FUN NEW WAYS FOR DENSITY AND PRORATION RULES TO BUST YOUR LEASE: RETAINED ACREAGE CLAUSES AND "GOVERNMENTAL AUTHORITY" LANGUAGE IN THE WAKE OF THREE RECENT TEXAS CASES

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For decades, drafters of Texas oil and gas leases have commonly referenced density and proration rules adopted by the Railroad Commission of Texas (the "Commission") to define certain aspects of their leases. Such references are often called "governmental authority" clauses because they define the quantum of lease acreage a lessee may pool or retain by incorporating by reference into the text of the lease the applicable density and proration rules for its wells. Such clauses can lead to a variety of interpretive questions, but one of the more common is, "How much acreage?"

Jones v. Killingsworth[1] is the seminal Texas case addressing this question. *Jones* was decided by the Supreme Court of Texas in 1965 and now forms the basis for the "permitted vs. prescribed" drafting paradigm that is commonplace in governmental authority clauses today. At its core, *Jones* addressed the question of how the Commission's density and proration rules can interact with a governmental authority clause to determine the maximum acreage an oil and gas lessee may pool into a unit.

Until recently, all reported Texas cases directly addressing the "how much?" question have involved pooling authority clauses with lease language substantially similar to that in *Jones*, with likewise similar holdings. Texas has now seen three unique cases in as many years that involve the same fundamental question, but as it applies to retained acreage clauses with novel governmental authority language. This paper aims to analyze and compare the holdings in *Endeavor Energy Resources, L.P. v. Discovery Operating, Inc.*,[2] *XOG Operating, LLC v. Chesapeake Exploration L.P.*,[3] and *ConocoPhillips Company v. Vaquillas Unproven Minerals*,[4] and comment on the status of Texas law in their wake.

DENSITY AND PRORATION RULES

In 1953, the Railroad Commission of Texas first adopted what would become Statewide Rule 38 for the regulation of the minimum acreage required to drill an oil or gas well.[5] Although the text and mechanics of Rule 38 have changed significantly since then, the core concept remains the same: an

[1] 403 S.W.2d 325 (Tex. 1965). *See* Doug J. Dashiell, *Pooling Update*, STATE BAR OF TEXAS 25TH ANN. OIL, GAS & MIN. L. INST. (Mar. 26, 1999); *see* Mark W. Hanna, *Drafting Tips in the Modern Oil & Gas World*, STATE BAR OF TEXAS 32ND ANN. OIL, GAS & MIN. L. INST. (October 2-3, 2014).

[2] 448 S.W.3d 169, 2014 Tex. App. LEXIS 11664 (Tex. App.—Eastland 2014, pet. denied).

[3] 480 S.W.3d 22, 2015 Tex. App. LEXIS 9411 (Tex. App.—Amarillo 2015, pet. denied).

[4] 2015 Tex. App. LEXIS 8194, 2015 WL 4638272 (Tex. App.—San Antonio Aug. 5, 2015, pet. granted, judgm't vacated w.r.m.).

[5] Adopted under Special Order Nos. 20-27,088 and 20-31,866. *See* Andrew M. Taylor, *Overview of Railroad Commission's Regulatory Role and the Mechanics of Presenting a Case*, STATE BAR OF TEXAS 16TH ANN. OIL, GAS & MIN. L. INST. (Mar. 30, 1990).

applicant for a drilling permit must have a minimum number of undrilled acres to dedicate to the drilling of his oil or gas well. This concept is known as "well density" and the acreage dedicated to a well for issuance of a drilling permit is known as a "drilling unit."[6]

The density rule for a particular well depends on several increasingly complex factors. Most wells drilled in Texas are subject to special field rules for density, which preempt Statewide Rule 38 and establish a standard unit size for assignment of acreage to a well.[7] Upon completion of a well, field rules typically require the operator to designate the well's productive acreage, known as a "proration unit,"[8] in order to receive a production allowable to produce the well.[9] Special density and proration rules usually allow the operator to designate proration units larger or smaller than the standard size, often in exchange for a proportionate increase or decrease, respectively, in the maximum production allowable for that well.[10] An upward departure from the standard is known as adding "tolerance acreage"[11] and a downward departure is known as forming an "optional" drilling unit and/or a "fractional" proration unit.[12] For field rules in which the

[6] *See* 16 TEX. ADMIN. CODE §3.38(a)(2).

[7] *See id.* at §3.38(b)(2)(A).

[8] *See id.* at §3.38(a)(3). From Rule 3 of the current Eagleville (Eagle Ford-2) field rules: "The acreage assigned to the individual oil well for the purpose of allocating allowable oil production thereto shall be known as a proration unit. The standard drilling and proration units are established hereby to be EIGHTY (80) acres. No proration unit shall consist of more than EIGHTY (80) acres except as hereinafter provided." Final Order Amending Field Rules for the Eagleville (Eagle Ford-2) Field, DeWitt, Karnes, Lavaca, and Live Oak Counties, Texas (March 8, 2016) (Railroad Commission Oil & Gas Docket No. 02-0297221).

[9] An "allowable" is loosely defined as the volume of oil or gas that may be produced from a completed well, as regulated by the Commission. *See* 16 TEX. ADMIN. CODE §§3.31, 3.45, & 3.52. The maximum and actual daily production allowable for a well is typically found under Rule 4 of the field rules for the applicable field. The actual allowable for a well determined by formula that may involve proration unit size, well deliverability, and other factors, and is published in monthly proration schedules. The top allowable for a field is governed by a "yardstick" formula under Statewide Rule 45, which is then allocated among the wells in that field. Allowables may be further limited by market demand for the sake of price stability; however, the Commission has not done this since 1973. Ernest E. Smith & Jacqueline Lang Weaver, TEXAS LAW OF OIL & GAS §10.1(B) (2d ed. 2000). The top allowable for a field may be increased by proving at hearing that the maximum efficiency rate or "MER" for the field is higher than the yardstick, meaning it can be produced at a higher rate without causing waste. *Id.* at §10.3(C). Proration for gas wells is more complex than for oil due in part to the challenges of transportation and marketing, but generally follows the same principles. *Id.* at §10.4(A). Allowables for horizontal wells are controlled by formula under Statewide Rule 86, unless preempted by special field rules. 16 TEX. ADMIN. CODE §3.86(d)(5).

[10] From Rule 3 of the current Spraberry (Trend Area) field rules: "Notwithstanding the above, operators may elect to assign a tolerance of not more than EIGHTY (80) acres of additional unassigned lease acreage to a well on an EIGHTY (80) acre unit and shall in such event receive allowable credit for not more than ONE HUNDRED SIXTY (160) acres." Final Order Amending Field Rules for the Spraberry (Trend Area) Field, Various Counties, Texas (June 12, 2012) (Railroad Commission Oil & Gas Docket No. 7C-0297471).

[11] *See* 16 TEX. ADMIN. CODE §3.38(a)(6).

[12] For example, Rule 3 of the current Spraberry (Trend Area) field rules allows addition of tolerance acreage, but does not allow for administrative formation of fractional proration units. *Supra* note 10 regarding Rule 3 of Spraberry (Trend Area) field rules. Conversely, Rule 3 of the current Garden City, S. (Wolfcamp) field rules allows for administrative formation of fractional proration units, but does not allow addition of tolerance acreage: "For oil and gas wells, an operator shall be permitted to form optional drilling and fractional proration units of EIGHTY (80) acres, with a proportional acreage allowable credit for a well on fractional proration units." Order Nunc Pro Tunc Amending Field Rules for the Garden City, S. (Wolfcamp) Field, Glasscock County, Texas (July 8, 2014) (Railroad Commission Oil & Gas Docket No. 08-0287087). Note that "optional" is typically used to describe a substandard drilling unit and "fractional" is typically used to describe a substandard proration unit, though the terms are often used interchangeably. *See* 16 TEX. ADMIN. CODE §3.38(a)(4-6).

amount of acreage assigned to a well's proration unit is a factor in determining the maximum production allowable for that well, obtaining the largest maximum production allowable typically requires designation of the largest proration unit authorized under such rules.[13]

