation, or citation to authority. Nothing in the order adopted by the Commission indicates the reasoning behind the Commission's rejection of the Examiners' findings or its adoption of an order that is the direct opposite of that recommended by the Examiners. The Commission's order is simply a result, unencumbered by reasoning, support or justification.

The Commission's order is invalid for two separate, independent reasons. First, the order directs the staff to issue the subject drilling permit, when issuance of the permit violates current, legally adopted rules that bind the Commission. Second, the order holds that EOG has a "good faith claim" to the right to drill the subject well, when operation of the well will violate the leases that are the only source of EOG's rights.

At hearing, the Protestants argued, and the Examiners correctly found, that there is no statute and no rule that authorizes the issuance of a permit like the one EOG seeks. The Protestants also argued, and the Examiners correctly found, that it is the Commissioners, not the staff, who hold the power to amend Commission rules. This was relevant because a letter written by a Commission staff member was the sole support cited by EOG for the type of permit it sought. Another principle is equally important to the Commission's actions in this case: *Until the existing rules of the Commission are repealed or amended,* the Commissioners are as bound by them as is the staff. The rules that prohibit the permit sought by EOG have not been amended or repealed. The Commission cannot repeal or amend them in the context of this case -- it must abide by them.

The only support provided by the Commission in its order for the conclusion that EOG has a "sufficient good faith claim" to drill the proposed well is the Commission's substitute Finding of Fact, which is technically incorrect. But regardless of whether EOG owns 100% or just 70% of the working interest in the subject leases, because it indisputably lacks the authority to pool, it lacks the authority, as a matter of law, to drill the proposed well. Commissioner Smitherman correctly observed at conference that the

leases give EOG authority to drill *two* wells, one on *each* lease. However, the leases do not give EOG the authority to drill *a* well on *both* leases – and that is what EOG proposes to do.

The Commission is Bound by Its Own Rules

State agencies in Texas are bound by their own rules. *Rodriguez v. Service Lloyds Insurance Company*, 997 S.W.2d 248 (Tex. 1999). Orders issued in violation of those rules are invalid. Though a reviewing court may defer to the agency's interpretation of its own rule, it "cannot defer to an administrative interpretation that is 'plainly erroneous or inconsistent with the regulation.'" *Id.* at 254-55, citing *Public Utility Commission v. Gulf States Util. Co.*, 809 S.W.2d 201, 207 (Tex. 1991). If the agency does not follow its own regulation, the court will "reverse its action as arbitrary and capricious." *Id.* at 255.

In certain rare circumstances, an agency may engage in adjudicative rulemaking, but "a presumption favors adopting rules of general applicability through the formal rulemaking procedures as opposed to administrative adjudication." *Id.* In fact, "Allowing an agency to create broad amendments to its rules through administrative adjudication rather than through its rulemaking authority undercuts the Administrative Procedure Act (APA)." *Id.* When an agency follows APA rulemaking procedures, the agency "must provide notice, publication and invite public comment. . ." The APA thereby "assures that the public and affected persons are heard on matters that affect them and receive notice of new rules." *Id.*

Whether an agency has failed to follow its own rules is a question of law. *Texas Department of Public Safety v. Pierce*, 238 S.W.3d 832, 835 (Tex. App. – Austin 2007, *no writ*). Agency actions that fail to follow the agency's own rules will be struck as "arbitrary and capricious." *Myers v. State*, 169 S.W.3d 731 (Tex. App. – Austin 2005, *writ ref.*). The Railroad Commission's actions will be reversed when the Commission chooses to "arbitrarily ignore" its own valid rules. *Railroad Commission et al. v. Shell Oil Co., Inc., et al.,* 154 S.W.2d 507 (Tex. App. – Austin, 1941).

The EOG Permit Violates the Commission's Statewide Rule 40

EOG proposes to create a drilling unit comprised of acreage from two separate leases. Statewide Rule 40 (16 Tex. Admin. Code §3.40) requires an operator to "file the Form P-12 and certified plat" whenever "two or more tracts are joined to form a pooled unit for Commission purposes to obtain a drilling permit." 16 Tex. Admin. Code §3.40(a)(5). The rule provides that an operator "may pool acreage" for "the purpose of creating a drilling unit or proration unit," but it must do so "in accordance with appropriate contractual authority and applicable field rules." The Form P-12 filing requirement serves to enforce this part of the rule. On that form, the applicant swears subject to penalties that he has authority to pool the tracts comprising the unit and designates which acreage has been "pooled." RRC Form P-12.

Because it is indisputable that EOG proposes to combine acreage from "two or more tracts" to form its drilling unit, Statewide Rule 40 provides that it must file a Form P-12. Statewide Rule 40 dictates that on the Form P-12, EOG "shall separately list each

tract committed to the pooled unit *by authority granted to the operator.*" 16 Tex. Admin. Code §3.40(a)(2)(A).

