RAILROAD COMMISSION OF TEXAS
OFFICE OF GENERAL COUNSEL

APPLICATION OF EOG RESOURCES, INC., KLOTZMAN LEASE (ALLOCATION) WELL NO. 1H, EAGLEVILLE (EAGLE FORD - 2) FIELD, DEWITT COUNTY, TEXAS	§ § § § § §	OIL AND GAS DOCKET NO. 02-0278952

CLOSING STATEMENT OF EOG RESOURCES INC.

TO THE HONORABLE RAILROAD COMMISSION OF TEXAS:

COMES NOW EOG Resources, Inc. ("EOG") the Applicant and files this, its Closing Statement in this docket.

I. Introduction and Background

EOG seeks an "allocation" drilling permit to drill a horizontal well in the Eagleville (Eagle Ford – 2) Field, DeWitt County across two (2) leases in which EOG and its partners own 100% of the leasehold estate.[1] Although the Railroad Commission ("Commission") has approved at least sixty seven (67) allocation permits since year 2010 (EOG Exhibit 13), this is the first such application set for a contested hearing. There are no material facts in dispute in this case. There are no unleased interests in the lands covered by the leases or within a 330 foot spacing distance of the wellbore. In all previous allocation well applications, the Commission approved the permit based upon the operator's representation of these identical controlling facts without notice or a hearing. This case has been set for hearing solely because the Protestants, Katherine Larson Reilly and Melanie McCollum Klotzman, individually and sole Trustee of the Melanie McCollum Klotzman Exempt Trust ("Klotzman") filed a protest on July 20, 2012, while this application was pending administrative approval, alleging that a production sharing agreement was required for any drilling permit for a horizontal well drilled

[1] See EOG Exhibit 1 for the complete application.

across separate tracts. After a series of letters were exchanged concerning the protest, on October 5, 2012, Mr. Lineberry wrote to the parties advising that the protest "casts sufficient doubt on the Applicant's assertion of a good faith claim to preclude the administrative approval of the requested permit at this juncture." Mr. Lineberry offered the parties an opportunity to present evidence regarding whether "EOG has a sufficient good faith claim to authorize issuance of an RRC drilling permit for the proposed allocation well." (EOG Exhibit 7).

The Klotzman protest calls into question not only the drilling permit for this well, but also seeks to end completely the Commission's almost three (3) year old practice of issuing drilling permits for allocation wells. The Protestants, and others, have joined in a Petition to Initiate Rulemaking Proceedings to Amend Statewide Rule 40. (TR. 19 – 20). Their rule proposal would expressly ban drilling of horizontal wells across separate tracts unless 65% or more of the "interest holders for each affected lease or pooled unit" join in a production sharing agreement. The proposed rule would require at least 65% agreement of both working interest and royalty owners to authorize drilling across separate tracts. Regardless of whether the Commission elects to proceed with this rulemaking, such a rule does not currently exist and EOG has met all current requirements for an allocation permit. To selectively deny EOG's permit application would be arbitrary and capricious. As explained below, such denial would also cause substantial waste and harm the correlative rights of lessees to drill for and produce their minerals in the most efficient manner to maximize oil and gas recovery.

II. This Application Meets the Commission's Current Guidelines for Allocation Permits and Should be Approved

Texas law has long required that an applicant for any drilling permit have a good faith claim of ownership in the property. *Magnolia Petroleum v. Railroad Commission,* 170 S.W.2d 189 (Tex. 1943). As shown below, the oil and gas leases in this case, granted in 1956 and 1959

respectively, grant the Lessee a determinable fee estate in the minerals in both leases and the exclusive right to drill wells for oil and gas production.

An allocation permit is simply a drilling permit authorizing the operator to claim acreage from two or more separate leases or pooled units as a drillsite tract for a horizontal well. Mere assignment of acreage to a drilling or proration unit does not "pool" the interests of any owner. All owners retain the right to receive oil or gas produced from their respective tracts.[2] The Commission issued the first allocation permit to Devon Energy Production Company, LP ("Devon") for its Well No. 1H, Taylor-Abney-O'Banion (Allocation) Unit, Carthage, (Haynesville Shale) Field, Harrison County, Texas. (EOG Exhibit 3). As Mr. Lineberry wrote in his April 21, 2010 letter in that case:

> Based on information submitted and particularly the representation by Applicant that it holds leases covering 100% of each tract traversed by the wellbore and that there are no unleased interests within 330 feet of any point on the wellbore, it appears that Applicant has met the minimal good faith claim standard necessary for issuance of a permit.