Fields in which horizontal development is common, whether for oil or gas, typically allow the operator additional acreage on top of the standard or maximum unit size for a vertical well. The quantum of additional acreage allowed is roughly proportionate to the length of the wellbore and is determined either by formula under the field rules[14] or by reference to acreage schedules under Statewide Rule 86.[15]

Density and proration rules thus regulate both the maximum and minimum sizes authorized for a well's proration unit in its applicable field. From a regulatory standpoint, an operator typically has discretion whether to add tolerance acreage or form an optional/fractional unit for his vertical well, and whether to take advantage of additional acreage allowed for a horizontal well. Addition of tolerance acreage typically does not require a rule exception or hearing, though formation of a fractional proration unit may.[16]

To designate a well's proration unit, the operator files a completion report (Form W-2), often accompanied by a certified plat of the proration unit, a Statement of Productive Acreage (Form P-15),[17] a Certificate of

[13] From Rule 4a of the current Spraberry (Trend Area) field rules: "The maximum daily oil allowable for each well on an EIGHTY (80) unit in the subject field shall be the [Maximum Efficient Rate] Allowable of 515 barrels of oil per day, and the actual allowable for an individual well shall be determined by the sum total of the two following values: a. Each well shall be assigned an allowable equal to the top allowable established for a well having a proration unit containing the maximum acreage authorized exclusive of tolerance acreage multiplied by SEVENTY FIVE percent (75%) and by then multiplying this value by a fraction, the *numerator of which is the acreage assigned to the well* and the denominator of which is the maximum acreage authorized for a proration unit exclusive of tolerance acreage. b. Each well shall be assigned an allowable equal to TWENTY FIVE percent (25%) of the maximum daily oil allowable above." *Supra note* 10 (emphasis added). Note that field rules that calculate tolerance acreage as a percentage of the standard proration unit, rather than a fixed number of acres, typically do not allow for an increase in production allowable. *See infra* note 32 regarding *Yelderman*.

[14] From Rule 3 of the current Hoefs T-K (Wolfcamp) field rules: "For the purpose of allocating allowable oil production, acreage may be assigned to each Horizontal Drainhole Well up to the acreage determined by the following formula: A = (L x 0.11488) + 160 acres, where A = calculated area assignable, if available, to a horizontal drainhole for proration purposes rounded upward to the next whole number evenly divisible by 40 acres; and L = the Horizontal Displacement of the well measured in feet between the point at which the drainhole penetrates the top of the designated interval for the field and the horizontal drainhole end point within the designated interval for the field, provided that L is at least 150 feet." Final Order Amending Field Rules for the Hoefs (T-K) Wolfcamp Field, Reeves County, Texas (March 29, 2016) (Railroad Commission Oil & Gas Docket No. 08-0299178). *See* Final Order Amending Field Rules for the Fort Trinidad, East (Buda) Field, Houston, Walker, and Madison Counties, Texas (May 3, 2016) (Railroad Commission Oil & Gas Docket No. 03-0298325).

[15] Order Adopting Field Rules for the Grice (Wolfcamp) Field, Loving County, Texas (February 23, 2016) (Railroad Commission Oil & Gas Docket No. 08-0298535); *see* Order Nunc Pro Tunc Adopting Field Rules for the Atlee (Olmos) Field, LaSalle County, Texas (May 7, 2012) (Railroad Commission Oil & Gas Docket No. 01-0280555). *See* 16 TEX. ADMIN. CODE §3.86(d)(1).

[16] *See supra* note 12 regarding field rules for Spraberry (Trend Area) and Garden City, S. (Wolfcamp).

[17] From Rule 3 of the current Spraberry (Trend Area) field rules: "For the determination of acreage credit in this field, operators shall file for each oil or gas well in this field a Form P-15 Statement of Productivity of Acreage Assigned to Proration Units. On that form or an attachment thereto, the operator shall list the number of acres that are being assigned to each well on the lease or unit for proration purposes. For oil and gas wells, operators shall be required to file, along with the Form P-15, a plat of the lease, unit or property;

Pooling Authority (Form P-12),[18] and/or an Acreage Designation Data Sheet (Form P-16).[19] Note that many field rules make the plat optional and allow an operator to assign undivided proration acreage using Forms P-15 and/or P-16.[20]

Note that some wells in Texas do not have proration units, such as wells drilled under the statewide density rule[21] and under field rules for some conventionally-operated gas fields.[22] Other field rules require designation of proration units even though the wells in the field are exempt from allowables[23] or the size of the well's proration unit has no bearing on the size of its maximum production allowable.[24]

Further note that "spacing" rules, although conceptually related to density and proration, regulate minimum distances from the well to lease boundary lines and other wells. As such, they generally are not invoked in the construction of governmental authority provisions.[25] Also, be careful to distinguish tolerance acreage, discussed above, from the related but distinct concept of a "tolerance well," which is a well that may be drilled on substandard surplus acreage after a lease is drilled to density.[26]

GOVERNMENTAL AUTHORITY CLAUSES UNDER *JONES V. KILLINGSWORTH*

Governmental authority clauses most commonly occur in an oil and gas lease's pooling authority language, "Pugh" clause, retained acreage provision, and/or continuous development program.[27] There is no standard form of governmental authority clause, and the phrase is certainly not a term of art.[28] In

provided that such plat shall not be required to show individual proration units. Operators may, however, file such proration unit plats for individual wells in the field if they so choose." *Supra* note 10 regarding Rule 3 of the Spraberry (Trend Area) field rules.

[18] *See* 16 TEX. ADMIN. CODE §3.40(a).

[19] From Rule 3 of the current Grice (Wolfcamp) field rules: "For the determination of acreage credit in this field, operators shall file for each oil or gas well in this field a Form P-16 Acreage Designation. On that form or an attachment thereto, the operator shall list the number of acres that are being assigned to each well on the lease or unit for proration purposes. For oil or gas wells, operators shall be required to file, along with the Form P-16, a plat of the entire lease, unit or property; provided that such plat shall not be required to show individual proration units. Provided, however, an operator may at their option file the Form P-16 and individual proration plats at their sole discretion." *Supra* note 15. *See* 16 TEX. ADMIN. CODE §3.40(g).

[20] *See supra* notes 18 and 19. Note that a well's initial drilling unit does not have to be the same size as its ultimate proration unit; for example, a well may be permitted based on its standard drilling unit acreage but its proration unit may be later designated to include tolerance acreage.

[21] Smith & Weaver, *supra* note 9, at §10.1(B)(2).

[22] *See* Final Order Adopting Field Rules and Regulations for the Ozona (Clear Fork, Upper) Field, Crockett County, Texas (January 8, 2002) (Railroad Commission Oil & Gas Docket No. 7C-0230124); *see infra* note 44 regarding Vaquillas Ranch (Lobos Cons.) field rules.

[23] *See* Final Order Adopting Field Rules for the Massie West (Paluxy) Field, Val Verde County, Texas (August 6, 2013) (Railroad Commission Oil & Gas Docket No. 01-0282218).

[24] *Supra* note 15.

[25] Smith & Weaver, *supra* note 9, at §10.3(A).

[26] *See* 16 TEX. ADMIN. CODE §3.38(c).

[27] For samples of the types of lease provisions that may incorporate a governmental authority clause and their various forms, *see* Hanna, *supra* note 1; Carrol Martin, *What Works and What Doesn't in Drafting Leases*, STATE BAR OF TEXAS 29TH ANN. OIL, GAS & MIN. L. INST. (October 6-7, 2011); H. Phillip Whitworth, *Horizontal Drilling in Urban Areas and Particularly the Barnett Shale*, STATE BAR OF TEXAS 25TH ANN. OIL, GAS & MIN. L. INST. (October 4-5, 2007).

[28] Although there is no universally adopted clause, the language construed in *Jones v. Killingsworth*, *infra* note 30, is a historically common form. For a list of common variations on this form, *see* Dashiell, *supra* note 1. *See also Hunt Oil Co. v. Moore*, 656 S.W.2d 634, 1983 Tex. App. LEXIS 4855, 79 Oil & Gas Rep. 576 (Tex. App.—Tyler 1983) (" … should governmental authority having jurisdiction prescribe or permit the creation of units larger than those specified, units thereafter created may conform substantially in size with those prescribed by governmental regulations.""); *Atlantic Richfield Co. v. Westbrook*, 491 S.W.2d 207, 1972

fact, the clause often appears in unique and irregular forms, and may not contain the phrase "governmental authority" at all.[29] They can vary widely from lease to lease, and even between clauses within a single lease. They can be highly deferential to the lessee or extremely restrictive and exacting. But they all attempt, in one form or another, to tie the size of pooled unit or the amount of acreage retained after partial lease termination to density and proration rules established by the Commission.