One of the clearly undisputed facts in this case is that EOG *has no authority to pool the subject acreage.* EOG's drilling permit application does not comply with Statewide Rule 40. EOG may argue that horizontal wells should not be held to compliance with Statewide Rule 40, but any doubt that these provisions are applicable to horizontal wells is eliminated by Statewide Rule 86, the Commission's rule specifically directed at horizontal wells. That rule provides that "All points on the horizontal drainhole must be within the proration and drilling unit," and "assignment of acreage to proration and drilling units for horizontal drainholes must be done in accordance with Statewide Rule 40, §3.40 of this title (relating to Assignment of Acreage to Pooled Development and Proration Units)." 16 Tex. Admin. Code §3.86(d)(2)&(4).

The Commission's existing rules, which bind the Commissioners just as they bind those subject to their jurisdiction, require that an operator like EOG, seeking to combine acreage from separate tracts to form a drilling unit, must include with his drilling permit application a Form P-12 on which he swears that he has the "contractual authority" to pool the subject acreage. EOG cannot do that, because it indisputably lacks the authority to pool the subject acreage. Therefore, EOG cannot, under existing rules, obtain the permit it seeks.

The Commission might, at some future date, decide to amend Statewide Rule 40 so that it no longer requires operators creating drilling units from separate tracts to file a Form P-12. But for now, the Commission is bound by its own rules.

Though no rule has ever been adopted by the Commission authorizing "allocation well" permits, the Commission has, through rulemaking, recognized a category of wells called "Production Sharing Agreement wells."

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.

EOG did prepare and file a PSA-12 as part of its application for a permit to drill. EOG Exh. 1. That filing, however, is meaningless at best and dishonest at worst. On the filing, entitled "Production Sharing Agreement Code Sheet," EOG's Richard Ryan provided the "Sharing Agreement Name" and a "Description of Individual Tracts Contained Within the Production Sharing Agreement." Mr. Ryan provided this information and declared that his responses are "true, correct and complete" to the best of his knowledge. However, *there is no Production Sharing Agreement between EOG and the mineral owners.* Mr. Ryan was fully aware of this. Tr. 36, ln. 15-18. Mr. Ryan

might claim that he was instructed to complete the form by Commission staff. If that is true, it should have been an indication to everyone involved that something was wrong with a process that required an applicant, subject to the penalties provided in Tex. Nat. Res. Code §91.143, to describe the "tracts contained within the Production Sharing Agreement" when there is no Production Sharing Agreement.

Because the Commission had never adopted rules or forms for something like an "allocation well," operators and members of the staff were required to cobble together pieces of other rules and procedures that clearly did not fit. Their efforts did nothing to legalize the process.

The EOG Permit Violates Statewide Rule 26

The Commission's Statewide 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). If EOG completes the proposed well, production from the non-surface-location lease will leave that lease without being measured. That is inevitable. At the hearing, EOG admitted that it will commingle production from the two leases, just not "at the surface." Tr. 116-117. It is impossible for EOG to operate the proposed well, as it proposes to complete it, in compliance with Rule 26. The Commission's order does not address this issue.

Rule 26 provides for exceptions to the prohibition 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. EOG, in fact, never sought an exemption from Rule 26. It is unclear from the Commission's order whether the Commission intends to grant EOG an exemption from Rule 26, despite the fact that it never sought one, or if the Commission is choosing simply to disregard Rule 26.

For the reasons explained in the discussion of Texas law above, it is not possible for the Commission to disregard Rule 26. If the Commission is planning to give EOG an exemption from Rule 26, it must first notice up the issue and give affected parties like the Protestants an opportunity to object and counter EOG's evidence, if any, in support of the exemption. The General Land Office made this point at the hearing. "When the Commission grants an allocation permit, in effect, it is essentially also granting an exception to Statewide Rule 26 or 27, but without the notice protections." Tr. 22, ln. 15-20.

EOG has taken the position in this proceeding that, by calling its proposed well an "allocation well," it can exempt itself from separately measuring production from the two leases, even without permission from the affected mineral owners. The Commission's order implicitly accepts that proposition, but without any explanation or rationale.