EOG Exhibit 3. Mr. Lineberry went on to explain:

> The Commission expresses no opinion as to whether the leases alone confer the right to drill across lease lines as contended by Applicant or whether a pooling agreement or production sharing agreement is also required. However, until that issue is directly addressed and ruled upon by a Texas court of competent jurisdiction, it appears that a 100% interest in each of the leases is a sufficient colorable claim to the right to drill a horizontal well as proposed to authorize the removal of the regulatory bar and the issuance of a drilling permit by the Commission, assuming the proposed well is in compliance with all other relevant Commission requirements.

Id. (Emphasis added).

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[2] It is important to distinguish an allocation drilling permit, which has no impact on the rights of royalty owners to be paid under their lease, from the "allocation rule" proposed by Devon in Oil & Gas Docket No. 06-0262000. The "allocation rule" purported to create a presumption that allocation based on completed wellbore footage beneath each tract constituted "fair and reasonable" allocation. An allocation permit, by contrast, merely satisfies the permitting requirement and removes the regulatory bar to drilling the well.

Commission staff continues to approve these permits administratively as recently as November 2012 as shown on EOG Exhibits 15 and 16. Because EOG unquestionably owns title to the oil and gas leasehold estate beneath both tracts involved, it has met the standard set forth by Mr. Lineberry of a ""sufficient colorable claim to the right to drill." This showing should end the inquiry in this docket and the Commission should approve EOG's permit just as this agency has done for the other allocation well permit applicants. EOG Exhibit 13.

III. EOG Has Met the Good Faith Claim to Title Standard

Mr. Lineberry's 2010 letter correctly concludes that the controlling legal inquiry for allocation well permit applications is whether the applicant has a good faith claim of ownership in to its leases. As the Texas Supreme Court has held:

> The function of the Railroad Commission in this connection is to administer the conservation laws. When it grants a permit to drill a well it does not undertake to adjudicate questions of title or rights of possession. These questions must be settled in the courts. When the permit is granted, the permitee may still have no such title as will authorize him to drill on the land.

Magnolia Petroleum v. Railroad Commission, 170 S.W.2d 189 (Tex. 1943). The Supreme Court went on to hold:

> If the applicant makes a reasonably satisfactory showing of a good faith claim of ownership in the property, the mere fact that another in good faith disputes his title is not alone sufficient to defeat his right to the permit; neither is it ground for suspending the permit or abating the statutory appeal pending settlement of the title controversy.

Id. at 191. (Emphasis added).

As shown by EOG Exhibit 1, EOG proposes to drill across two (2) separate oil and gas leases where the royalty ownership is similar, but not identical. The granting clause of the "Georgia Dubose" Lease provides that the Lessor:

> . . . does hereby grant, lease and let unto Lessee the land covered hereby for the purposes and with the exclusive right of exploring, drilling, mining, and operating for, producing and owning oil, gas, sulphur, and all other minerals (whether or not similar to those mentioned) with the right to make surveys on said land, lay pipelines, establish and utilize facilities for surface or subsurface disposal of salt water, construct roads and bridges, dig canals, build tanks,

> power stations, telephone lines, employee houses, and other structures on said land, necessary or useful in Lessee's operations in exploring, drilling for, producing, treating, storing, and transporting minerals produced from the land covered hereby or any other land adjacent thereto.

EOG Exhibit 9. (Emphasis added).

The granting clause in the "Dubose B" Lease provides that the Lessor:

> . . . hereby grants, leases, and lets exclusively unto Lessee for the purpose of investigating, exploring, prospecting, drilling and mining for and producing oil, gas, and all other minerals, laying pipelines, building tanks, power stations, telephone lines, and other structures thereon to produce, save, take care of, treat, transport, and own said products, and housing its employees . . ..

EOG Exhibit 10. (Emphasis added).

The term of these leases is controlled by the habendum clauses contained in Paragraph 2 of each lease. Both leases were for a five (5) year primary term "and as long thereafter" as operations or production are conducted as required by the terms of the leases. There is no dispute that the leases remain in effect, and EOG and the working interest owners own the exclusive right to drill and develop the leases. These leases grant the lessee determinable fee ownership of all the minerals in place:

> In Texas it has long been recognized that an oil and gas lease is not a 'lease' in the traditional sense of a lease of the surface of real property. In a typical oil or gas lease, the lessor is a grantor and grants a fee simple determinable interest to the lessee, who is actually a grantee. Consequently, the lessee/grantee acquires ownership of all the minerals in place that the lessor/grantor owned and purported to lease, subject to the possibility of reverter in the lessor/grantor . . .. A royalty interest, as distinguished from a mineral interest is a non-possessory interest.

Natural Gas Pipeline Co. of America v. Pool, 124 S.W.3d 188, 192 (Tex. 2003).

EOG, as owner of both leases, could unquestionably drill a vertical well on each of the leases, just one foot from the common boundary line, pursuant to a Rule 37 exception granted by its own waiver. EOG's right to drill horizontally across its leases, using modern technology designed to maximize recovery, should accordingly not be subject to legitimate dispute.

