NON CONSENT ALLOCATION – WILL IT SURVIVE JUDICIAL SCRUTINY

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I. INTRODUCTION. WHERE DID ALLOCATION COME FROM?

Allocation is a recent phenomenon involving horizontal drainholes that traverse multiple leases owned by one operator, or put together under some sort of operating agreement by several operators, in which one more of the several leases have no pooling provisions. For the purposes of this paper they are referred to as "nonconsent allocations" because the operators give the royalty ownership no say in the creation of these allocation wells. In the last five years, numerous allocation applications have come before the Railroad Commission which involved leases without pooling provisions. The matter first came to the attention of the wider bar as the result of an application that involved a royalty owner named Klotzman. Now allocation orders are issued routinely and nonconsent allocation units are created without lessor approval or lease terms. This complex issue is treated in a recent Texas Tech Law Review article,[1] but the writing has no case law to support a firm conclusion whether nonconsent allocation is here to stay. As noted in that article, it would appear that the outcome of contested allocations will be grounded on a court's view of the interplay between contract law, the role of the dominant estate created by an oil and gas lease, and the law of ingress and egress. This is correct. But there are no appellate decisions addressing the issues. Yet. Those issues are set out below. But first, here is the history of the Klotzman application.

II. THE KLOTZMAN CASE

On June 25, 2013, examiners for the Railroad Commission of Texas issued a Proposal for Decision recommending dismissal of EOG's application to drill its Klotzman (Allocation) Well No. 1H in the Eagleville (Eagle Ford-2) Field in DeWitt County.[2] The applied-for well would be drilled across 80 acres, comprised of two adjacent 40-acre tracts under separate oil and gas leases that did not provide pooling authority. The permit application was protested by royalty owners and the General Land Office.[3] In the proposal, the examiners concluded that EOG's actions would constitute an unauthorized pooling of the adjacent tracts, and that issuance of a drilling permit would effectively strip the application protestants of their retained property right to pool their lands. The examiners further found, "[t]here is no Texas statute, Commission Statewide Rule or Commission Final Order authorizing the permitting of

[1] *See* Clifton A. Squibb, *The Age of Allocation: The End of Pooling As We Know It?*, 45 TEX. TECH. L. REV. 929 (2013).

[2] Tex. R.R. Comm'n, *Application of EOG Resources, Inc., Klotzman Lease (Allocation) Well No. 1H, Eagleville (Eagle Ford - 2) Field, DeWitt County, Texas*, Oil & Gas Docket No. 02-0278952 (Proposal for Decision, June 25, 2013).

[3] It is unclear how the lessors obtained notice of the application and what their standing before the Commission was. Generally, a person who has leased his minerals is not entitled to notice of Railroad Commission proceedings; only the lessee will receive notice.

'allocation' wells." The examiners specifically found that "allocation" was the legal equivalent of "pooling." In citing several cases defining the Railroad Commission's limited power to govern private property rights, the examiners determined that because EOG did not have the requisite authority to pool the subject tracts, it lacked a good faith title claim to drill the proposed well. At the Railroad Commission's September 10, 2013 Open Meeting, the Commissioners unanimously rejected the hearings examiner's proposal for decision. The Commissioners voted to approve EOG's permit to drill its well, agreeing that EOG had made a reasonably satisfactory showing of a good faith claim of ownership, and that the lack of pooling authority in the underlying leases was inconsequential to issuing the drilling permit. The Commissioners reasoned that pooling authority, and methods for allocating production from this type of well, are private contractual matters to be decided by the parties to the transaction, or potentially the courts, and are not within the bounds of the Railroad Commission's jurisdiction. Commissioner Craddick stated, "[I]t's our job as commissioners to figure out if EOG has a good faith claim to title, which I think they do, and it's not our job really to look at the lease." The Commission's action is consistent with Texas longstanding case law that the Railroad Commission lacks authority to adjudicate property disputes; determine ownership of oil and gas; and decide inherently judicial matters, e.g., trespass or other torts.[4] The next step for the mineral owners was to file a lawsuit.[5] The lawsuit was settled before it went to trial.