In general, the goal of a governmental authority clause is regular and consistent well development. Drafted well, it prevents the lessee from pooling or retaining more lease acreage than what is necessary or reasonable for drilling and operating a given well. It also compels efficient and regular lease development by making well units coextensive with an already-existing regulatory scheme. Further, the generality of its terms make it flexible enough to function under a variety of different field rules.

However, this efficiency and flexibility is achieved by incorporating by reference the myriad regulations and orders of a state agency, which can result in unintended consequences. Put another way, a governmental authority clause puts the fate of your lease and wells in the ever-competent hands of a benevolent state bureaucracy—an alarming thought.

The first significant Texas case to address how density and proration rules can interact with a governmental authority clause was *Jones v. Killingsworth*,[30] decided by the

Tex. App. LEXIS 2111, 44 Oil & Gas Rep. 620 (Tex. Civ. App.—Tyler 1972); *Atlantic Richfield Co. v. Hilton*, 437 S.W.2d 347, 1969 Tex. App. LEXIS 2164, 32 Oil & Gas Rep. 688 (Tex. Civ. App.—Tyler 1969); *Banks v. Mecom*, 410 S.W.2d 300, 1966 Tex. App. LEXIS 2430, 26 Oil & Gas Rep. 91 (Tex. Civ. App.—Eastland 1966); *Humble Oil & Refining Co. v. Kunkel*, 366 S.W.2d 236, 1963 Tex. App. LEXIS 1973, 18 Oil & Gas Rep. 344 (Tex. Civ. App.—San Antonio 1963).

[29] *Chesapeake Exploration, LLC v. Energen Res. Corp.*, 445 S.W.3d 878, 2014 Tex. App. LEXIS 10881 (Tex. App.—El Paso 2014) (" … each proration unit established under" Commission rules and regulations "upon which there exists … a well …."); *Samson Lone Star, Ltd. P'ship v. Hooks*, 389 S.W.3d 409, 2012 Tex. App. LEXIS 4353, 177 Oil & Gas Rep. 542 (Tex. App.—Houston 1st Dist. 2012) (… "'unless the [Commission] or any governmental authority having and asserting jurisdiction over the subject matter thereof prescribes for the drilling or operation of a well at a regular location, or permits for the obtaining of the maximum allowable from any well to be drilled, drilling, or already drilled, larger pooled units than any of those herein permitted, then any such pooled unit may be established or enlarged to conform to the size either required of a well or permitted for the obtaining of the maximum allowable.'"); *Browning Oil Co. v. Luecke*, 38 S.W.3d 625, 2000 Tex. App. LEXIS 7572, 149 Oil & Gas Rep. 127 (Tex. App.—Austin 2000) (" … such unit or pooled unit may … contain the greatest acreage allowable to the extent prescribed or permitted by the [Commission] or other governmental authority having jurisdiction, including, without limitation, Statewide Rule 86 … and any amendments or supplements thereto."'); *Holman v. Meridian Oil, Inc.*, 988 S.W.2d 802, 1999 Tex. App. LEXIS 827, 144 Oil & Gas Rep. 209 (Tex. App.—San Antonio 1999) (" … save and except as to all lands included within the proration units established and approved by the [Commission]."'); *Fisher v. Walker*, 683 S.W.2d 885, 1985 Tex. App. LEXIS 6046, 84 Oil & Gas Rep. 378 (Tex. App.—El Paso 1985) ("'… all lands covered hereby … which are not contained in a producing proration unit that is specified and approved by the [Commission]."'); *Mayfield v. De Benavides*, 693 S.W.2d 500, 1985 Tex. App. LEXIS 6772, 85 Oil & Gas Rep. 162 (Tex. App.—San Antonio 1985) (lease terminates except as to "'such land as may be allocated to a well for production purposes[,]'" which allocated land "'shall not exceed 640 acres plus a tolerance of ten per cent (10%).'"); *Hunt Oil Co. v. Dishman*, 352 S.W.2d 760, 1961 Tex. App. LEXIS 2085, 16 Oil & Gas Rep. 397 (Tex. Civ. App.—Beaumont 1961) (" … unless, in order to comply with an order, rule or regulation of governmental authority or agency, more than forty acres has been allotted to each well, in which case Lessee shall have the right to retain around each such well the number of acres so allotted to each well."'); *see infra* note 33 regarding *TransTexas Gas Corp.* and *Yelderman*; *see infra* note 47 regarding *Ramirez*.

[30] 403 S.W.2d 325 (Tex. 1965).

Supreme Court of Texas in 1965. The oil and gas lease at issue in *Jones* authorized the lessee to form pooled units up to 40 acres for oil wells, "'provided that should governmental authority having jurisdiction *prescribe or permit* the creation of larger units than those specified, units thereafter created may conform substantially in size with those *prescribed* by governmental regulations"' (emphasis in opinion). The lessee purported to pool part of the lease into a 172.85-acre unit for a well in the Fairway (James Lime) field, and located the well on the other unit lease. At that time, the special field rules for that field provided for a standard proration unit of 80 acres and allowed assignment of an additional 80 acres as tolerance for additional allowable credit. The lessor sued for declaration that the lease had terminated for lack of production, specifically alleging that the pooled unit was void because it exceeded the lease's pooling authority, and therefore production from the well did not perpetuate the lease.

The lessee in *Jones* argued that the pooling clause, as amended by reference to the field rules, should be construed to authorize units "not substantially less than 80 acres nor substantially more than 160 acres." The Court disagreed, holding that the "lessors did not consent to enlarge an oil proration unit to any size permitted by governmental regulations," but merely "gave their consent to enlarge a unit of substantially 40 acres, but only to the extent of the size of units prescribed by the regulatory authority." In other words, the Court construed "prescribed" as a reference to the standard proration unit under the field rules, which is the minimum acreage required for regulatory compliance (absent a fractional proration unit or exception permit). Conversely, "permitted" refers to tolerance acreage that an operator "may" add to its proration unit for an increased allowable, but is not so required by regulation. Because the lessee's 172.85-acre pooled unit exceeded the effective 80-acre maximum authorized under the pooling provision, the lease terminated for lack of production.

Several subsequent Texas cases have relied on *Jones* for the "prescribed vs. permitted" paradigm.[31] For example, in the 1971 case *Yelderman v. McCarthy*, the Houston Court of Civil Appeals likewise held a pooled unit invalid for inclusion of tolerance acreage in violation of the lease's pooling authority, which stated that pooled units shall not "exceed in acreage the minimum size tract on which a well may be drilled in order to conform to the spacing pattern prescribed in the field" by the Commission.[32] The field rules for the Rosenberg (8150' Cockfield) field established a 320-acre standard proration unit and allowed 10% tolerance, and the *Yelderman* lessee used the tolerance rule to create a 346.82-acre pooled unit. Citing *Jones*, the court reasoned that adding the tolerance acreage caused the pooled unit to exceed the "minimum" acreage necessary to "conform" to the "prescribed" rules.

The holdings in *Jones* and its progeny have prompted industry-side lease drafters to amend lease language to authorize units that conform in size with those "prescribed *or* permitted" by governmental authority, rather

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[31] *See Westbrook v. Atlantic Richfield Co.*, 502 S.W.2d 551, 1973 Tex. LEXIS 221, 17 Tex. Sup. J. 94, 46 Oil & Gas Rep. 499 (Tex. 1973); *see Hunt Oil Co.*, 656 S.W.2d at 637.

[32] 474 S.W.2d 781, 1971 Tex. App. LEXIS 2338, 41 Oil & Gas Rep. 402 (Tex. Civ. App.—Houston 1st Dist. 1971). Note that, under the applicable field rules in *Yelderman*, addition of tolerance acreage did not allow for an increased production allowable. In the author's experience, this is typical for a percentage-based tolerance rule. This is perhaps because a 10% tolerance is meant only to accommodate small land variances, such as survey errors, not to allow the operator to significantly increase the size of the proration unit.

than merely "prescribed."[33] After *Jones*, it stands to reason that such language allows pooled units up to the maximum acreage allowed under the applicable field rules for a given well, whether that entails a standard-plus-tolerance analysis or some other density rule formulation.

