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

PROTESTANTS' RESPONSE
TO CLOSING STATEMENTS

This is the response of Katherine Larson Reilly and Melanie McCollum Klotzman (hereinafter "Protestants" or "Klotzmans") to Closing Statements filed in this docket on January 4, 2013 by EOG Resources, Inc.'s ("EOG") and Devon Energy Production Company, L.P. ("Devon").

Preface

The hearing in this docket was called for the purpose of giving EOG the opportunity to prove why it has a good faith claim to the right to drill the Klotzman 1H, a well that will cross lease lines, despite the fact that EOG has no authority to pool the respective leases. Though the central issue was a legal one, EOG did not sponsor a lawyer or legal expert as a witness. It sponsored a landman and objected to him being asked questions about case law, including case decisions EOG itself cited as relevant, because he is "not a lawyer."

Though EOG itself argued that operators should be granted the authority to drill "allocation wells" when "the leases do not authorize pooling" and "the lessees have exhausted reasonable efforts to reach an agreement with lessors," (EOG Closing at 6) EOG made no effort to prove the reasonableness of its refusal to agree to terms proposed by the Klotzmans --- offering no evidence at all on how terms proposed by the Klotzmans and rejected by EOG compared with terms afforded other mineral owners.

Though EOG and Devon relied heavily on an 11 page letter by a recognized oil and gas expert, they did not sponsor him as a witness. Though EOG concedes that the Klotzman leases do not grant EOG the power to pool, it based its argument on an expert opinion that concludes with the words "This conclusion has assumed a traditional pooling clause that has not been amended or modified in any way." Smith letter at 11.

Though both EOG and Devon assert, correctly, that this is a case about whether a well may be drilled, not about how the proceeds should be allocated, they both cite as authority a court opinion that held that the drilling of the subject horizontal well violated the terms of the lease.

Though one of the terms sought by the Klotzmans in exchange for allowing their leases to be pooled was a stronger drilling commitment from EOG, EOG claims now that the Commission must override the Klotzmans and issue the permit over their objections, because to require EOG to acquire pooling authority from the Klotzmans would cause "waste."

EOG's Proof Fails to Meet Its Own Standards

EOG makes the following statement in its Closing: "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.*" EOG Closing at 6. This statement necessarily raises several questions that are central to this dispute. First of all, who decides when "the lessees have exhausted reasonable efforts to reach agreement with lessors"? Apparently, EOG believes that it gets to decide, because it gave the Commission no evidence on which the Commission could base such a decision.[1]

Secondly, the question arises, why does EOG include the qualification that this power may be exercised only after "the lessees have exhausted reasonable efforts to reach agreement with lessors" when EOG contends elsewhere that it has the right to drill regardless of the lessor's position? Apparently, even EOG concedes that it is improper for the Commission to simply *ignore* and override the lessor's intent that its leases not be pooled.

Lastly, there is the question: where does this notion come from – that the Commission can step in and permit development of acreage despite the inability of the lessor and lessee to lay the necessary groundwork by reaching an agreement on terms? It appears to come from the MIPA and the MIPA's requirement that an applicant must first

[1] EOG states that the lessee sought higher royalty – but never addresses what that royalty was or how it compares to what EOG and other operators were paying other lessors in the area. EOG acknowledges that the negotiations with the lessor included discussions of drilling commitments, but never addresses the reasonableness of the commitment sought by the lessees.

make a "fair and reasonable" offer to pool to the other party before pursuing a remedy at the Commission. The problem here is: EOG is not employing the MIPA. It is employing a procedure that it and other operators invented --- without the adoption of necessary rules or legislation, without even prevailing in contested cases addressing the seminal issues. But EOG does not have the option of circumventing limitations in its leases by simply inventing new procedures at the Commission – even if those procedures mimic existing, legally adopted procedures.

The MIPA is the product of years of effort by the Texas legislature, the Commission and stakeholders to develop a fair means of providing for development when operators and mineral owners fail to reach a voluntary agreement on the terms. EOG's "allocation well" process is not the result of legislative efforts, or of rulemaking at the Commission --- or even of consideration by the Commission of the positions of various stakeholders. It is an effort by operators to use Commission authority to avoid difficult negotiations with mineral owners.