III. ALLOCATION AND THE ROLE OF EASEMENT CASE LAW

Allocation is not per se void. Parties enter into allocation agreements all the time. It is one of three ways to obtain a drilling permit for a horizontal well that traverses multiple leases. The other two methods are the traditional pooled unit and a production sharing agreement. Any of these three methods of obtaining production from several tracts may be accomplished by an agreement that disclaims cross-conveyancing yet allocates production or its proceeds to owners of interests in the pooled tract or allocation unit. This disclaimer of cross-conveyancing is common to joint operating agreements[6] and pooling clauses of oil and gas leases. It is also found in allocation and production sharing agreements. Obviously, cross conveyancing is not a matter of concern for nonconsent allocations. What does concern the bar and the oil and gas industry is the contractual nature of pooling, and the lack of any contract that addresses nonconsent allocation. An oil and gas lease is a contract.[7] The absence of contractual authority to pool or to allocate seems at first blush to present an insurmountable obstacle to a lessee's ability to traverse two or more tracts owned in severalty with a horizontal drainhole by means of a Railroad Commission allocation order. Nevertheless,

[4] *Gregg v. Delhi-Taylor Oil Corp.*, 344 S.W.2d 411 (Tex. 1961); *see also Coastal Oil & Gas Corp. v. Garza Energy Tr.*, 268 S.W.3d 1 (Tex. 2008).

[5] *See* Plaintiffs' Original Petition for Judicial Review & Declaratory Relief, *Reily v. R.R. Comm'n of Tex.*, No. GN-13-004306 (98th Dist. Ct., Travis Cty., Tex. Dec. 23, 2013), http://www.oilandgaslawyerblog.com/files/2015/02/Klotzman-Petition.pdf.

[6] *See*, for example, the AAPL 1989 Joint Operating Agreement, which provides, "Nothing contained in this Article III.B. shall be deemed an assignment or cross-assignment of interests covered hereby, and in the event two or more parties contribute to this agreement jointly owned Leases, the parties' undivided interests in 31 said Leaseholds shall be deemed separate leasehold interests for the purposes of this agreement."

[7] *See*, for example, Commentary Paragraph 10.a.

it is conceivable that today's Supreme Court might conclude that one or more lessees who collectively own the leasehold rights in the minerals in several tracts have the power under *Altman v. Blake*[8] to "develop" their leases by an agreement to drill a horizontal well across the leases and allocate production or proceeds to the respective working interest owners under the several leases who would then be responsible for their respective royalty burdens. The rights and appurtenances inherent in fee simple determinable title to oil and gas are listed in *Altman v. Blake* as follows: "(1) the right to develop (the right of ingress and egress), (2) the right to lease (the executive right), (3) the right to receive bonus payments, (4) the right to receive delay rentals, (5) the right to receive royalty payments."[9] It is now a settled rule that pursuant to the "greatest estate rule," a conveyance of minerals carries with it all of these rights unless one or more of them has been previously severed or is being reserved in the deed or lease.[10] It is the first right—the right to develop, i.e., the right of ingress and egress—that might be the lynchpin of a decision that allocation is permissible even in the face of leases with no pooling provisions. The oil and gas bar is divided on the issue whether nonconsent allocation is legal. Some attorneys (and the companies they represent) hold the opinion that because drilling a drainhole is drilling a well, and because the oil and gas lease gives the lessee rights of ingress and egress (the right under *Altman* to drill a well), the right to an allocation unit incorporating leasehold acreage, even where the lease has no pooling provision or has a pooling provision that is restrictive, is permissible.