As the Austin Court of Appeals has held in *Browning Oil Co. v. Leucke,* 38 S.W.3d 625, 634:

> Each tract traversed by the horizontal wellbore is a drill site tract, and each production point on the wellbore is a drillsite. The basic purpose of the oil and gas lease is the development of any oil and gas reserves beneath the land subject to it.

Citing Smith and Weaver § 4.1B.

As Professor Smith opined in his July 23, 2009 letter:[3]

> Although the parties to leases executed over a half century ago were almost certainly thinking of 'drilling' in terms of vertical drilling, the specific type of drilling, like the type of exploration and prospecting, is not specified. The word 'drilling' is broad and general enough to include any type of drilling including 'horizontal drilling' and so forth that is or has become standard industry practice.

These authorities clearly demonstrate that EOG, through its oil and gas leases, has a good faith claim to title and is entitled to a drilling permit for the proposed horizontal well to develop its leases.

IV. Issuance of the Allocation Permit Will Prevent Waste

The availability of allocation well drilling permits is essential for operators such as EOG to efficiently develop leases in unconventional plays that require horizontal drilling across multiple tracts in cases such as this where the leases do not authorize pooling and the lessees have exhausted reasonable efforts to reach agreement with lessors. The ability to permit and drill allocation wells will prevent the waste of millions of barrels of crude oil. As EOG demonstrated in this case, in the vicinity of the Klotzman Leases alone, over 5 million barrels of additional crude oil will be recovered by drilling allocation wells as opposed to lease wells. (EOG Exhibit 19).

[3] This letter is part of the administrative record in Oil & Gas Docket No. 06-0262000 which has been officially noticed in this case. (TR page 13).

The Railroad Commission has broad powers to prevent waste. Texas Natural Resources Code §§ 85.045 and 86.011 declare waste is "unlawful" and "prohibited." Waste is defined in § 85.046(a)(6) to include "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." EOG presented uncontroverted evidence in this case that substantial physical waste of oil will occur on the Klotzman Leases if EOG is not allowed to drill this and numerous additional allocation wells on the Klotzman acreage. (EOG Exhibits 17 – 19). EOG showed that an additional 5 million plus barrels of crude oil will be recovered through the use of allocation permits on the Klotzman acreage alone. Denial of this recovery would be waste as defined by § 85.046(a)(6), caused by spacing or locating wells in a manner that reduces the total ultimate recovery of oil. The additional waste resulting on the Klotzman acreage is just a snapshot of EOG's overall drilling program in the Eagle Ford and other areas and these numbers will be multiplied many times over if the Texas oil and gas industry is not allowed to use allocation permits for drilling and spacing horizontal wells.

V. Protection of Correlative Rights

The Railroad Commission has jurisdiction over and a duty to protect correlative rights. Although not defined by statute, correlative rights are recognized as the property rights of those who own land overlying a common reservoir. Texas law insures that each person will be entitled to recover a quantity of oil or gas substantially equivalent in amount to the volume of recoverable oil or gas under his land. Granting this permit protects the correlative rights of all mineral owners to recover their oil in place. As the evidence in this docket established, the oil and gas leases grant to the Lessees, including EOG, a determinable fee estate in the minerals. The Lessors, including the Klotzmans, have reserved a total Lessor's royalty of 1/8th of

production (12 ½% of the revenue). Out of this 12 ½% Lessor's royalty, the evidence shows that the Protestants own .07812499, or just under 8%, of the revenue interest in the Georgia Dubose Lease, and revenue interests ranging between .07812499 and .109374998 (approximately 8 – 11%) in the Dubose B Lease. (EOG Exhibit 11). In other words, less than 11% of the revenue interest in the land objects to this permit. The owners of 100% of the possessory mineral estate and over 89% of the revenue interest in both leases do not object to this Application, but desire to drill and develop their mineral estate. These majority owners have correlative rights entitled to protection. Texas courts have recognized that a lessee such as EOG has a property interest entitled to protection against confiscation separate and distinct from his lessor's right. *Texaco, Inc. v. Railroad Commission,* 716 S.W.2d 138, 141 (Tex. Civ. App. Austin 1986, writ ref'd n.r.e.). As Professor Smith opined on Pages 7 and 8 of his July 23, 2009 letter, a multiplicity of royalty owners may make obtaining production sharing agreements from all owners logistically impossible and that "the absence of such an agreement will not preclude drilling." In this letter, Professor Smith further opines as follows:

> Uncertainty over how production should be allocated does not override a Lessee's right to drill. 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 Lessee's right to drill.

See generally Ernest T. Smith & Jacqueline L. Weaver, Texas Oil & Gas Law, § 2.3(A), (2nd Ed., 2009 Update.)