The Intervenors had previously attempted to excuse an allocation well's compliance with Rule 26 by asserting that Rule 26 exists only so that the Commission can enforce allowables and that it is therefore inapplicable to allocation wells because "An allocation well, on the other hand, is treated as a single well for regulatory purposes

and is assigned only one allowable." (Intervenors' Exceptions p.14) There are at least two problems with this excuse. First, it is not true that Rule 26 exists solely for the purpose of enforcing allowables. If that were true, Rule 26 would not include a provision that allows an exception if the affected mineral owners consent. Obviously, one of the purposes of Rule 26 is to protect mineral owners. Second, Intervenors are inconsistent about whether an "allocation well" is one well or multiple wells for regulatory purposes. When seeking to avoid the requirement that an applicant for an "allocation well" permit certify that he has pooling authority, Intervenors contend that an "allocation well" is the equivalent of "multiple wells" producing from all of the traversed tracts. The proposed well cannot be "multiple wells" when that is necessary to evade one regulation, but a "single well" when needed to evade another.

EOG also sought to evade Rule 26 by arguing that it applies only to "surface commingling" and that the commingling of oil from separate leases that will occur in the EOG well will occur subsurface If it were valid, any operator could commingle production from separate leases whenever he chose, simply by burying the portion of the gathering line where production from the two leases came together.[1]

EOG's Claim is Not a "Good Faith" Claim

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

[1] Even if one were to arbitrarily classify what EOG proposes to do as "downhole commingling," subject to Statewide Rule 10, it would still, technically, be prohibited. Because the proposed lateral crosses the DeWitt – Gonzales county line, it would produce (and commingle) oil from two "Commission-designated fields."

"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 drilling permit. *Cheesman v. Amerada Petroleum Corporation*, 227 S.W.2d 829 (Tex. Civ. App. – Austin 1950, *no writ*).

The courts "recognize that the Railroad Commission has no power and authority to decide the ownership of the title to the land or to adjudicate boundary lines. . . It is, however, incumbent on an applicant for a permit to make a reasonably satisfactory showing of a good faith claim . . ." *Humble Oil & Refining Company v. H. D. MacDonald,* 279 S.W.2d 914 (Tex. Civ. App. – Austin 1955, *writ ref. n.r.e.*) A permit issued to an operator who knows he lacks authority to drill the well will be invalidated. *Id.* at 915.

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. As the Commission's Examiners correctly found, that is "the very essence of pooling." EOG both disclaims and asserts the right to pool. That does not meet any definition of "reasonable."

At hearing, EOG's counsel admitted that the only reason operators like EOG seek "allocation well" permits is because they lack the authority to pool the subject acreage. ("None of the other allocation permits have pooling authority. If they did, we wouldn't be here. We would be forming pooled units." Tr. 17, ln. 5-9.) EOG's witness admitted that EOG sought to permit the well as an "allocation well" only after attempting unsuccessfully to obtain pooling rights from the mineral owners. Tr. 36-37.[2] If a mineral owner has elected not to confer pooling rights on the operator through the lease, "allocation wells" provide the operator with a means to defeat the mineral owner's intent – by doing something that achieves the same purpose (the combining of acreage from separate tracts to form a drilling and/or proration unit) and calling it something else.

[2] EOG's witness, Richard Ryan, was also asked about his understanding of what it means when the word "allocation" appears in the name for a well. He responded: "That it's a well that is drilled without pooling provisions, adequate pooling provisions in at least one or more of the leases involved in the well." Tr. 109, ln 17-22.

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). The Commission has no authority to infer an operator's power to effectively pool separate leases based on the fact that the operator proposes to drill a horizontal well. "[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 in this case, *Browning Oil Company, Inc. v. Luecke,* 38 S.W.3d 625 (Tex. App. -- Austin 2000, *writ denied*), a case involving a horizontal well. In *Luecke*, the plaintiff, a mineral owner, brought suit against an operator who had drilled a horizontal well in breach of the terms of his lease. The court's holdings demonstrate why EOG's claim to drill the subject well cannot be a "good faith" claim. The court rejected the plaintiff's theory of damages but the court *accepted* the Plaintiff's argument that the drilling of the horizontal well violated the terms of the lease: "A lessee's authority to pool derives from the provisions in the lease and is limited as stipulated in the lease. It cannot be expanded by an implied covenant. If these Lessees determined that drilling a horizontal well on an eighty acre unit was economically impractical, they could have attempted to expand their pooling authority." *Id.* at 641. The court found that the lessees could have negotiated different pooling provisions with the

lessor or sought a field-wide change in the spacing and density rules at the Railroad Commission. "Failing that, they could have exercised the option of not drilling a well on the Lueckes' tracts. *What they could not do was pool the Lueckes' interests beyond the authority expressed in the leases.*" *Id.* at 642 (emphasis added).