Other oil and gas practitioners believe that nonconsent allocation across their client's land is a trespass—that an oil and gas lease gives easement rights upon and within the leased tract, but not otherwise, and allocation may result in numerous breaches of the oil and gas lease. There is some case law that supports this contention. Allocation, of course, involves horizontal development. Drainholes must traverse lease lines. Crossing a lease line without a permit or easement, whether the crossing is surface or subsurface, may run afoul of case law that speaks to other easement situations. The courts have held that easements covering separate tracts cannot be cobbled together as a bridge to serve all the tracts, or a landlocked tract. *Jordan v. Rash* discusses the use of surface of land over which a party has a right of ingress and egress, to reach contiguous lands.[11] The conclusion of the court is that a party has no right to cross the various tracts owned by it simply by right of ingress and egress specific to each separate tract. In other words, a party cannot assert rights of ingress and egress over adjoining lands if the easement rights are specific to each separate tract. The Waco Court of Appeals temporarily enjoined the Jordans from using the portion of the road that crossed Tracts 7 and 8. The Jordans contended that they had a right to build the road across Tracts 7 and 8 to access Tract 3A, because each separate tract came with the right of ingress and egress. The Court of Appeals stated, "They had the burden of proving these contentions because the party claiming an easement across another person's land must prove all of the facts necessary to establish its

[8] 712 S.W.2d 117, 118 (Tex. 1986); *see also Schlittler v. Smith*, 101 S.W.2d 543, 544 (Tex. 1937).

[9] *Altman*, 712 S.W.2d at 118.

[10] *Cockrell v. Tex. Gulf Sulphur Co.*, 299 S.W.2d 672, 675 (Tex. 1956) ("A warranty deed will pass all of the estate owned by the grantor at the time of the conveyance unless there are reservations or exceptions which reduce the estate conveyed.").

[11] 745 S.W.2d 549, 553 (Tex. App.—Waco 1988, no writ).

existence."[12] The Court of Appeals laid out their basic premise—that they could access Tract 3A because it abutted the 1984 and 1986 easements. The Court noted that a similar argument had previously been made and rejected before the Texas Supreme Court:

> "Rights of way granted or reserved are appurtenant to the dominant tenement, and can be used only for the purposes of that tenement. . . . *One having a right of way appurtenant to specified land cannot lawfully use the way to reach another tract owned by him to which the way is not appurtenant.* . . . The way is granted for the benefit of the particular land, and its use is limited to such land. Its use cannot be extended to other land, nor can the way be converted into a public way without the consent of the owner of the servient estate."[13]

The Court of Appeals concluded that unless the wording of an easement creates a more extended right of use, the grantee cannot use it to benefit other premises owned by him or others, and that the Jordans could not use the express easements set out in instruments of conveyance as to other tracts to benefit yet a third tract unless the wording extended the easements to property to which they were not appurtenant.[14] These principles were reiterated in *Holmstrom v. Lee*:[15]

> It is well established that an easement cannot be used to pass onto another parcel of land; it can only be used to serve the land to which it is appurtenant. In other words, unless the wording of the easement creates a more extended right of use, a grantee cannot use it to benefit other land owned by him.[16]

This case law presents a clear analogy to the claim that ingress and egress created by one lease gives the proponent of an allocation drainhole the right to cross into other leases. This issue would have to be addressed for any allocation well to effectively traverse the land of an objecting lessor. But that is not the only impediment to nonconsent allocation.

IV. THE ROLE OF CUSTOM LEASES

We live in an era of the modern oil and gas lease form. Those who printed up and sold the Producer's 88[17] never dreamed of continuous drilling and retained acreage clause. But today's sophisticated lessors have fashioned a multiplicity of oil and gas lease forms with various types of continuous drilling and retained acreage provisions, and it may be impossible to harmonize a custom lease with a nonconsent allocation unit. The typical continuous drilling clause has fixed dates for each new well to be drilled, retained acreage clauses that mandate the size, shape, and location of producing units and partial

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[12] *Id.* (citing *Bains v. Parker*, 182 S.W.2d 397, 399 (Tex. 1944)).