The Klotzmans have objected to this permit on the grounds that the Commission should require a production sharing agreement to be in place before a permit is issued to drill across separately owned tracts. The Klotzmans and their affiliated group of landowners have proposed amendments to Statewide Rule 40 which, if adopted by the Commission, would require a minimum of 65% of working interest and royalty interest owners to agree before a permit will be granted to drill across separate tracts. Quite simply, the Klotzman's position and

their proposed rule would end the Commission's three (3) year practice of permitting allocation wells, would significantly curtail drilling, cause waste, and harm correlative rights of lessees and other mineral interest owners desiring development of their minerals. Even if the Commission were to adopt such a 65% requirement, however, the need for Lessees to allocate production to separately owned tracts would not be eliminated. For example, if a hypothetical PSA well were permitted with 65% royalty owner sign up as proposed in the Klotzman's Rule 40 amendment, there would still be up to 35% of the royalty interest unsigned. If the oil and gas leases contained a 25% lessor's royalty, 35% of that 25% royalty interest, or 8.75% of the revenue interest owners in the well, would not have agreed to a PSA. That is approximately the same interest the Klotzman's own in this case. The proposed rule amendment begs the question why the Commission should grant a permit for a PSA well with 8.75% nonjoining revenue interest, but yet deny a permit with approximately that same interest objecting to an "allocation well." The answer is that the Commission should not deny an allocation permit. In both the PSA well and allocation well case, the operator/lessee will have a contractual duty to protect the royalty owners by making a determination of what production may be attributed to their separate tracts with reasonable probability. *See, Browning Oil Co. v. Leucke,* 38 S.W.3d 625, 647 (Tex. App. - Austin 2000, pet denied). Similarly, the issue of allocating royalty to separate ownership exists not only with PSA and allocation wells but also with "lease wells" as shown in this docket by the recently drilled EOG Reilly No. 1H. (EOG Exhibit 8). Although entirely drilled within the boundaries of the Dubose B Lease, that wellbore crosses separately owned tracts in which the Klotzmans own royalty interests varying from .07812499 to .109374998, the same ownership difference as presented in the Klotzman No. 1H. As with an allocation well, the lessee must allocate production to separately owned tracts for this lease well. In all three cases (PSA well with nonjoined interest, allocation well, or lease well crossing

differing revenue interest), the lessors rights are protected by Texas law, including the lessee's duty to properly account to them for all production attributable to their tract. The correlative rights of lessees are protected only if the Commission grants the drilling permits that are needed for the proper development of their mineral estate.

VI. Allocation Permits Do Not Violate Current Commission Rules

In argument at the hearing, counsel for the Klotzmans alleged that allocation permits violate various Commission rules and prior precedent. They further advised that a legal brief had been prepared and would be submitted to the Examiners as part of their Closing Statement. EOG denies that the Commission's ongoing practice of issuing allocation permits violates any existing rule or law. However, because EOG has not yet seen the Klotzman's arguments on these points EOG will reply to any such arguments in its response to the Klotzman's closing statement.

VII. Conclusion

The availability of allocation well drilling permits is good policy and essential for operators such as EOG to efficiently develop leases in unconventional plays that require horizontal drilling across multiple tracts in cases where the leases do not authorize pooling. The ability to permit and drill allocation wells will prevent the waste of millions of barrels of crude oil. As EOG demonstrated in this case, in the vicinity of the Klotzman Leases alone, over 5 million barrels of crude oil will be recovered by drilling allocation wells as opposed to lease wells. (EOG Exhibit 19). The Commission has a statutory duty to prevent waste and promote development of the State's oil and gas resources. It has no jurisdiction to determine proper royalty allocation or payments. If the Commission were to single out this EOG application and refuse to grant the requested allocation permit, substantial waste of recoverable oil and gas will occur, and EOG and the non-objecting mineral owners' correlative rights will be harmed by

denying them the reasonable opportunity to produce the reserves underlying their lands. Operators, including EOG, have relied upon the Commission's issuance of these permits in acquiring and planning to develop their leases, and if the Commission elects in this case to discontinue this practice, it will substantially harm development and cause major economic loss to all mineral interest owners.

The Commission should continue its sound regulatory policy of permitting allocation wells which promote efficient recovery of hydrocarbons in the state.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that a true and correct copy of the foregoing has been served on all counsel of record, in the manner indicated below on the 4th day of January, 2013.

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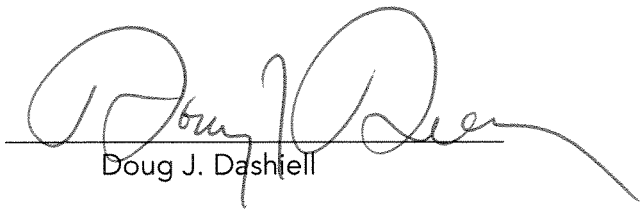

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