ENDEAVOR V. DISCOVERY

The author's research indicates that, until recently, all reported Texas cases that have directly construed a governmental authority clause to determine how it interacts with applicable field rules to define the amount of acreage a lessee may dedicate to a well: (a) involved a pooling authority clause; and (b) involved "permitted" and/or "prescribed" in the operative lease language.[34] As such, the analysis and holding in such cases have varied little from the principles established in *Jones*. However, we now have three Texas cases in as many years that invoke the same type of question as *Jones*—namely, how a governmental authority clause interacts with applicable field rules to define the amount of acreage a lessee may dedicate to a well—but that involve retained acreage clauses, rather than pooling authority, and involve governmental authority language that differs significantly from that in *Jones* and its progeny.

The first such case is *Endeavor Energy Resources, L.P. v. Discovery Operating, Inc.*, decided by the Eastland Court of Appeals in 2014.[35] The base lessee in *Endeavor* owned a lease covering the North half of a regular 640-acre section and drilled two vertical oil wells in the Spraberry (Trend Area) field, both located in the Northeast quarter of the section. The retained acreage clause in the lease provided that, at the end of continuous development, the lease would terminate as to all lands and depths, save and except "those lands … located within a governmental proration unit assigned to a well … with each such governmental proration unit to contain the number of acres required to comply with the applicable rules and regulations of the [Commission] for obtaining the maximum producing allowable for the particular well." Continuous development terminated and a top lessee brought a trespass to try title action to dispute the quantum of acreage the base lessee claimed to retain under its partially terminated lease.

The applicable field rules in *Endeavor* were substantially the same as those in *Jones*; they prescribed an 80-acre standard proration

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[33] *See TransTexas Gas Corp. v. Forcenergy Onshore, Inc.*, 2004 Tex. App. LEXIS 7877, 2004 WL 1901717 (Tex. App. Corpus Christi Aug. 26, 2004) ("'[TransTexas] must reassign to [Forcenergy] any and all acreage which has not been allocated to a producing or proration unit, as prescribed or permitted by the State.'"); *see Yelderman*, 474 S.W.2d at 3 (non-operative pooling language states that units may be "'created or enlarged to conform in size 'to the drilling or spacing units so prescribed or permitted or to the proration units as may be authorized for obtaining the maximum allowable production from one well.'"); *see supra* note 29 regarding *Browning*. Note that use of the terms "permitted" and "prescribed" to loosely describe, respectively, the maximum and minimum size proration units authorized for a given well occurs not only in oil and gas leases, but in the text of field and statewide rules themselves. For example, the initial field rules for the Allison-Britt (12,350') field (at issue in *XOG Operating, LLC v. Chesapeake Exploration L.P.*, discussed below) state that the "acreage assigned to the individual gas well for the purpose of allocating allowable gas production thereto shall be known as the *prescribed* proration unit" and that an operator "shall be *permitted* to form fractional units" for proportional allowable credit (emphasis added). *See infra* note 40. Statewide Rule 38 also defines "standard unit" as the size "prescribed" by the rule applicable to the well. *See* 16 TEX. ADMIN. CODE §3.38(b)(2)(A).

[34] For a demonstration of the variety of governmental authority clause forms compared to the dearth of case law interpreting them, *see* Martin, *supra* note 27; Whitworth, *supra* note 27.

[35] 448 S.W.3d 169, 2014 Tex. App. LEXIS 11664 (Tex. App.—Eastland 2014, pet. denied).

unit for vertical oil wells and allowed up to 80 tolerance acres for a proportionate increase in the maximum allowable, authorizing a maximum proration unit of 160 acres.[36] Along with the completion report for each well, the base lessee filed a proration unit plat assigning to each well an 80-acre proration unit.

The top lessee argued that the each well retained only 80 acres because the partial lease termination is tied to the acreage actually "assigned" to and included within the "governmental proration unit," regardless of how much could have been included under applicable rules. Thus, by assigning only 80 acres to each proration unit via the proration unit plats filed for each well, the base lessee elected to retain only an 80-acre tract around each well.

The base lessee countered that each well automatically holds a full 160 acres because the last clause, which directs that the retained proration units contain the number of acres required to obtain the maximum producing allowable, cannot otherwise be given effect. As such, the actual number of acres assigned to the wells' proration units and the well's actual maximum allowable, as determined by regulatory filings, are irrelevant to the function of the retained acreage clause.

The Eastland Court of Appeals agreed with the top lessee and declared that each well held only 80 acres. Citing and discussing the applicable field rules in depth, the court reasoned that obtaining the maximum allowable thereunder required assignment of 160 acres to a well's proration unit. It relied on the word "assigned" as an indication of the parties' intent to make the actual proration unit plat controlling on the area of acreage retained. Because the only way to make such an assignment of proration unit acreage is through appropriate regulatory filings, the actual proration unit plat itself, as filed with the Commission when the retained acreage clause was triggered, directly controls how much acreage the base lessee retained.

The court went so far as to say the retained acreage clause imposed an "obligation" on the base lessee that "unambiguously required" it to file a proration unit plat to avoid reversion of its productive acreage. Further, "it is not the failure to designate the larger proration unit that automatically terminates the lease as to the disputed quarter sections; the automatic termination is the result of the lease terms. The failure to designate the additional acreage merely quantifies the amount of acreage as to which the lease provides for automatic termination."

Despite parallels between the questions posed in both cases, the governmental authority language at issue in *Endeavor* differs significantly from that in *Jones*. As a result, the *Endeavor* opinion does not cite *Jones* at all, though the parties both do so generally in their appellate briefs.[37] Still, *Endeavor* confirms the effectiveness of another drafting paradigm common in governmental authority clauses, which may be referred to as (for lack of a more concise term) the "minimum acreage for maximum allowable" clause.[38] However, this confirmation is not controversial as both parties seemed to agree that such retained acreage language authorized the base lessee to designate, and thereby

[36] *See supra* notes 10, 12, and 13 regarding the Spraberry (Trend Area) field rules.

[37] Appellees' Amended Response Brief at 31, 36, *Endeavor Energy Resources, L.P. v. Discovery Operating, Inc.*, 448 S.W.3d 169, 2014 Tex. App. LEXIS 11664 (Tex. App.—Eastland 2014, pet. denied) (No. 11-12-00322-CV); Appellant's Reply Brief at 15, 21 *Endeavor Energy Resources, L.P. v. Discovery Operating, Inc.*, 448 S.W.3d 169, 2014 Tex. App. LEXIS 11664 (Tex. App.—Eastland 2014, pet. denied) (No. 11-12-00322-CV).

[38] *See supra* note 29 regarding *Browning* and *Samson Lone Star*; *see supra* note 32 regarding *Yelderman*.

retain, the maximum size proration unit. The more controversial part of the *Endeavor* holding, as will be demonstrated in the next case discussed herein, is how much acreage the base lessee retained when it did *not* designate the maximum size proration unit, and why.

XOG v. Chesapeake

Shortly after issuance of the *Endeavor* opinion, the Amarillo Court of Appeals construed a similar "governmental authority" retained acreage clause in *XOG Operating, LLC v. Chesapeake Exploration L.P.*[39] The retained acreage clause in *XOG* occurs in a term assignment of oil and gas leases covering 1,625 acres over three regular sections. The pertinent language reads as follows:

> "Upon expiration of the Primary Term …, this Assignment … shall terminate as to all lands and depths covered hereby. Said lease shall revert to Assignor, save and except that portion of said lease included within the proration or pooled unit of each well drilled under this Assignment and producing or capable of producing oil and/or gas in paying quantities. The term "proration unit" as used herein, shall mean the area within the surface boundaries of the proration unit then established or prescribed by field rules or special order of the appropriate regulatory authority for the reservoir in which each well is completed. In the absence of such field rules or special order, each proration unit shall be deemed to be 320 acres of land in the form of a square as near as practicable [surrounding] a well ….