[13] *Id.* (citing *Bickler v. Bickler*, 403 S.W.2d 354, 359 (Tex. 1966)).

[14] *Id.* (citing *Storms v. Tuck*, 579 S.W.2d 447, 451 (Tex. 1979)).

[15] 26 S.W.3d 526, 533 (Tex. App.—Austin 2000, no pet.).

[16] *Id.* at 534 (citations omitted).

[17] My apology for use of the term. Of course, the "Producer's 88" label is meaningless. It was originally a header put on oil and gas leases to make them look standard or customary; that is, a lease that everyone was using. If everyone was using that form, there was no reason for a land owner to object to it or want to change it or add to it, and few did. The label denotes a form so diverse in its many varieties that a contract to sign a "Producer's 88" is unenforceable as a violation of the Statute of Frauds. *See Fagg v. Tex. Co.*, 57 S.W.2d 87 (Tex. Comm'n. App. 1933).

reverter clauses that require termination of acreage not timely placed within a producing unit in accordance with lease terms. Nonconsent allocation will certainly ignore Pugh considerations and agreed production unit sizes in a lease and may create an allocation unit that is in direct conflict with lease terms. While the "Pugh Clause" (also known as a "Freestone Rider") originally provided that undeveloped acreage *outside a pooled unit* would terminate upon some date,[18] the term "Pugh" has become rather elastic, and it is now used in the oil and gas industry to refer to any acreage reverting to the lessor; that is, acreage which has "Pughed Out."[19] This usage, once a misnomer, is now blessed in the case law[20] and may, therefore, be used freely and without the taint of ambiguity. An allocation unit that lies across or produces from Pughed acreage clearly interferes with the lessor's rights to re-lease the acreage. If the lessee under the lease created or participated in the creation of the allocation unit that disrupted or prevented performance of the very lease covenants it agreed to, that is a breach of contract. If another participates in the creation or participates in this invasion of property rights, that is trespass. The lessee and the lessor came to agreement on how wells would be drilled; when and how much acreage those leases or wells would hold; and what acreage would terminate when the drilling program was terminated. An allocation well that spills across open acreage that has Pughed out or retained units or undeveloped acreage still subject to continuous drilling and partial reverter may totally disrupt the development scheme negotiated by a lessor and lessee. Here is a retained acreage clause with Pugh provisions drawn from the author's form files:

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> Notwithstanding anything contained herein to the contrary, this lease shall terminate
>
> (1) upon the expiration of the primary term
>
> **Or**
>
> (2) upon the expiration of _ days/months/years after the expiration of the primary term,
>
> **Or**
>
> (3) upon the expiration of the primary term or upon termination of the Continuous Drilling Program herein provided for, whichever event is the later to occur,
>
> as to the following parts of the Lease Premises, to wit: all acreage outside the perimeter of each Retained Unit, as defined in this lease, for a vertical or horizontal oil or gas well; and all acreage within the perimeter of each Retained Unit for a vertical oil or gas well, as defined in this lease, to wit:
>
> (1) from 100 feet above a stratigraphic line established by the highest producing perforation in the production string of the well to the surface, and from 100 feet below a stratigraphic line established by the lowest producing perforation in the production string of the well to all depths.

[18] The history of the clause is mentioned in *Sandefer Oil & Gas, Inc. v. Duhon*, 961 F.2d 1207, 1208 n.1 (5th Cir. 1992).

[19] See 4 E. KUNTZ, OIL AND GAS § 48.4 (1990); 5 SUMMERS, OIL & GAS § 960 (1966); 4 WILLIAMS & MEYERS 1, at § 669.14.

[20] *TDC Eng'g, Inc. v. Dunlap*, 686 S.W.2d 346, 348 (Tex. Civ. App.—Eastland 1985, writ ref'd n.r.e.).

Or

(2) from 100 feet above the top of the producing [interval/zone] within the applicable field or formation to the surface and from 100 feet below the bottom of the producing [interval/zone] to all depths.