Though the *Luecke* court fully recognized the benefits associated with horizontal drilling, it rejected the operator's argument that those benefits justified ignoring the lease's language on pooling:

> Moreover, in considering public policy, we must attempt to balance two competing interests. First, *we recognize that Lessees should not be allowed to ignore anti-dilution provisions and exceed their pooling authority with impunity.* A reasonably prudent operator may conclude that horizontal drilling in the Austin Chalk formation will benefit a lessor, and the operator may correctly opine that reasonable prudence dictates the drilling of a horizontal well that exceeds the authority granted under the applicable lease. *Nevertheless, rather than ignore the written lease, the prudent operator must seek to negotiate a solution mutually beneficial to both the lessee and the lessor or forego drilling.*

Id. at 646-47 (emphasis added).

The *Luecke* court rejected the operator's contention that "some form of forced pooling should apply to the drilling of horizontal wells." *Id.* at Fn. 20. Because of the way the case was presented on appeal, the Court looked only at proper payment of royalties as a means of recovering damages for the lessors, but, given the breach of the lease by the operator, the court ruled that "Lessors may not be limited to this remedy on remand." *Id.* at Fn. 30.

Just as the lessees in *Luecke* breached the lease by drilling the horizontal well at issue in that case, EOG will breach its lease with the Klotzmans if it drills the Klotzman

1H without first negotiating the necessary pooling rights with the Klotzmans. EOG proposes to do exactly what the operator in *Luecke* proposed to do: abandon efforts to negotiate the necessary pooling authority with the lessors and take the position that horizontal wells are different and do not require pooling authority. The court rejected that argument in *Luecke*.

When the drilling of a horizontal well is inconsistent with the pooling provisions in the subject leases, the *Luecke* court holds there are two options for the operator – not drilling the well, or seeking proper authority from the lessor. The court notes that "several legal articles and treatises have advised lessees to seek amendments to existing leases prior to drilling horizontal wells," and goes on to cite them. One of those treatises is Smith & Weaver. In the section of the treatise cited by the court, Professors Smith and Weaver discuss problems involving lease pooling provisions that could have been avoided if the provisions had been drafted differently or if they had been amended prior to the operator drilling the well.

> "Other changes in both the printed form and special additions thereto may be necessary if the lessee anticipates engaging in new or experimental drilling techniques. To maximize the benefits from horizontal drilling, a lessee may need considerable flexibility in determining how much acreage to pool, for the size of the proration unit permitted a horizontal well is based on the length of the horizontal well bore and so is not determined until after the well is completed. *The lessee also needs to assure that it is authorized to pool* land into the long, relatively narrow unit which is consistent with the model used in setting the proration allowable for horizontal wells within the field."

1 Ernest E. Smith & Jacqueline Lang Weaver, *Texas Law of Oil and Gas* 4.8[C][2] (LexisNexis Matthew Bender 2012)(emphasis added).

The Court of Appeals in *Luecke* also rejected the operator's claim that his actions were justified because completion of a horizontal well that complied with the lease pooling provisions would have been uneconomic, holding that if drilling a well in compliance with the lease provisions was "economically impractical," the operator's options did not include creating a unit in excess of the authority granted by the lease. *Id.* at 642.

EOG Lacks Authority to Drill and Operate the Proposed Well Without Pooling

EOG's well, as proposed, will traverse two leases, the Georgia Dubose – Glassell lease and the Georgia Dubose – Pierce lease. Though the wellbore will extend across both leases and is expected to produce from both leases, surface operations will be located on the Pierce lease.

A mineral lessee in Texas has the right to make whatever use of the surface is reasonable and necessary to recover the minerals beneath the tract. That right, however, does not include the right to use the surface of a tract to support recovery of minerals from a different tract. *Robinson v. Robbins Petroleum Corp.,* 501 S.W.2d 865 (Tex. 1973). Absent pooling of the two tracts, or some explicit authority obtained from the owner, the operator has no authority to burden the drill-site tract with operations that are conducted to facilitate production from the non-drill-site tract. *Cole v. Anadarko Petroleum Corp.*, 331 S.W.3d 30 (Tex. App. – Eastland 2010, *writ den.*); *Delhi Gas Pipeline Corp. v. Dixon*, 737 S.W.2d 96 (Tex. App. – Eastland 1987, *writ den.*).

Absent pooling, which EOG has no authority to perform, or some explicit permission from the mineral owner, EOG has no authority to conduct operations on the Pierce tract for the benefit of production from the Glassell tract. Because EOG proposes to use surface equipment located on the Pierce lease to produce oil from the Glassell lease, EOG's proposed operation is not authorized and EOG cannot claim the right to drill or operate the proposed well in good faith.

If EOG were to negotiate with the owners and obtain pooling rights, pooling the two tracts would also eliminate the need, under the terms of the leases, to accurately measure the oil "produced and saved from said land" before it leaves the lease. Because the two tracts to be produced by EOG will not be pooled, EOG has no legal authority to treat the production from the two tracts collectively and EOG remains obligated to accurately measure the oil produced and saved from each lease separately. The method by which EOG intends to produce the oil renders that impossible.