The assignee completed five vertical gas wells in the Allison-Britt (12,350') field on the assigned acreage during the primary term. The then-applicable field rules prescribed a 320-acre standard proration unit, but allowed for formation of smaller "fractional" proration units.[40] The assignee designated a total of 802 acres of proration unit acreage to the five wells via Form P-15 filings, giving each a fractional proration unit averaging about 160 acres each. The assignor brought a trespass to try title suit against assignee to dispute the quantum of acreage the assignee claimed to retain after partial termination of the term assignment.

The assignor argued that the retained acreage clause ties partial termination directly to the "included within the proration … unit of each well," which units total 802 acres, not the full 1,625 acres. The assignor further argued, similar to the top lessee's argument in *Endeavor*, that the parties must have intended the assignee to retain only the acreage it actually dedicated to a proration unit because such dedication is the only means by which a proration unit is created. The assignor points out that, despite the express definition of "proration unit" as the area established or prescribed by field rules themselves, the Commission itself has no power to designate

[39] 480 S.W.3d 22, 2015 Tex. App. LEXIS 9411 (Tex. App.—Amarillo 2015, pet. denied).

[40] Final Order Adopting Temporary Field Rules and Regulations for the Allison-Britt (12,305') Field, Wheeler County, Texas (January 18, 1982) (Railroad Commission Oil & Gas Docket No. 10-77,485); Final Order Making Temporary Field Rules Permanent for the Allison-Britt (12,305') Field, Wheeler County, Texas (January 18, 1982) (Railroad Commission Oil & Gas Docket No. 10-81,043).

or configure proration acreage; only the operator may do so. Therefore, the reference to "area" and "boundaries" in such definition must refer to the actual Form P-15 filings and associated proration unit plats.

The assignee argued that because the applicable field rules allowed up to 320 acres in a proration unit for each well, the five completed wells were sufficient to hold the entire 1,625-acre assignment. Specifically, it contended that the parties intended the assignee to retain the "number of acres prescribed by the [Commission] in its special field rules for obtaining the maximum production allowable for well in that particular field." Because the assignment expressly defines "proration unit," discussed above, as that prescribed by the field rules, the actual acreage designated by an operator as a proration unit should not control how much acreage is retained.

The court agreed with the assignee and held that it had retained all of the assignment acreage. The court's opinion relies on the express definition of "proration unit" as "the area within the surface boundaries of the proration unit then established or prescribed by field rules" of the Commission to tie partial termination directly to the standard proration unit itself as prescribed by the field rules, rather than the assignee's regulatory filings.

In rejecting the assignor's argument that only an operator, not the Commission or the field rules, can designate a proration unit, the court stated that "field rules do not *prescribe* the *area* or boundaries of a proration unit; they merely set limits on the units designated by producers." This is a baffling statement for several reasons, most principally because it appears to be nothing more than a restatement of the assignor's argument, not a refutation of it. The statement also conflicts not only with the holding in *Jones v. Killingsworth*,[41] which specifically acknowledges that field rules "prescribe" the size or area of a proration unit, but also the language of the assignment itself, which defines "proration unit" as the "*area* within the surface boundaries of the proration unit then established or *prescribed* by the field rules …" (emphasis added).

Perhaps the court merely misused the word "prescribe," as quoted in the paragraph immediately above; a more apt word might be "designate" or "assign." Indeed, the court uses "prescribed" frequently in the opinion, though never in reference to the parallels between *XOG* and *Jones*. Specifically, the court does not acknowledge the obvious similarity between "prescribed or established" in the assignment text and the "permitted vs. prescribed" paradigm established in *Jones*. In fairness, however, the author's review of the briefs on the merits submitted in this case indicates that the parties likewise did not cite or discuss *Jones* in their arguments.[42] It is possible the parties and the court did not consider *Jones* relevant because it was a pooling case, not a retained acreage case; however, this seems like a trivial basis on which to distinguish *Jones*.

In another questionable remark, the court also seems to say that the assignee's actual proration designations may be irrelevant to the retained acreage analysis because a "fractional proration unit" is not actually a "proration unit" under the clause language. This is an odd statement since "fractional proration unit" is—logically, empirically, and grammatically—a subset or subcategory of "proration unit."

Finally, the court also appears to endorse the assignee's position that the retained acreage clause should be read to

[41] *Supra* note 30.
[42] *Id.*

allow it to retain the acreage necessary to obtain the "maximum production allowable." The quoted phrase does not appear in the *XOG* assignment, as it does in the *Endeavor* lease, so the court's reference of this phrase is puzzling. The court does not appear to rely on this argument, but its presence in the opinion smacks of the judicial no-no of rewriting the lease or reading extra-contractual terms into it.

Although the author does not necessarily disagree with the ultimate result in *XOG*, the court's basis for so holding is not clear or well-reasoned.

CONOCOPHILLIPS V. VAQUILLAS

The third case in the recent trilogy of "governmental authority" retained acreage cases is *ConocoPhillips Company v. Vaquillas Unproven Minerals*,[43] decided by the San Antonio Court of Appeals in 2015. This case involved 33,000 acres of oil and gas leasehold on which the lessee drilled over 200 vertical gas wells in the Vaquillas Ranch (Lobo Cons.) field. The applicable retained acreage clause in the leases reads:

> Lessee covenants and agrees to execute and deliver to Lessor a written release of any and all portions of this lease which have not been drilled to a density of at least 40 acres for each producing oil well and 640 acres for each producing or shut-in gas well, except that in case any rule adopted by the Railroad Commission of Texas or other regulating authority for any field on this lease provides for a spacing or proration establishing different units of acreage per well, then such established different units shall be held under this lease by such production, in lieu of the 40 and 640-acre units above mentioned[.]

The applicable field rules provide for 467-foot lease-line spacing and 1,200-foot between-well spacing, but do not contain any density rules at all. Indeed, the field rules do not even require designation of a proration unit; they simply prescribe an allowable based on allocated total field allowable and well deliverability.[44]

Shortly after the lessee's continuous drilling program ended, the lessor demanded release of 15,351 lease acres, being all of the lease acreage except 40 acres around each gas well. The lessee responded that it was entitled to retain 640 acres per well and the lessor brought breach of contract and declaratory judgment actions to decide the controversy.

The lessee argued that because the field rules do not contain any density rules at all, they cannot be said to "provid[e]" a rule "establishing different units of acreage." Therefore, the exception was not triggered and it retained the default 640 acres per gas well. The lessee pointed out that Statewide Rule 38(b) only sets a minimum acreage for the wells, not a maximum, and therefore it cannot be considered as establishing a "different unit[]"; and even if it does, such

[43] 2015 Tex. App. LEXIS 8194, 2015 WL 4638272 (Tex. App.—San Antonio Aug. 5, 2015, pet. granted, judgm't vacated w.r.m.).

[44] Final Order Consolidating Various Fields into a New Field Called the Vaquillas Ranch (Lobo Cons.) Field and Adopting Field Rules for the Vaquillas Ranch (Lobo Cons.) Field, Webb County, Texas (February 4, 1998) (Railroad Commission Oil & Gas Docket No. 4-0217435); Final Order Amending Field Rules for the Vaquillas Ranch (Lobo Cons.) Field, Webb County, Texas (November 2, 2010) (Railroad Commission Oil & Gas Docket No. 4-0265630).

units are established as any size larger or equal to 40 acres, including 640 acres, as lessee urges.

The lessor countered that the special spacing rules for the field must be read in conjunction with statewide rules to establish well density. Specifically, Statewide Rule 38(b) establishes by schedule the standard drilling unit sizes for oil and gas fields with no special density rule, which unit sizes are based on the special spacing rule for the field. Based on the field's 467-foot lease-line spacing, standard drilling unit size in this case is 40 acres. Therefore, the special spacing rule itself "establish[ed] different units," albeit indirectly, and therefore triggered the exception, limiting the lessee to 40 acres per gas well.

The court agreed with the lessor and ordered release the disputed acreage. Addressing each of the lessee's arguments in turn, the court relied principally on the broad lease language allowing "any rule … for any field on this lease" to serve as the basis for establishing a different unit size, expressly including "spacing or proration" rules. The court stated that lack of a maximum acreage figure under Statewide Rule 38(b) does not disqualify it as establishing "different units" because the lease did not expressly require it; "different" is all that is necessary.