"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." EOG Closing at 3. EOG goes on to distinguish an "allocation permit" from the "allocation rule" proposed in Docket No. 06-0262000. EOG concludes: "An allocation permit, by contrast, merely satisfies the permitting requirement and removes the regulatory bar to drilling the well." How does an allocation permit "remove the regulatory bar to drilling the well"? By ignoring the fact that the applicant has no authority to combine the leases? What is the legal authority for that?

The Court of Appeals Opinion in Luecke Does Not Support EOG's Position

EOG and Devon both assert that this case is about the *permitting* of a well, not the allocation of proceeds. But when EOG and Devon discuss the *Luecke* case, they quote liberally from the court's holdings regarding the allocation of proceeds from the production of a horizontal well ---- and completely ignore the court's holdings regarding the drilling of the well itself. Presumably, that is because the court's holdings regarding the drilling of the well are completely inconsistent with what EOG wants the Commission to do in this case.

In *Luecke*, the court rejected the plaintiff's theory of damages (as EOG and Devon have noted) 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." *Browning Oil Co. v. Luecke*, 38 S.W3d 625, 641 (Tex. App. – Austin 2000, pet. denied). 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. Interestingly, 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).

If the Commission Created a New Category of Permit, It Failed to Comply With Applicable Law

EOG and Devon write about "allocation well permits" as if they were well established and clearly defined creatures of Texas oil and gas law. EOG claims that its application meets "all current requirements for an allocation permit" and that an "allocation permit" is "a drilling permit authorizing the operator to claim acreage from two or more leases or pooled units as a drillsite tract for a horizontal well." EOG Closing at 2, 3. EOG and Devon go so far as to depict the routine issuance of "allocation well permits" as the status quo and to suggest that the Klotzmans have the burden of proving why the Commission should deviate from the practice in this instance. But that is the complete opposite of reality. *There is no Commission rule or Commission order defining or authorizing "allocation well permits."*

As authority for the issuance of the permit in dispute in this case, EOG and Devon cite the April 21, 2010 letter admitted as EOG Exhibit B. EOG and Devon both clearly rely on the April 10, 2010 letter to Devon, not merely as a statement applicable to the drilling permit Devon sought at that time, but as a statement of how all similar applications should be evaluated and processed. EOG and Devon read the 2010 letter as a statement of general applicability. But under Texas law, statements of general applicability *must be promulgated as rules.*

The Texas Administrative Procedure Act defines a "rule" as "a state agency statement of general applicability that (i) implements, interprets or prescribes law or policy; or (ii) describes the procedure or practice requirements of a state agency." Tex.

Gov. Code §2001.003(6). That is how EOG and Devon regard the 2010 letter and how they expect it to be treated in this case. EOG and Devon cite the 2010 letter as the Commission's statement that describes the requirements for "allocation well permits" and they are insisting on it being followed in this instance. EOG and Devon expect the 2010 letter to be afforded treatment as a rule. That would violate Texas law.

As the Texas Supreme Court said, "A presumption favors adopting rules of general applicability through the formal rule-making procedures the APA sets out. These procedures include providing notice, publication and public comment on the proposed rule. The process assures notice to the public and affected persons and an opportunity to be heard on matters that affect them. When an agency promulgates a rule without complying with the proper rule-making procedures, the rule is invalid." *El Paso Hospital District v. Texas Health and Human Services Commission*, 247 S.W.3d 709 (Tex. 2008)(citations omitted). The 2010 letter EOG and Devon rely upon had none of the required elements of notice, publication or public comment. If, as EOG and Devon suggest, it is a rule, then it is indisputably an invalid rule.

Upholding the Klotzmans' Rights Under the Leases Does Not Cause "Waste"

EOG says "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 Closing at 7. As Protestants noted in their Closing, this assertion is absurd. If EOG would reach an agreement with the mineral owners on the terms for combining acreage from separate

leases for horizontal wells, there would be no barrier at all to EOG completing the wells it proposes. An operator who has failed to obtain (or elected not to pursue) an agreement with a mineral owner on the terms necessary to develop the lease optimally is not in a position to argue that waste will result if the Commission does not override the mineral owner's decisions.

If the Klotzmans offered unleased acreage to EOG and EOG declined to lease the property because the terms were not acceptable to EOG, the Klotzmans would not be permitted to come to the Commission and complain that EOG's refusal to accept the lease on the Klotzman's terms was "causing waste." EOG's claim in this case is no less absurd.