The undisputed fact that EOG has no authority to pool the subject leases led the Examiners to their conclusion that EOG did not, in fact, have "all necessary real property and contractual rights to drill and produce the applied-for well." FF 15. The Commissioners did not adopt any findings regarding EOG's pooling authority, leaving it unclear whether the Commission concluded that EOG does, in fact, have pooling authority for the subject tracts, or that it does not, but that what EOG proposes to do does not constitute pooling. If it is the former, the Commission's conclusion is contradicted by a fact that was universally acknowledged and undisputed in the hearing. If it is the latter,

the Commission's conclusion is contradicted by the leading treatises on Texas oil and gas law, which were cited in the Examiners' Proposal for Decision:

> "Pooling occurs when tracts from two or more leases are combined for the purpose of drilling a single well." 1 Smith & Weaver, Texas Law of Oil & Gas, §4.8 (Matthew Bender & Company, 2012).
>
> "Pooling, or a pooled unit, will describe the joining together of small tracts or portions of tracts for the purpose of having sufficient acreage to receive a well drilling permit under relevant state or local spacing laws and regulations. . ." 1 Bruce M. Kramer & Patrick H. Martin, The Law of Pooling and Unitization, §1.02 (Matthew Bender & Company, 2012).
>
> "Although the terms 'pooling' and 'unitization' are frequently used interchangeably, more properly 'pooling' means the bringing together of small tracts sufficient for the granting of a well permit under applicable spacing rules. . ." Williams & Meyers (Abridged), Oil & Gas Law §901 (Matthew Bender & Company, 1975).

The Commission's Substitute Finding of Fact is Incorrect

The order signed by the Commissioners excluded the Examiner's proposed Findings of Fact 4 through 15 and substituted Finding of Fact No. 4 which finds that "EOG is the operator of and owns 100% of the working interest rights to the Eagleville (Eagleford-2) Field under" the subject leases. That is not correct. EOG acquired its interest in the leases by assignment. EOG placed the Assignment in the record. EOG Exh. 12. The document was titled "Term Partial Assignment of Oil and Gas Leases." It assigned "an undivided seventy percent (70%) of Assignors' collective right, title and interest" in the leases. *Id.* This document was identified by EOG's witness as the source of EOG's interest in the subject leases. Tr. at 66.

EOG's witness did not claim that EOG owned 100% of the working interest in the leases. He stated that EOG "and its working interest partners" owned 100% of the working interest in the leases. Tr. at 55. (see also Tr. 55, ln. 14-17, and Tr. 57, ln. 6-10.) He did not identify those "partners." The Assignment referenced a "farmout agreement," but that agreement was not put in the record, nor was it discussed by EOG's witness.

The Commission's Substitute Finding of Fact is presumably pertinent, if not essential, to the Commission's overruling of the Examiners' conclusion that EOG lacked a good faith claim to the right to drill the proposed well, given that it is the only new Fact Finding included in the Order. If the record evidence does not support that Finding, there is no basis for the Commission's conclusion that EOG has a good faith claim.

The Smith Letter Provides no Support for the Commission's Order

Because the Commission adopted only four Findings of Fact, it is impossible to know if the Commission relied to any extent on arguments presented by EOG and the Intervenors based on a July 23, 2009 letter by Professor Ernest Smith. If the Commission relies on those arguments, its reliance is misplaced.

In his letter, Professor Smith never asserts that an operator like EOG, with no authority to pool, has the right to drill a horizontal well that will cross lease lines. In fact, Professor Smith carefully and explicitly limits his opinions to the circumstance where an operator *does* have the authority to pool.

Professor Smith begins his letter by stating that he has been asked to make certain assumptions, including the following: "please assume that the units in question are

validly formed and pool gas rights to all depths from 'grass roots to the center of the earth.' . . . Further assume that (i) the leases pooled grant a fee simple determinable to the lessee/operator with the right to pool . . ." Smith Letter at 1. Professor Smith goes on to discuss the fact that Texas courts disfavor policies that would discourage the use of new technology in the recovery of oil and gas. However, he never states, or even suggests, that new technology should be viewed as giving the operator the right to override a mineral owner's reservation of pooling authority.

In fact, Professor Smith acknowledges that the court in *Luecke* rejected the argument that the availability of horizontal drilling technology and the "prudent operator rule" excused the operator's compliance with the "express pooling limitations" in the lease. Smith Letter at 9. He then proceeds to distinguish the facts in *Luecke* from what he has been asked to assume for purposes of his opinion. "Unlike the *Browning* situation, however, the assumption, as stated in the request for my opinion, is that each of the existing units here was validly formed. In addition, gas rights have been pooled to all depths and all leases within each of the three units have been maintained by production from the original vertical well and/or by infill drilling of vertical wells. Hence, the allocation of production among the tracts within each unit depends upon the provisions of the pooling clause or clauses governing each of the three units." Smith Letter at 9.