A major consequence of the *Vaquillas* holding could be that the "exception" component of a governmental authority clause will almost always be triggered. Specifically, if Statewide Rule 38(b) can serve as the basis for the regulatory unit as the alternative to the fixed default acreage, the lessee may never be able to take advantage of the fixed default acreage calls (40 acres for oil and 640 acres for gas, in this case), except in the case of true wildcat wells drilled purely under Statewide Rules. Indeed, in rejecting the lessee's argument, the court can deliver no other examples of situations when the exception would not be triggered.

The *Vaquillas* opinion also contains an interesting holding regarding a standard canon of construction. The lessee argued that the retained acreage should construed in favor of a smaller partial termination because contract terms should not be held to impose a special limitation on the grant without clear, precise, and unequivocal language. The court disagreed, holding that the canon applies only in determination of *whether* a special limitation exists, not the extent to which it applies; in this case, there was no argument that the retained acreage clause was not a special limitation.

Although the *Vaquillas* court does not cite *Jones v. Killingsworth*, the parties both cite it in support of their respective interpretation of the term "establish" in the lease clause. Interestingly, both parties seem to agree that "establish" is more linguistically similar to "prescribe" as defined in *Jones* than to "permit." Their disagreement is whether the applicable field rules, by reference to Statewide Rule 38(b), do in fact "prescribe" or "establish" a standard 40-acre unit size (lessor's argument) or merely "permit" formation of proration units of any size no less than 40 acres (lessee's argument).[45] (Also interestingly, "prescribe or establish" is literally the exact operative phrase used in the *XOG* lease language, yet neither the parties

[45] Defendant's Motion for Summary Judgment at 9-11, *ConocoPhillips Co. v. Vaquillas Unproven Minerals, Ltd.*, 2015 Tex. App. LEXIS 8194, 2015 WL 4638272 (Tex. App.—San Antonio Aug. 5, 2015, pet. granted, judgm't vacated w.r.m.) (No. 04-15-00066-CV); Plaintiff's Cross-Motion for Partial Summary Judgment and Response to Defendant's Motion for Summary Judgment at 19-22, *ConocoPhillips Co. v. Vaquillas Unproven Minerals, Ltd.*, 2015 Tex. App. LEXIS 8194, 2015 WL 4638272 (Tex. App.—San Antonio Aug. 5, 2015, pet. granted, judgm't vacated w.r.m.)(No. 04-15-00066-CV).

nor the court in *XOG* make the analogy to *Jones*.)[46]

The language at issue in *Vaquillas* is irregular in comparison to the more common governmental authority clauses, though it does appear in at least one other reported Texas case;[47] as such, *Vaquillas* may have limited precedential value. However, two drafting guidelines may be gleaned from the opinion. First, if drafting for the lessee, a governmental authority clause should expressly state that the lessee is entitled to retain the fixed default acreage per well unless special field rules establish *larger* well units, rather than merely different well units, which will prevent the type of unexpected downward departure in retained acreage that resulted in this case.

Second, retained acreage clauses tied to regulatory authority may be more reliable and predictable if based specifically on density rules and/or proration units, which deal in acreage, rather than spacing rules, which deal in setback distances. If the clause in this case allowed for deviation from the fixed default acreage only for special density or proration rules (rather than spacing and proration rules), the court arguably would not have applied the exception.

STATUS OF LAW

After extensive briefing by all parties involved, the Supreme Court of Texas denied the petitions for review in *Endeavor*[48] and *XOG*[49] on March 31, 2017. Subject to motions for rehearing, both of these opinions are now final dispositions and good law.

The Supreme Court of Texas has remanded *Vaquillas* to the trial court to implement the litigants' settlement agreement after lifting a joint motion to abate. Although the judgment of the San Antonio Court of Appeals in *Vaquillas* was set aside, the Supreme Court of Texas did not vacate the opinion, meaning the opinion still stands as citable precedent.[50]

As they stand today, the *Endeavor* and *XOG* opinions arguably constitute a split of authority, at least in a general sense, between the Eastland and Amarillo Courts of Appeal regarding whether the amount of acreage retained under governmental authority clause should be based on: (a) the lessee's actual regulatory filings for designation of a proration unit (*Endeavor*); or (b) the quantum of acreage a lessee must or may designate under the applicable field rules themselves (*XOG*). Of course, the two cases are arguably reconcilable due to the significant differences in the text of the lease clauses involved.

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[46] *See supra* notes 41 and 42.

[47] *See supra* notes 27, 28, and 29. The *Vaquillas* clause appears to be part of a custom lessor-oriented South Texas lease form. *See ConocoPhillips Co. v. Ramirez*, 2006 Tex. App. LEXIS 5710, 2006 WL 1748584 (Tex. App.—San Antonio June 28, 2006) (Involving substantially identical governmental authority clause: "… except that in case any rule adopted by the [Commission] for any field on this lease provides for a spacing or proration establishing different units of acreage per well, then such established different units shall be held under this lease by such production").

[48] Case Detail for Endeavor Energy Resources, L.P. v. Discovery Operating, Inc., Sup. Ct. of Tex. Case No. 15-0155, http://www.search.txcourts.gov/Case.aspx?cn=15-0155&coa=cossup (last visited April 3, 2017).

[49] Case Detail for XOG Operating, LLC v. Chesapeake Exploration L.P., Sup. Ct. of Tex. Case No. 15-0935, http://www.search.txcourts.gov/Case.aspx?cn=15-0935&coa=cossup (last visited April 3, 2017); Case Detail for ConocoPhillips Company v. Vaquillas Unproven Minerals, Sup. Ct. of Tex. Case No. 15-0831), http://www.search.txcourts.gov/Case.aspx?cn=15-0831&coa=cossup (last visited April 3, 2017).

[50] *Conocophillips Co. v. Vaquillas Unproven Minerals, Ltd.*, 2016 Tex. LEXIS 280 (Tex. Apr. 1, 2016); *Conocophillips Co. v. Vaquillas Unproven Minerals*, 2016 Tex. LEXIS 918 (Tex. Oct. 14, 2016); *see* Tex. R. App. P. 56.3.

Vaquillas asks the same general question as *Endeavor* and *XOG* regarding a retained acreage clause based on governmental authority: "How much?" However, *Vaquillas* is fundamentally different in that the answer depends on *whether* the governmental authority clause, whereas the other two cases answer the question by analyzing *how* it applies, similar to *Jones v. Killingsworth*. *Vaquillas* nevertheless presents a novel issue that, according to the author's research, has apparently never previously come before a Texas court in a reported case.

As may now be redundantly clear, the author is surprised by the general lack of reliance on *Jones* in the three cases discussed herein. Indeed, none of the opinions cite it at all, despite it being generally recognized as the seminal Texas case on construction of governmental authority clauses.[51] Of the three cases, the briefs in *Vaquillas* cite *Jones* most frequently,[52] though *Jones* is arguably more akin to *Endeavor* and *XOG* for reasons in the paragraph immediately above. The litigants in *XOG* in particular may have left potentially potent arguments unclaimed by not analogizing to *Jones*; nevertheless, they may ultimately make such arguments to the Court if review is granted.[53]

Although the state of Texas law on governmental authority clauses is currently in flux, the three new cases discussed herein prompt several unaddressed issues that we may see in future cases on the topic. For example, no reported Texas case has yet construed governmental authority language as it applies to field rules for horizontal development. It stands to reason that the additional incremental acreage that an operator may add to a proration unit for a horizontal well would be treated the same as tolerance acreage as in *Jones* and *Endeavor*.[54] However, such application may lead to the absurd result that a well with a two-mile lateral displacement in the Spraberry (Trend Area) field only retains the 80-acre standard of "prescribed" proration unit. This would result in an extremely thin proration unit which, if made the basis of partial lease termination, risks violating maximum diagonal[55] or lease-line spacing rules.[56]

Another outstanding question is whether the deliverability of a well may have an impact on the effect of a governmental authority clause.[57] An eager lessor might argue that, under a form of governmental authority clause with "minimum acreage for maximum allowable" language, his lessee is only authorized to pool or retain as much acreage as is actually necessary to produce the well. For example, if the hypothetical two-mile lateral well above were assigned its maximum proration unit of 680 acres, it would have a 6,823 barrel-per-day actual oil allowable.[58] If that well were capable of delivering 1,000 barrels per day—an exceptional well[59] in the

[51] *See* Dashiell, *supra* note 1; *see* Hanna, *supra* note 1.
[52] *See supra* note 45.
[53] *See supra* notes 41 and 42.

