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

EOG RESOURCES INC.'S REPLY CLOSING STATEMENT

TO THE HONORABLE RAILROAD COMMISSION OF TEXAS:

Comes now EOG Resources, Inc. ("EOG") and files this, its Reply Closing Statement. EOG will reply herein to the "Closing Brief" filed by the Klotzman Protestants and to the Closing Statement filed on behalf of the Texas General Land Office.

I. Reply to Closing Brief of Protestants Katherine Larson Reilly and Melanie McCollum Klotzman

A. Introduction.

The Klotzmans' "Closing Brief" reveals the protestants' ultimate objective in this case: to have the Commission intervene in a private contractual dispute in hopes of exacting additional consideration from its Lessee, EOG. The Klotzmans do not dispute EOG's title, or that its evidence proves allocation permits such as this one will result in substantial additional recovery of oil. Instead, they complain that "EOG was unwilling to give the Klotzmans the commitments they sought" (Page 1) and that "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" (Page 2). They conclude by arguing that a denial of the permit will simply mean that EOG "Will remain free to negotiate amendments to its leases with the Klotzmans" (Page 14). In other words, all of the alleged harm they contend will occur from allocation wells would disappear if only the Lessee would pay additional royalty, make drilling commitments, or other contractual amendments they seek. This position is akin to an offset

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mineral owner asking the Commission to deny a Rule 37 permit unless the applicant agrees to pay him an overriding royalty in the well. The Commission has no power to intervene in private contractual disputes. The Klotzmans' pleas should be rejected.

All Parties agree that this case is governed by the good faith claim to title standard. All but the GLO cite the Examiners to *Magnolia Petroleum Co. v. Railroad Commission* as controlling authority. Yet the Klotzmans' Closing Statement reflects a misunderstanding of the source of EOG's good faith claim. They allege that EOG has asserted a mere "legal conclusion" of its right to drill through the testimony of a landman. EOG's landman, Mr. Ryan, testified primarily to sponsor and authenticate EOG's oil and gas leases and assignments which were admitted into evidence. It is EOG's oil and gas leases which establish, without question, that it owns the determinable fee mineral estate in all of the lands involved in this application. EOG's title is not in dispute. The Protestants cannot point to a single provision of the oil and gas leases which purport to deny EOG the right to drill on any portion of its leases.

B. **Granting the Permit Would Not Violate Commission Policy.**

Contrary to the Klotzmans' argument, EOG's application fully complies with current Commission policy. EOG demonstrated the original expression of this policy in Mr. Lineberry's April 21, 2010 letter (Exhibit B to EOG Exhibit 3). EOG further proved that the Commission has implemented this policy consistently through a three (3) year practice of granting at least sixty seven (67) allocation permits. A first-hand account of the events leading up to the April 21, 2010 Lineberry letter is set out on Pages 2 through 4 of Devon's Closing Statement, including the fact that the letter was issued only after Devon had filed suit in State district court to appeal the decision in Oil & Gas Docket No. 06-0263000. On Page 4 of Klotzmans' Brief, a passage is quoted from the Examiners' discussion in the Proposal for Decision in that docket. In addressing Devon's proposed "Allocation Rule," the Examiners concluded that such field rule

would have directed "that the mineral owners be paid in a manner different than is provided in the lease contracts." The Allocation Rule would have created a presumption that footage based allocation would result in "fair and reasonable allocation" of production. Regardless of whether this quoted passage was an accurate characterization of Devon's proposed field rule amendment in year 2009, it has nothing to do with the permit requested in this case. EOG seeks only a drilling permit, on the same basis as the other sixty seven (67) allocation permits approved by the Commission to date. It does not seek any relief that would change the manner in which it calculates and pays royalty under any lease. Moreover, even if the Proposal for Decision in Docket No. 06-0263000 were some evidence of the Commission's policy in year 2009 relating to allocation permits, it predates Mr. Lineberry's April 21, 2010 letter which has reflected the Commission's policy since that date.

The Klotzman's further quote from the minutes of a Railroad Commission conference held September 9, 2008 regarding an unspecified Devon application for a production sharing agreement ("PSA") permit. The Klotzmans assert that those minutes 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.

EOG does not dispute that the Railroad Commission has granted drilling permits for PSA wells for a number of years. The practice of granting PSA permits long predates the approval of allocation permits and continues to this date. The fact that a prior Commission may have orally voiced approval of the Commission's PSA permitting policy in 2008 is no evidence that the Commission has not also adopted a policy of allowing allocation permits since 2010. That the Commission has also adopted a PSA-12 Form is not inconsistent with allocation well permitting. As shown on EOG Exhibit 16, the PSA-12 Form is utilized in the

processing of allocation permits as well as PSA permits. The Klotzmans concede that "the form as adopted did not set forth a minimum level of participation by mineral owners" (Page 5) but argue that "a form stating the percentage participation achieved by the operator would be completely unnecessary for an allocation permit." On the contrary, the Form PSA-12 gathers relevant acreage totals to demonstrate compliance with Rule 38, and the quantum of acreage from each of the separate leases. The form has a valid purpose for both PSA wells and allocation wells.