Just in case he has not been explicit enough, Professor Smith asserts again in his conclusion that his stated opinions rely on the existence of the operator's pooling authority. "This conclusion has assumed a traditional pooling clause that has not been amended or modified in any way." Smith Letter at 11.

EOG and the Intervenors ignored these limitations when they read too much into the statement: "The failure of the parties to reach any agreement on ownership, much less how royalty is to be divided once production is obtained, does not override the lessor's right to drill." Smith Letter at 8. The "parties" referred to in that sentence are the mineral cotenants. The citation that follows it is a citation to that portion of the Smith & Weaver treatise that explains the fact that "A lessee's right to drill and develop mineral land is not dependent on all cotenants having joined in the oil and gas lease." Smith & Weaver §2.3[A]. The Klotzmans acknowledge that not all mineral cotenants must join in a lease to give a lessor the right to drill. That is not in dispute. But it should also not be in dispute that when a lease is issued, the lessee's rights are limited to the rights conveyed in the lease. In this case, no mineral owner has given EOG the power to pool the subject leases.

The Professor Smith letter also does not support EOG or the Intervenors' position in this case because this case is about whether the Commission should issue a permit. Professor Smith never considers the permitting issue and, in fact, states in his letter that he has followed Devon's instruction that "it is not necessary to consider the need for regulatory approvals" when responding to the questions presented. Smith Letter at 1-2.

The Smith letter does not support EOG's argument that it should be issued a drilling permit to traverse the Klotzman leases despite its lack of pooling authority. The letter's very careful and repeated caveats that the stated opinion assumes the existence of pooling authority prohibits the interpretation of the letter advanced by EOG and Intervenors.

Lastly, but also important, the opinions that EOG and Intervenors attribute to Professor Smith based on the letter are flatly contradicted by what Professor Smith states explicitly in his treatise, Texas Law of Oil & Gas, Ernest E. Smith and Jacqueline Lang Weaver (Lexis/Nexis Matthew Bender 2013).

In part 4.8[C][2] of his treatise, addressing express provisions of oil and gas leases in Texas, Professor Smith takes up the issue of how horizontal drilling affects the rights that operators must acquire from mineral owners:

> "Other changes in both printed form and special additions thereto may be necessary if the lessee anticipates engaging in new or experimental drilling techniques. To maximize the benefits of horizontal drilling, a lessee may need considerable flexibility in determining how much acreage to pool, for the size of the proration unit permitted a horizontal well is based on the length of the horizontal well bore and so is not determined until after a well has been completed. *The lessee also needs to assure that it is authorized to pool land into the long, relatively narrow unit which is consistent with the model used in setting the proration allowable for horizontal wells within the field."*

(emphasis added)

Professor Smith clearly does not believe, as EOG and Intervenors contend, that pooling authority is irrelevant to the completion of horizontal wells.

EOG and Intervenors Have Misrepresented the Significance of "Allocation Wells"

The Intervenors claimed that adoption of the Examiners' Proposal for Decision would cause "enormous physical and economic waste" and would have "tremendous statewide impact on operators' ability to permit and drill horizontal wells."(Intervenors' Exceptions at 2 and 20.) This claim is false for two reasons: (1) the numbers don't

support it; and (2) if the decision recommended by the Examiners caused Intervenors to refrain from drilling any future wells, it would be because the Intervenors elected not to obtain the rights necessary to drill the wells from the mineral owners.

The "start date" for "allocation wells" is April 2010, when Mr. Lineberry wrote the letter to Mr. Sullivan that Intervenors assert authorized "allocation wells." Between that date and the date of the hearing in this docket, the Commission issued 18,335 permits for horizontal wells. (PFD at 18) Of those, 55 were "allocation wells." *Id.* Therefore, during the entire period in which "allocation well" permits were issued, they accounted for just three tenths of one percent of all the horizontal wells permitted. This means that 99.7% of the time, operators were able to drill the horizontal wells they desired without resorting to an end-run around their lack of pooling authority. This may be because most operators are less intransigent than EOG and the Intervenors in their negotiations with mineral owners, or it might be because few operators are confident of the legality of "allocation wells" in Texas.