[54] *See* Dashiell, *supra* note 1; *see* Hanna, *supra* note 1.
[55] Many fields have eliminated any maximum diagonal rule, especially fields recently amended for active horizontal development; however, many fields still require a maximum diagonal. *See supra* note 14 regarding the Fort Trinidad, East (Buda) field; Final Order Amending Field Rules for the Magnolia Springs (Austin Chalk) Field, Jasper County, Texas (May 22, 2014) (Railroad Commission Oil & Gas Docket No. 03-0287400). Statewide Rules for horizontal wells also still designate a maximum diagonal. 16 TEX. ADMIN. CODE at §3.86(d)(6); *see* Smith & Weaver, *supra* note 9, at §9.3(B).
[56] Smith & Weaver, *supra* note 9, at §9.3(A).
[57] *See* Dashiell, *supra* note 1.
[58] Calculated per Spraberry (Trend Area) field rules quoted *supra* notes 10 and 13.
[59] Robert Baillieul, *Seven Mind-Blowing Numbers From the Spraberry/Wolfcamp*, THE MOTLEY FOOL, November 30, 2013, http://www.fool.com/investing/general/2013/11/30/7-incredible-numbers-from-the-spraberry-wolfcamp.aspx.

Spraberry (Trend Area) field—it would only need 80 acres to be produced at full deliverability, not the 680 acres permitted by the rules.[60]

In a similar vein, a lessor might argue that, in fields classified open flow or with allowables indefinitely suspended, the lessee may be limited to only the standard or even fractional proration unit acreage because acreage has no bearing on the well's allowable.[61] An interpretive problem also may occur when applying a governmental authority clause tied expressly to a "proration unit" to a well in a field that has no proration units, such as the field in *Vaquillas*; such a situation would arguably render the clause inoperative due to the statute of frauds for lack of a legal description. And, speaking of legal descriptions, the common procedure of assigning undivided proration acreage using Forms P-15 and/or P-16 leaves open the question of where a well's proration unit tract is actually located and could be the source of partition disputes between lessors and lessees.[62]

CONCLUSION

In sum, the holdings in *Endeavor*, *XOG*, and *Vaquillas* demonstrate that Texas law on the application of retained acreage clauses based on governmental authority is in a state of flux. This is due to the disparity between the holdings in the three cases and the wide variety of forms the clause may take. The cases offer a fresh update of the guidelines for drafting governmental authority clauses, which was previously limited to *Jones v. Killinsgworth* and its progeny.

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[60] The maximum daily oil allowable for an 80-acre well in the field is 1,030 barrels-per-day. *See supra* note 13.
[61] *See* Dashiell, *supra* note 1.
[62] *See supra* notes 17–20.

DYKEMA COX SMITH

Fun New Ways for Density and Proration Rules to Bust Your Lease: Three New Retained Acreage Cases

Brandon Durrett, San Antonio
43rd Annual Ernest E. Smith
Oil, Gas & Mineral Law Institute

About the Presentation

- Three new cases interpreting "governmental authority" language in retained acreage clauses
- First significant movement since 1965
- New benchmarks for drafting and negotiating oil & gas leases

Cases for Discussion

- *Endeavor Energy Resources, L.P. v. Discovery Operating, Inc.*, 448 S.W.3d 169, (Tex. App.—Eastland 2014, pet. denied).
- *XOG Operating, LLC v. Chesapeake Exploration L.P.* 480 S.W.3d 22, (Tex. App.—Amarillo 2015, pet. denied).
- *ConocoPhillips Company v. Vaquillas Unproven Minerals*, 2015 Tex. App. LEXIS 8194 (Tex. App.—San Antonio Aug. 5, 2015, pet. granted, judgm't vacated w.r.m.).

Density and Proration

- Well Density: Regulated number of undrilled acres required to drill well in given field
- Drilling Unit: Acreage assigned to well for issuance of drilling permit
- Statewide Rule 38: If no field rule for density, standard drilling unit for field is based on applicable spacing rule

Density and Proration

- Special field rule overrides statewide rule
- May set special rule for spacing, density, both, or none
- May create proration rule to assign well allowable

Density and Proration

- Allowable: Maximum production volume per well
- Proration Unit: Acreage assigned to well for assignment of production allowable
- Distinguish from drilling unit and pooled unit

Density and Proration

- "Standard" drilling and proration unit: Minimum size (unless field rules authorize fractional units)
- "Tolerance" acreage: Acreage operator may add to standard proration unit, usually for increased allowable
- "Fractional" proration unit: Smaller than standard, usually for decreased allowable, but often requires exception

Retained Acreage

- Lease clause allowing lessee to keep only productive acreage at end of primary term (or continuous development, if applicable)
- Terminates as to all but acreage around producing wells
- Usually defined by regulatory well units using "governmental authority" language

Retained Acreage

- Incentive for lessee to drill more and allows lessor to lease undrilled acreage to new operator
- Wide variety of forms, often custom
- Governmental authority language also often appears in pooling clauses and Pugh clauses

Jones v. Killingsworth

- 403 S.W.2d 325 (Tex. 1965)
- Seminal Texas case for interpretation of "governmental authority" language
- "Permitted" vs. "Prescribed" drafting paradigm

Jones v. Killingsworth

- Pooled units shall be 40 acres, "provided that should governmental authority having jurisdiction *prescribe or permit* the creation of larger units than those specified, units thereafter created may conform substantially in size with those *prescribed* by governmental regulations."

Jones v. Killingsworth

- Field rules for Fairway (James Lime) field in Henderson County had 80-acre standard proration unit and allowed up to 80 acres tolerance.
- Operator pooled 160-acre unit.
- Lease in question was non-drillsite tract.
- Lessor sued claiming lease terminated because 160-acre unit exceeded pooling authority.

Jones v. Killingsworth

- SCOTX: "The lessor did not consent to enlarge an oil proration unit to any size *permitted* by gov't regulations. They gave their consent to enlarge a unit … but only to the extent of the size of the units *prescribed* by regulatory authority."

Jones v. Killingsworth

- Lessee may only pool up to 80 acres, the standard or "prescribed" unit size.
- Field rule "prescribes" 80 acre units as minimum
- Merely "permits" larger units up to 160 acres as tolerance at operator's discretion.
- Pooled unit invalid and lease terminated.

Jones v. Killingsworth

- "Prescribed" and/or "permitted" used frequently in drafting pooling and retained acreage clauses
- Reflects same language often used in field rules (see rules in *XOG*)
- "Established"?
- "Authorized"?
- "Required"?
- "Adopted"?

Endeavor v. Discovery

- 448 S.W.3d 169, (Tex. App.—Eastland 2014, pet. denied)
- Same question as in *Jones*: How much acreage?
- Now applied to retained acreage clause
- Spraberry (Trend Area) rules in Martin County

Endeavor v. Discovery

- At end of continuous development, lease shall automatically terminate as to all lands and depths, save and except those within "governmental proration unit assigned" to a well, with each such unit to contain the acreage "required to comply" with applicable rules for obtaining the "maximum producing allowable"

Endeavor v. Discovery

RULE 3: The acreage assigned to an individual well shall be known as a proration unit. The standard drilling and proration units are established hereby to be EIGHTY (80) acres. No proration unit shall consist of more than EIGHTY (80) acres except as hereinafter provided. There is no maximum diagonal limitation in this field. All proration units shall consist of continuous and contiguous acreage which can reasonably be considered to be productive of oil. Except as provided in these rules, no double assignment of acreage will be accepted.

Notwithstanding the above, operators may elect to assign a tolerance of not more than EIGHTY (80) acres of additional unassigned lease acreage to a well on an EIGHTY (80) acre unit and shall in such event receive allowable credit for not more than ONE HUNDRED SIXTY (160) acres.

Furthermore, for purposes of additional acreage assignment to horizontal drainhole wells under Statewide Rule 86 (d)(1), the amount specified by applicable rules for a proration unit for a vertical well shall be the EIGHTY (80) acres plus EIGHTY (80) acres tolerance provided in this Rule 3.