Further, and notwithstanding the rules of the regulatory authority governing spacing and density of oil and gas wells, including but not limited to field rules and statewide rules, it is expressly agreed that Retained Units for vertical oil or gas wells shall be defined by the following sizes and dimensions:

(1) A Retained Unit for a vertical oil well shall contain no more acreage than that allowed by the rules of the Railroad Commission of Texas or _ surface acres, whichever is less.

And

(2) A Retained Unit for a vertical gas well shall contain no more acreage than the minimum sized proration unit allowed by field rules, or _ surface acres, whichever is less.

Further, this Lease shall also terminate at that time as to all acreage within the perimeter of each Retained Unit for a horizontal oil or gas well, as defined in this lease

(1) from 100 feet above the center of the drainhole to the surface, and from 100 feet below the center of the drainhole to all depths.

Or

(2) from 100 feet above the top of the producing [interval/zone] within the applicable [field/formation] to the surface, and from 100 feet below the bottom of the producing [interval/zone] to all depths, as shown on the logs of the well.

The term "Retained Unit" means a block of acreage having the vertical and horizontal perimeters described above, which is either producing oil or gas or which is otherwise held under the terms of this Lease, limited as to size by the following agreements, to wit: notwithstanding the rules of the regulatory authority governing spacing and density of oil and gas wells, including but not limited to field rules, statewide rules, and Rule 86, it is expressly agreed that both pooled and unpooled Retained Units supporting horizontal oil or gas wells subject to this Lease shall be calculated under the following formula:

(1) A = calculated area assignable, if available, to a horizontal drainhole for this lease purposes;
(2) VA = the minimum proration acreage for a vertical well completed in the same field as the objective horizontal well on this lease;
(3) L = the horizontal drainhole distance measured in feet between the point of penetration and terminus;
(4) OA = optional acres based on formula
(5) The formula is:
(6) A = VA + (L x OA) acres = total acres in Retained Unit

Diagonals shall be calculated in accordance with the rules of the Railroad Commission of Texas.

Or

shall never exceed the following acreage limitations based on formations in which the well is completed, to wit:

(1) For a well completed in the _ Formation, _ acres;
(2) For a well completed in the _, Formation, _ acres;
(3) For a well completed in any other formation, _ acres.

Each stacked lateral shall be deemed to be a separate Retained Unit of the size herein specified for horizontal wells, whether pooled or unpooled, subject to this Master Lease. Horizontal drainholes and stacked laterals shall not be permitted to cross lease lines without Lessor's written consent. Upon the expiration of [the primary term/the Continuous Drilling Program], this Lease shall be construed as a master lease agreement. By this is meant that each Retained Unit (including each lateral in a set of stacked laterals) shall be deemed to be a separate Lease Premises, but governed by and subject to all of the agreements, covenants, and conditions set out in this agreement, and each separate lease shall be held or shall terminate in accordance with the limitations on the leasehold estate herein contained. It is expressly agreed that neither production nor operations on one Retained Unit shall be sufficient to hold any other Retained Unit after the operation of the partial reverter provisions of this Lease. It is expressly agreed that the requirements of the Continuous Drilling Program and Retained Acreage clause shall act as a special limitation on the defeasible fee estate granted to Lessee as it pertains to acreage not included within properly designated Retained Units so that this Lease shall terminate at the end of the Continuous Drilling Program as to any acreage not included within a Retained Unit as defined in this Lease.