At its core, the Klotzmans' closing argument is a direct challenge to Mr. Lineberry's authority to issue the April 21, 2010 letter. While conceding that the letter reflects "an apparent change in policy," (Page 6), the Klotzmans imply that the requirements for an allocation permit set out by Mr. Lineberry are not supported by the Commissioners themselves because the letter "does not cite any action by the Commissioners in support of the apparent change in policy." All Commission staff, including Mr. Lineberry, have a statutory obligation to perform the duties prescribed by the Commission in accordance with its rules. Tex. Nat. Res. Code § 81.019. There is no basis to infer that the April 21, 2010 letter is inconsistent with this duty.

The Klotzmans further claim that Mr. Lineberry's letter is "irrelevant" to this case because it was issued prior to Mr. Lineberry's October 5, 2012 letter (EOG Exhibit 7). The Klotzmans mischaracterize that letter as "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." What Mr. Lineberry actually wrote in the October 5, 2012 letter was "The complainants' assertions cast sufficient doubt on the applicant's assertion of a good faith claim to preclude the administrative approval of the

requested permit <u>at this juncture</u>." (Emphasis added). It did nothing more than require EOG to document its good faith claim at a hearing, which it has done.

C. Allocation Permits are Not Inconsistent with Commission Rules.

The Klotzmans argue that allocation permits violate both Statewide Rule 40 and Statewide Rule 26. They allege that "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." This misstates the rule. Rule 40(a) actually says that "An operator <u>may</u> pool acreage, in accordance with appropriate contractual authority and applicable field rules, for the purpose of creating a drilling unit or proration unit . . .." The rule simply acknowledges that when leases are pooled together, pursuant to lease pooling authority or otherwise, the pooled unit may be used as the drilling or proration unit at the Commission. The Klotzmans attempt to boot strap a Rule 40 violation by leaping to the erroneous legal conclusion that by permitting an allocation well EOG, is actually "pooling." This is not pooling. All royalty owners will be paid royalty on the volume of production produced from their tract as required by the leases and Texas law. If EOG were in fact pooling, a cross conveyance of royalty interest would occur which would "vest all royalty owners with joint ownership of the royalty earned from all of the land in such block." *Veal v. Thomason,* 159 S.W.2d 472, 476 (Tex. 1942). That is not the case with a horizontal well drilled across two or more tracts where no pooling authority exists. When faced with these operative facts, the Austin Court of Appeals in *Browning v. Leucke*, 38 S.W.2d 625 (Tex. App. – Austin 2000, pet. denied) held that each lessor is entitled only to be paid royalty on production from the tract on which he owns royalty. ("Without valid pooled units, the leases do not and cannot award the Leuckes royalty on oil and gas produced from tracts they do not own.) *Id.* at 645.

The Klotzmans' argument that allocation wells violate Rule 26 is both erroneous and inconsistent with their own proposed amendment to Rule 40. They claim that "A lessor's right to actual measurement of the hydrocarbons produced from his lease is protected by Statewide Rule 26" and that "The Klotzmans are therefore entitled to the protections afforded by Rule 26." Rule 26 requires separation and measurement of production of oil at the surface of a lease prior to movement of the oil off lease. It does not and has never been construed to require downhole measurement in the wellbore. The Klotzman's Rule 26 argument is disingenuous, considering the rulemaking petition Klotzman has initiated to amend Statewide Rule 40. The Klotzmans have proposed that Rule 40 be amended to expressly authorize drilling permits for PSA wells with approval of 65% of the royalty and working interest owners. If up to 35% of the royalty interest remains unpooled and a non-participant in the PSA, every PSA well approved by the Commission would also violate Statewide Rule 26 under their argument, because the production was not actually measured in the wellbore before it crosses lease lines. In other words, if allocation permits violate Statewide Rule 26, then so do the over 600 PSA permits previously issued by the Commission and all future PSA permits that may be issued. This construction of Rule 26 is simply ludicrous. Rule 26 was enacted long before the advent of horizontal drilling and has no provisions requiring measurement of hydrocarbons below the surface of the ground.