The Smith Letter Does Not Support EOG's Position

The leases pursuant to which EOG proposes to drill do not include pooling authority for oil. EOG has never contended that they do. Tr. at 36-37. Given this undisputed fact, EOG's and Devon's extensive reliance on the July 23, 2009 letter from Professor Ernest Smith is entirely 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.[2] 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

[2] Devon confuses the *Luecke* court's holdings on the right to drill with its holdings on the allocation of royalties and then incorrectly attributes that confusion to Prof. Smith: "Dean Smith also points to the decision in *Browning Oil Co., Inc. v. Luecke*, 38 S.W.3d 625 (Tex. App. – Austin 2000, pet. denied) as another example of cases supporting operators' authority under their leases to drill across unit lines." Devon Closing at 6. The *Luecke* court held that the drilling of the subject well violated the lease, and Prof. Smith acknowledges this fact.

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 Devon ignore 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.

Lastly, the Professor Smith letter does not support EOG or Devon's 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 Devon.

EOG's Peculiar Math Calculations Are Irrelevant

EOG claims "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." The percentage of the "possessory mineral estate" or "revenue interest" held by EOG is not the issue. The lease --- the document from which *all* of EOG's interests flow – does not convey the power to pool. So, it does not make any difference what percentage of the "possessory mineral estate" or "revenue interest" EOG holds --- EOG cannot have any power or right that the lease does not convey. What EOG argues is like arguing that 100% of the tenants in an apartment building support decreasing the rent by half and the ability to remove walls between apartments. It does not matter whether the percentage of the tenants supporting such changes is 1% or 100% – they cannot change the lease unilaterally. Because this case is about what rights were or were not conveyed by the lease, the *relevant* number is that the owners of 100% of the power to confer pooling authority on EOG have not done so.

The Lease Well Issue

EOG and Devon both point out that an existing lease well on Klotzman property will require allocation of royalty, as if that fact is somehow determinative of the issue in this case. In reality, it has no bearing on this case. The leases --- the documents that determine the respective powers and privileges held by EOG and the Klotzmans ---- give EOG the ability to drill the Reilly 1H without additional amendment. That is not true

with respect to the proposed well. The proposed well will traverse tracts covered by separate leases – leases that do not allow for pooling for oil. EOG wants to pretend that there is no legal consequence in the fact that the two tracts to be traversed by the proposed well are covered by separate leases. But there are consequences, and to ignore them would wrongfully deprive the mineral owners of the powers they retained by leasing the tracts separately.

The Protestants are Not Asking the Commission to Allocate Royalties

EOG and Devon assert repeatedly that the allocation of royalties is not the job of the Commission. It is unclear why the parties make this argument, because the Klotzmans have not asked the Commission to allocate any royalties. The Klotzmans have protested the issuance of a drilling permit to an operator who lacks the legal authority to drill the well. Denying the permit will not allocate royalties. Denying the permit appropriately leaves the negotiation of that issue with the parties.

Conclusion

In its Closing Statement, Devon describes various possible wells that could be drilled as alternatives to a horizontal well that crosses lease lines and concludes that "the lessor is better protected by a well crossing lease or unit lines than by a separate well." Devon Closing at 10. The Klotzmans respectfully submit that, as lessors, they are better protected by allowing *them* to negotiate the terms on which the lessee may drill a horizontal well across a line that divides two leases without pooling authority – and then respecting those agreements.

The Klotzmans respectfully request that the Commission deny EOG's application for a permit to drill the Klotzman Lease (Allocation) Well No. 1H. EOG does not presently have the authority to drill the well as proposed.

Respectfully submitted,

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Certificate of Service

I certify that on January 11, 2013, a copy of the foregoing Protestants' Response to Closing Statements was sent by **email** to the persons listed below.

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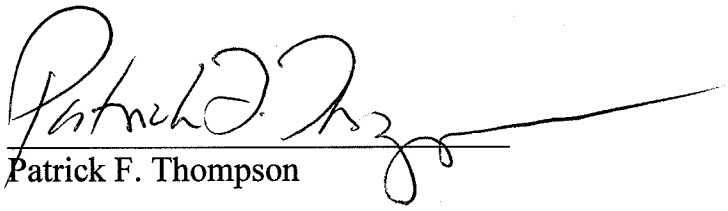

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