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These drilling and partial reverter provisions are modern. Because much care went into their promulgation, they are admittedly complex, but no more so than most such agreements now being negotiated between lessors with bargaining power and lessees. They are superior to several poorly drafted pugh clauses that recently failed in their purpose.[21] It is very doubtful that a lessee would be able to harmonize a nonconsent allocation drainhole or unit with

[21] *See, e.g., Chesapeake Expl. v. Energen Res. Corp.*, 445 S.W.3d 878, (Tex. App.—El Paso 2014, no pet. h.); *Humphrey v. Seale*, 716 S.W.2d 620, 622 (Tex. App.—Corpus Christi 1986, no writ) (holding the retained acreage clause did not require the lessee to relinquish additional acreage from the lease after the initial release was accomplished "within 180 days of the first oil well" because all three of the 40-acre tracts were under the same lease and lease terms, and production on one well kept the lease in effect for all.); *Nafco Oil & Gas, Inc. v. Tartan Res. Corp.*, 522 S.W.2d 703 (Tex. Civ. App.—Corpus Christi 1975, writ ref'd n.r.e). The distinction between a Pugh Clause and a partial reverter clause was made clear in *Utley v. Marathon Oil Co.*, 31 S.W.3d 274, 280 (Tex. App.—Waco 2000, no pet.), where the lease contained a Pugh Clause but no partial reverter or retained acreage clause and since the acreage was not pooled, the court held that one well held the entire lease.

these contractual requirements. The plan of development is that acres above and below and outside of agreed vertical and horizontal production units will Pugh out. A nonconsent allocation well that traverses acreage to be drilled, or acreage within a retained unit, interferes with the scheme of development that the lessor and lessee negotiated. It prevents re-leasing Pughed acreage. It may drain contractually established production units. All of this will present a court attempting to apply contractual lease terms to nonconsent allocation drainholes or units with a difficult task.

Finally, there is the potential that the extension of the allocation drain hole onto a lease, but not very far, may operate to hold the entire lease under the standard habendum. In other words, an owner of minerals who has leased a large tract may eschew continuous drilling and pooling with the expectation that Railroad Commission rules mandate a large amount of acreage to a well or formation. It is possible that a very small extension of the allocation drain hole onto his tract will result in a very small portion of production attributable to his interest and yet the well will hold the entire tract. The typical habendum clause states that an oil and gas lease will be for a term of years and thereafter "for so long thereafter as oil or gas is produced from the lands herein described or lands pooled therewith." If oil or gas is produced from one or more take points on the lease, then the lease may be held by production. The lessor may not want his lease held by production from the tail end of a long lateral that only extends a short distance into his acreage.

The operator who pursues nonconsent allocation may very well find itself facing not just a lawsuit for trespass, but a claim of damages that encompass 100% of the production from the drainhole. The remedy for confusion is recovery of the whole unless the defendant can prove what the plaintiffs share is.[22]

V. DISTRIBUTION OF REVENUE

There is a general consensus among oil and gas professionals that allocation has no adverse financial consequences for mineral and royalty ownership if the method of allocating production and proceeds from sale of production is fair. This might not be quite correct. It is common thinking that any formula for the distribution of proceeds from the sale of production should meet two requirements: it should be fair, and it should be in accordance with lease terms. Who decides fairness will become a major issue if legislation covering nonconsent allocation into "forced allocation" is passed.

Today, one customary method of allocating production and sales proceeds is

[22] *Humble Oil & Ref. Co. v. West*, 508 S.W.2d 812, 819 (Tex. 1974) (providing a fine discussion of commingling and its case law history, as well as a succinct statement on the burden of proof: "As we have indicated, it is our view that the act of commingling native and extraneous gas did not impose upon Humble the obligation of paying royalties on all gas thereafter produced from the reservoir, if the evidence establishes with reasonable certainty the volume of gas reserves upon which the Wests would have been entitled to royalties, absent injection of extraneous gas. The burden of this showing devolves upon Humble after proof by the Wests of their royalty interests, together with proof of Humble's commingling of extraneous and native gas. The threshold question for determination is whether the requisite computation of reserves is capable of establishment with reasonable certainty; and, if so, the further question to be resolved is whether the burden defined above is discharged by Humble under the evidence. We have concluded that the cause should be generally remanded to the trial court for determination of these issues at the trial level, as well as for consideration of any other issues the parties may raise in the light of our rulings.").