In Denying the Permit, the Commission is Not "Adjudicating Title," It is Enforcing Its Own Rules

Despite EOG's and Intervenors' insistence to the contrary, Protestants and the Commission's Examiners are fully aware of the fact that the Commission does not have the authority to adjudicate title. This is a red herring. Protestants are not asking the Commission to adjudicate title. Protestants are asking the Commission to enforce its own rules – rules that require an operator seeking to combine acreage from separate leases into

a single drilling unit to represent in good faith that it has the right to do that. Statewide Rule 40 has required that for more than thirty years --- and it has never been amended to make an exception for when the operator chooses to label his well an "allocation well."

The Klotzmans did not introduce any leases or title documents into the record. EOG did. It is not necessary to examine a single title document to decide in favor of the Klotzmans. All parties agree that EOG does not have the right to pool the subject acreage. That is not in dispute and does not require determination by the Commission. That fact having been established, all the Commission needs to do to find in favor of the Klotzmans is to enforce its own rules.

Issuance of "Allocation Well Permits" is Not a "Well Established" or "Well Reasoned" Practice

EOG and Intervenors contended that the issuance of "allocation permits" such as the permit sought by EOG in this case is a "well established" and "well reasoned" practice. It is neither.

As the Commission's Examiners correctly noted, the Commissioners have never adopted a rule or order, or statement of policy, or *anything* authorizing the issuance of the type of drilling permit EOG seeks here. (PFD p.18) In fact, the Commissioners actions have been to the contrary. In 2009, the Commissioners voted unanimously to adopt a recommended decision that rejected Devon's proposal to make "allocation wells" part of the field rules for the Carthage (Haynesville Field). Oil & Gas Docket No. 06-026200.[3]

[3] The Examiners in this proceeding took official notice of the file in Docket No. 06-026200.

The Proposal for Decision adopted in that case stated that the practice would be "unprecedented in Commission practice" and would "far exceed the Commission's statutory authority."[4] On another occasion, two of the Commissioners voted to approve a Production Sharing Agreement well permit *if* the operator could represent that he had at least 65% of the mineral ownership in each tract signed on.[5] EOG does not have a Production Sharing Agreement with the mineral owners.

Despite the fact that there has never been any action by the Commissioners authorizing "production allocation wells" -- and despite that fact that the Commission has never sought to amend or repeal rules that prohibit them (Statewide Rules 40 and 26), EOG and Intervenors insisted on calling the issuance of such permits "an established practice."

Intervenors contended that there have "historically" been three procedures for granting drilling permits for wells that traverse multiple leases. Intervenors described these three methods as: (1) pooling, "where the applicant has the right – and desires—to pool acreage from the tracts to be traversed"; (2) production sharing agreement wells "where the applicant seeks and obtains requisite approvals from parties with an interest in the well in the form of a production sharing agreement"; and (3) "allocation wells." (Intervenors' Exceptions p. 3) But if the Commission's "method" for approving allocation well permits requires no proof of pooling authority, then operators have no need to ever file P-12 forms for horizontal wells crossing lease lines. If the approvals

[4] PFD in Docket No. 06—026200 at 14.
[5] Railroad Commission Minutes of Formal Commission Actions, September 9, 2008.

obtained from parties to drill Production Sharing Agreement wells are "requisite" --- as Intervenors themselves describe them, it makes no sense to have an option like "allocation wells" where no agreement at all from the interest holders in the well is required. In fact, Intervenors and EOG obviously believe that it is proper to obtain an "allocation well" permit without even providing notice to the parties with interests in the well.

Typically, when Commission rules provide an alternative means of obtaining a permit that excuses compliance with some of the normal requirements for such a permit, the rule includes a check on the procedure – such as the requirement that the applicant provide notice to affected parties and give them 15 or 21 days to protest the proposed permit. But under EOG's and Intervenors' version of "allocation well" permit procedures, there is no such check. An operator merely needs to call his well an "allocation well" in his application and he is instantly excused from the normal requirements of certifying his right to pool or acquiring the "requisite" approvals from parties with interests in the well. This makes no sense. EOG and Intervenors contend that an applicant for an allocation well must have the right to produce from the tracts to be traversed, but that is also true for pooled unit wells and production sharing agreement wells. In EOG's and Intervenors' system, a drilling permit applicant is required to prove nothing in order to be excused from certifying his right to pool or obtaining agreements from mineral owners. Such an interpretation of Commission rules is inherently contradictory.