There are certain oil and gas activities, such as hydraulic fracing, where the Commission has wisely decided that it should not regulate. The method by which production is allocated to separate tracts crossed by horizontal wells is another such area. The Commission should acknowledge that it is the Lessee's right to drill such wells and the Lessee's duty to properly pay royalties on production from each tract. As the Austin Court of Appeals opined, "We recognize the immense benefits that have accompanied the advent of horizontal drilling,

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including the reduction of waste and the more efficient recovery of hydrocarbons. . . . We decline to apply legal principles appropriate to vertical wells that are so blatantly inappropriate to horizontal wells and will discourage the use of this promising technology." *Id.* at 647.

D. Allocation Wells do not Violate Texas Law.

All Parties agree that this case is governed by the good faith claim to title standard. Although the Klotzmans do not actually dispute title, they claim that the Railroad Commission has "the duty to examine that claim for reasonableness." They then repeat the straw man argument that EOG is actually attempting to "pool" the Klotzmans' royalty and claim the Railroad Commission must examine the reasonableness of such pooling authority. The Klotzmans devote a substantial portion of their brief to the argument that EOG cannot pool, a point that is not disputed.

Klotzman mischaracterizes the holding of *Browning* case by alleging that EOG is unable to "reconcile" its application with the opinion in *Browning.* Klotzman broadly alleges that in *Browning* "The court found that an operator's completion of a horizontal well across lease lines violated the terms of the lease." The actual holding was much more narrow. The issue in *Browning* was whether or not the pooled units that the lessee had attempted to form complied with the pooling clause in the leases. The court found that they did not and, therefore, the lessee had breached the pooling clause. After the court emphasized the strong policy reasons why horizontal wells should be treated differently than vertical wells, it opined "Draconian punitive damages for a lessee's failure to comply with applicable pooling provisions could result in the curtailment of horizontal drilling." *Id.* at 647. The court then remanded the case for determination of how much oil or gas had actually been produced from the Leuckes' leases. The court in *Browning* was not presented with the question, and therefore did not hold, that the mere drilling of the well across lease lines violated the lease terms. It did hold that the

lessee's attempt to pool in violation of the lease pooling clause violated the pooling clause. *Browning* at 642.

The Klotzmans' Brief concludes by attempting to refute various other legal theories that are not involved in this case. They allege that EOG has not met the requirements of the Mineral Interest Pooling Act. EOG does not seek to do so. They argue that "estoppel" does not run against the Commission, another claim EOG is not making. EOG's position is simply that: (1) it has a good faith claim to a right to drill the proposed well under its leases and Texas law; (2) other operators possessing the same rights have been granted drilling permits for the past three years; (3) a denial of EOG's permit would be arbitrary and capricious; (4) the permit is necessary to protect correlative rights; and (5) denial of this and other allocation permits would be a wasteful policy decision that would ultimately reduce oil and gas recovery in the State.

II. Reply to the General Land Office's Closing Statement

The GLO's Closing Statement serves notice to its lessees of its belief that the State's consent is required for an allocation permit involving State owned lands. It asks the Railroad Commission to require "notice to the lessors and an opportunity to protest." It is unclear if this request is limited to State owned lands, or if the GLO seeks to impose this requirement on private lands as well. In any event, notice to lessors is not at issue in this case, where the protesting lessors have appeared and fully participated in the hearing.

EOG submits that the relevant policy issue for the Commission is not notice of allocation permit applications to the non-possessory royalty owners. The relevant issue presented is whether or not the Commission will continue its policy of granting allocation permits to operators who possess 100% of the possessory mineral estate through their oil and

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gas leases. If the Commission continues this sound policy, notice to non-possessory owners serves no purpose other than delay in the permitting process.

III. Conclusion

EOG has met all requirements for an allocation well drilling permit for the Klotzman (Allocation) No. 1H. The Commission should not sanction the use of its hearing process merely for the purpose of allowing parties to seek leverage in a private, contractual dispute that is not within the jurisdiction of the Commission to decide. We request that the permit be approved.

Respectfully submitted,

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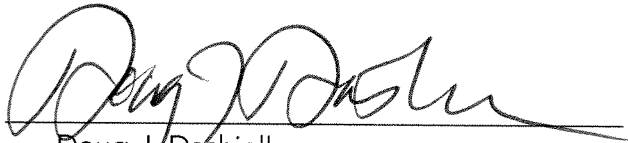
By 

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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 11th day of January, 2013.

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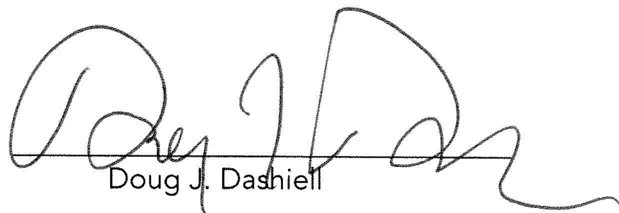

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