by take points. Another is by lateral extent of a drainhole on a royalty owner's land as it bears to the entire length of the lateral from point of penetration to terminus. There seems to be developing a presumption that each take point will generate the same flow of hydrocarbons. Thus, there is presumed take point uniformity across the entire lateral from the first take point to the last take point. From an engineering point of view, it is almost impossible to contest this presumption. The drain hole would have to be tested all along its length to prove or disprove this presumption. Well logs from vertical nearby holes might shed some light on formation thickness and faulting. Permeability might differ from take point to take point. The operator may have tested the take points during and after fracking. Almost certainly a royalty owner will want a directional survey of the drainhole showing take points and any tests that have been performed. But generally royalty owners will have neither the will nor the checkbook to contest an operator's revenue distribution scheme. The take point formula is generally expressed as the number of take points within the boundary of Lessor's lease lines as that number bears to the total number of take points.

Another, and perhaps better, formula uses the lateral extent of acreage on a royalty owner's land as it bears to the entire length of the lateral from point of penetration to terminus. This approach avoids conflict if there are differences in formation thickness or permeability, or other geologic features along the drainhole resulting in the possibility that different take points will deliver different volumes. Even where there is no pooling provision in the leases, nor a production sharing agreement among the parties, most royalty owners accept allocation across lease lines and their share of proceeds based on a take point formula or a formula based on lateral length that seems fair. Here are how the different formulae might be worded:

1) The number of feet from the first take point to the last take point within the boundaries of Lessor's lease lines, as that number bears to the total number of feet between the first take point and the last take point in the entire drainhole.
2) The number of take points within the boundary of Lessor's lease lines as that number bears to the total number of take points.
3) The number of feet of drainhole located within the boundaries of Lessor's lease lines, as that distance bears to the total number of feet between the drainhole's point of penetration and terminus.
4) The number of feet of productive drainhole located within the boundaries of Lessor's lease lines, as that distance bears to the total number of feet between the drainhole's point of penetration and terminus.
5) The number of feet of drainhole located within the boundary of Lessor's lease line, as that distance bears to Measured Depth of the wellbore from surface to terminus.

Formula 1 appears fairly simple, until you consider where that first take point and last take point on lessor's land are located. If the first take point is a considerable distance from the drainhole's entry into the lessor's mineral formation, or if the last take point is a long way from the exit point, this formula can be argued to be unfair. There won't be enough take points favoring the lessor to balance against the total number of take points in the lateral. Formula 2 also appears to be fair until one starts thinking about disparities in the number of take points on a lessor's portion of the drainhole as opposed to the total number of take points in the lateral. If the engineers laying in the drainhole decided that a portion of it doesn't have the permeability to support fracking, or they must honor an NPZ order of the Railroad Commission, the lessor owning that portion of the minerals may be shorted by less take points along his way. Any royalty owner considering Formula 1 or 2 should request a directional survey from the operator showing take points and a copy of the Commission order authorizing the allocation well, as well as any tests run on deliverability of take points.

Formula 3 looks to be the choice of lessors. It presumes a uniformity of hydrocarbons along the length of the drainhole which will result in a correspondingly uniform, fair distribution of production and proceeds to each royalty owner along the way. But operators will tinker with this formula. Formula 4 is the result of the tinkering. Adding the word "productive" takes the formula right back into the objectionable territory of Formulae 1 & 2. The number of feet of "productive" drainhole renders the formula ambiguous. The only part of the drainhole that is "productive" is a take point. That alone produces hydrocarbons. The distance from one take point to another is not productive and cannot, therefore, be called "productive feet." Again, any royalty owner offered Formula 4 should look at a directional survey showing take points and the Commission order authorizing the allocation unit.

Formula 5 is nothing more than an invitation to file a Plaintiff's Original Petition. However, if one is representing the mineral and surface owner where the allocation well will be located, it might be tempting to try the formula. It won't work though.