CONCLUSION

The Commission's Examiners found that of the 18,335 wells permitted during the time period when "allocation well" permits were being issued, only 55 were applied for as "allocation wells." Even fewer were ever actually completed and operated as "allocation wells." This raises the question as to why so many operators lobbied so hard against adoption of the Examiners' recommendations. The answer is leverage. The use of horizontal wells to develop Texas shale formations has resulted in situations where some reserves can be developed more efficiently by drilling horizontal wells that cross existing lease lines. Where the operator has the authority to pool, there is no obstacle to such completions. Where operators lack those pooling rights, they must go to the mineral owners and negotiate the necessary rights to complete the wells across lease lines. Some operators would prefer not to be in that situation. They would rather complete the well first and then approach the mineral owners with a choice: a division order and a check --- or a lawsuit. For those operators who negotiate with mineral owners beforehand, some prefer to go into such negotiations with the added leverage that, if the mineral owner will not agree to the terms offered by the operator in exchange for pooling rights or a Production Sharing Agreement, the operator can simply threaten to walk away from the table and get the well permitted as an "allocation well."

The Examiners' Proposal for Decision threatened to remove that leverage by revealing that "allocation wells" are a regulatory fiction, with no authorization or support in Commission rules, the Texas Natural Resources Code or Texas case law. Threatened with the loss of that leverage in their negotiations with Texas mineral owners, operators

came out in force, supplementing EOG's low-key defense of "allocation wells" with exaggerated claims that the Examiners' proposal would significantly hinder horizontal drilling. Nothing in the record supports those exaggerated claims.

The right to pool is a part of the bundle of property rights held by the owner of the mineral estate. Texas law has jealously guarded that property right. Operators have failed in numerous attempts to obtain legislative approval of force-pooling bills that would take away that property right. The Commission's approval of allocation well permits, like the one sought by EOG, would ignore mineral owners' property rights and run counter to the Commission's long history of protecting those rights through its rules requiring proof of pooling authority.

The Protestants respectfully request that the Commission rescind its order of September 24th, 2013 and adopt the Examiners' Proposal for Decision, including all of the Examiners' Proposed Findings of Fact and Conclusions of Law, and their recommended order.

Protestants also respectfully request oral argument on this Motion.

Respectfully submitted,

Patrick F. Thompson
State Bar No. 19932950
pthompson@gdhm.com
John B. McFarland
State Bar No. 13598500
jmcfarland@gdhm.com
GRAVES, DOUGHERTY, HEARON & MOODY,
A Professional Corporation
401 Congress Avenue, Suite 2200
Austin, Texas 78701-3619
Tel: (512) 480-5786
Fax: (512) 536-9903

By: 
Patrick F. Thompson

Certificate of Service

I certify that on October 14, 2013, a copy of the foregoing Protestants' Motion for Rehearing was sent by **regular mail**, or by **email** if so indicated, to the persons listed below.

Doug Dashiell *(via email)*
Scott, Douglass & McConnico
1500 One American Center
600 Congress
Austin, Texas 78701
ddashiell@scottdoug.com

Brian Sullivan (*via email*)
McElroy, Sullivan & Miller
1201 Spyglass Drive, Suite 200
Austin, Texas 78746
bsullivan@msmtx.com

William Osborn (*via email)*
Osborn & Griffith
515 Congress Ave. #1704
Austin, Texas 78701
william@texasenergylaw.com

Jamie Nielson *(via email)*
7000 N. Mopac Expressway, 2nd Floor
Austin, Texas 78731
Jamie@nielsonlaw.com

Spencer Klotzman
603 E. Mesquite L.
Victoria, Texas 77901

Patrick Oegerle
7744 Broadway, #204
San Antonio, Texas 78209

Mickey Olmstead
McElroy, Sullivan, Miller,
Weber & Olmstead
P.O. Box 12127
Austin, Texas 78711

Errol J. Dietze
P.O. Box 841
Cuero,Texas 77954

Sue E. Hilbrich
P.O. Box 21
Westhoff, Texas 77994

Will & Lucille Gips
P.O. Box 1052
Cuero, Texas 77954

Wilfred & Barbara Konrad
22434 Unicorns
Karr, Texas 77449

Alan & Iona Buchhorn
7452 FM 108
Yorktown, Texas 78164

Mr. & Mrs. Will Haun
8006 Shadow Forest
San Antonio. Texas 78239

Michael Sheppard
106 S. Gonzales
Cuero, TX 77954

Robert D. Jowers
1301 McKinney St., Suite 2900
Houston, Texas 77010

Bill Warnick
General Counsel
Texas General Land Office
1700 Congress Avenue
Austin, Texas 78701

Andrew Abrameit
Law Offices of Donato D. Ramos, LPPC
P.O. Box 192
Cuero, Texas 77954

Gil Bujano
Railroad Commission of Texas
P.O. Drawer 12967
Austin, Texas 78711

Ramon Fernandez
Railroad Commission of Texas
P.O. Drawer 12967
Austin, Texas 78711

Lorenzo Garza
Railroad Commission of Texas
P.O. Drawer 12967
Austin, Texas 78711

Patrick F. Thompson