If there is a developing presumption that each take point will generate the same flow of hydrocarbons, what is said above should be proof of its flaws. Given differences in formation permeability, thickness, fracking results, and faulting, any presumption of uniformity in take point productivity across the entire lateral from first take point to last take point is dicey. Of course, company engineers will have their say, and their conclusions will be hard to dispute. But if nonconsent allocation becomes legitimized, that will be the next set of controversies. This paper proposes Formula 3 with its presumption of uniformity of productivity along the drainhole as the fairest way to resolve the matter.

VI. WAIVER

If the lessor accepts royalty from a nonconsent allocation well, he or she will probably be bound to both the allocation unit and its formula for distribution of revenue. Especially if the lessor signs a division order based on the allocation formula proposed by the lessee. While the division order statute states that a division order will not alter lease terms,[23] that is a known right that can be waived.[24] While waiver is a subject beyond the scope of this paper, its application in this

[23] Tex. Nat. Res. Code § 91.402(h) ("The execution of a division order between a royalty owner and lessee or between a royalty owner and a party other than lessee shall not change or relieve the lessee's specific, expressed or implied obligations under an oil and gas lease, including any obligation to market production as a reasonably prudent lessee. Any provision of a division order between payee and its lessee which is in contradiction with any provision of an oil and gas lease is invalid to the extent of the contradiction.").

[24] *Shepherd v. Ledford*, 962 S.W.2d 28, 36 (Tex. 1998) (Hecht, J., concurring in part and dissenting in part) ("Waiver is an intentional relinquishment of a known right or intentional conduct inconsistent with claiming that right.") (quoting *Sun Exploration & Prod. Co. v. Benton*, 728 S.W.2d 35, 37 (Tex. 1987)).

circumstance is possible, at least as to the payments made under the division order.[25]

VII. CURRENT LEGISLATION

Mention should be made of attempts to legitimize nonconsent allocation by legislative action. In the Texas House of Representatives, Tom Craddick of Midland introduced HB 1552. In the Senate, Troy Fraser of Horseshoe Bay introduced SB 919. These companion bills would have legalized allocation wells. The bills were opposed by the National Association of Royalty Owners, the Texas, Texas Land and Mineral Owners Association, the Texas Cattle Raisers Association, and the Texas Forestry Association. The Texas General Land Office estimated that the bill would cost the Permanent School Fund $100 million per year in lost royalties, and the University of Texas System estimated that the bill would result in a loss of $290 million per year in royalties from UT lands. The bills failed to get out of committee.

VIII. THE RAILROAD COMMISSION'S POSITION TODAY

The Railroad Commission is very aware of the controversy that has arisen around allocation wells. It has begun to place a disclaimer on its W-1 stating that it expresses no opinion as to whether a 100% ownership interest in each of the leases alone or in combination with a production sharing agreement confers the right to drill across lease/unit lines or whether a pooling agreement is also required. The disclaimer states that "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 and a production sharing agreement constitute 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." The disclaimer goes on to state that "Issuance of the permit is not an endorsement or approval of the applicant's stated method of allocating production proceeds among component leases or units" and reinforces production reporting rules. The disclaimer ends with the statement that "Payment of royalties is a contractual matter between the lessor and lessee. Interpreting the leases and determining whether the proposed proceeds allocation comports with the relevant leases is not a matter within Commission jurisdiction but a matter for the parties to the lease and, if necessary, a Texas court of competent jurisdiction." As of this date, there are no appellate decisions dealing with "nonconsent allocation."

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[25] While division orders may be binding on the parties with respect to payments made and accepted under them, case law holds that they are binding only for the time and to the extent that they have been, or are being acted on and made the basis of settlements and payments. Notice of cancellation terminates the division order and they cease to be binding. *Exxon Corp. v. Middleton*, 613 S.W.2d 240, 250 (Tex. 1981); *Yzaguirre v. KCS Res., Inc.*, 47 S.W.3d 532 (Tex. App.—Dallas 2000), *aff'd*, 53 S.W.3d 368 (Tex. 2001).