Endeavor v. Discovery

RULE 4: The maximum daily oil allowable for each oil well on an EIGHTY (80) acre unit in the subject field shall be the MER Allowable of ONE THOUSAND THIRTY (1,030) barrels of oil per day, and the actual allowable for an individual well shall be determined by the sum total of the two following values:

a. Each well shall be assigned an allowable equal to the top allowable established for a well having a proration unit containing the maximum acreage authorized exclusive of tolerance acreage multiplied by SEVENTY FIVE percent (75%) and by then multiplying this value by a fraction, the numerator of which is the acreage assigned to the well and the denominator of which is the maximum acreage authorized for a proration unit exclusive of tolerance acreage.

b. Each well shall be assigned an allowable equal to TWENTY FIVE percent (25%) of the maximum daily oil allowable above.

Endeavor v. Discovery

- Lease covers N/2 of regular section (320 acres)
- Operator (Endeavor) drills 2 vertical wells in NE/4 in Spraberry (Trend Area) field
- Operator files proration plat (W-2 & P-15) for both wells with RRC, assigning 80 acres to each
- Continuous development program expires

Endeavor v. Discovery

- Operator claims 2 wells hold 320 acres (160 each) because lease allows it to retain enough acreage to get maximum producing allowable, which is 160 per well (standard + tolerance)
- Subsequent lessee (Discovery) claims each well holds 80 acres each because operator so assigned proration units

Endeavor v. Discovery

- Eastland Court of Appeals holds for subsequent lessee
- Only way to "assign" acreage is RRC filing, and lease says lands outside proration unit terminate
- "Maximum production allowable" clause does not relieve operator of duty to designate acreage

Endeavor v. Discovery

- RRC filings can be critical to how much acreage you retain, even if lease does not require release of acreage or well unit designation
- "Maximum allowable" language is effective
- Real controversy was what determined acreage retained under lease terms: rules themselves or actual filings

XOG v. Chesapeake

- 480 S.W.3d 22 (Tex. App.—Amarillo 2015, pet. denied)
- Same question: How much acreage?
- Allison-Britt field rules in Wheeler County (1982)

XOG v. Chesapeake

- At end of term, assignment terminates except "that portion of said lease included within the proration or pooled unit of each well." "Proration unit" defined as "area within the surface boundaries of the proration unit then established or prescribed by field rules …"

XOG v. Chesapeake

The acreage assigned to the individual gas well for the purpose of allocating allowable gas production thereto shall be known as the prescribed proration unit. No proration unit shall consist of more than three hundred twenty (320) acres except as hereinafter provided; and the two farthermost points in any proration unit shall not be in excess of six thousand (6,000) feet removed from each other; provided that tolerance acreage of ten (10) percent shall be allowed for each unit so that an amount not to exceed a maximum of three hundred fifty-two (352) acres may be assigned. For allowable assignment purposes, the prescribed proration unit shall be a three hundred twenty (320) acre unit, and each unit containing less than three hundred twenty (320) acres shall be a fractional proration unit. All such proration units shall consist of continuous and contiguous acreage which can reasonably be considered to be productive of gas. No double assignment of acreage will be accepted.

An operator, at his option, shall be permitted to form fractional units of one **[*20]** hundred sixty (160) acres with a proportional acreage allowable credit for a well on such unit with the two farthermost points of such one hundred sixty (160) acre fractional unit not greater than four thousand five hundred (4,500) feet removed from each other.

XOG v. Chesapeake

- Field rules have 320-acre standard proration unit, but allow smaller "fractional" proration units
- Assignee (Chesapeake) designated 160-acre proration unit for each of 5 vertical wells on P-15 forms
- Assignor (XOG) sued for recovery of all acreage except the 5 160-acre proration units

XOG v. Chesapeake

- Assignor argued that "included within the proration … unit" means retained acreage is tied to assignee's actual 160-acre proration unit designations
- RRC itself cannot "include" or designate particular acreage for a proration unit; only operator can

XOG v. Chesapeake

- Assignee argued that assignee keeps the acreage "prescribed" by RCC in field rules, meaning standard 320-acre unit per well
- Actual unit designation irrelevant

XOG v. Chesapeake

- Amarillo Court of Appeals holds for assignee
- Relies on lease definition of proration unit, which ties retained acreage to standard proration unit prescribed by RRC, not actual designated by operator
- Dissent says majority opinion ignores "included" language, cites *Endeavor*

XOG v. Chesapeake

- Fun fact: *Jones* is never cited in *XOG* opinions or appellate briefs, despite obvious parallels between "established or prescribed" (*XOG*) and "permitted or prescribed" (*Jones*)
- States that "field rules do not *prescribe* the *area* … of a proration unit" – *Jones* says otherwise

XOG v. Chesapeake

- "Prescribed" doesn't necessarily mean "minimum"
- Same ultimate question as *Endeavor*: whether rules themselves or actual filings control
- Creates split of authority in Texas law

COP v. Vaquilas

- 2015 Tex. App. LEXIS 8194 (Tex. App.—San Antonio Aug. 5, 2015, pet. granted, judgm't vacated w.r.m.)
- Same question: How much acreage?
- Vaquillas Ranch (Lobo Cons.) field in Webb County

COP v. Vaquilas

- Lessee shall release all acreage not "drilled to density of at least … 640 for each producing or shut-in gas well, except that any rule adopted by the [RRC] for any field on this lease provides for a spacing or proration establishing different units of acreage per well, then such established different units shall be held under this lease by such production, in lieu of the … 640-acre units above mentioned."

COP v. Vaquilas

- New twist! No special density rule!
- Statewide Rule 38 applies, which prescribes standard drilling unit based on applicable spacing rules
- In this case, lease-line spacing is 467' and between-well spacing is 1,200'

COP v. Vaquilas

Figure: 16 TAC §3.38(b)(2)(A)

Spacing Rule	Acreage Requirement
(1) 150 - 300	2
(2) 200 - 400	4
(3) 330 - 660	10
(4) 330 - 933	20
(5) 467 - 933	20
(6) 467 - 1200	40
(7) 660 - 1320	40

COP v. Vaquilas

- Lessee (COP) drilled over 200 vertical gas wells on lease
- Allowable based on deliverability and field rules don't prescribe proration unit at all, so lessee did not designate them in filings
- Continuous development program expires
- Lessor (Vaquillas) sues for release of all but 40 acres per well

COP v. Vaquilas

- Lessee argues that it retains 640 acres per well, which is default under lease since field has no density rule
- Rules can't "establish … different" unit because it doesn't establish one at all
- Statewide Rule 38 only sets minimum acreage, so is consistent with lease default acreage of 640 acres

COP v. Vaquilas

- Lessor argues that Statewide Rule 38 establishes "different" size unit of 40 acres, albeit indirectly
- Lease says "any rule adopted" by RRC can trigger exception to default acreage, including statewide rules

COP v. Vaquilas

- San Antonio Court of Appeals holds for lessee
- Relied on "any rule" language to hold that statewide density rule triggered exception to default acreage
- Lease specifically cites "spacing" rule as catalyst for establishing different unit size, which occurred by reference to statewide rule

COP v. Vaquilas

- Court's literal reading arguably defeats purpose of stating default acreage
- If statewide density rule triggers governmental authority clause, then default acreage is superfluous
- Better for lessee if default acreage applies unless rules establish "larger" units, not "different"

COP v. Vaquilas

- Bonus holding: canon of construction that special limitation must be clear and unequivocal only applies to question of *whether* there is a special limitation, *not degree* to which special limitation applies
- Custom lease form with irregular language, so case may not be far reaching

COP v. Vaquilas

- *Endeavor* and *XOG* ask whether rules themselves or actual filings control under governmental authority clause
- *Vaquillas* is different: asks whether governmental authority clause was triggered at all

Appellate Status

- Petitions in *Endeavor* and *XOG* recently denied
- *Vaquillas* judgment set aside to effectuate settlement agreement, but opinion has NOT been vacated
- All are now good law

So What?

- Why does is matter if I lose 40 acres if I keep my well?
- Acreage value in parts of Permian as high as $50k/acre ($2m for 40 acres)
- COP lost 15,351 acres to Vaquillas (pre-settlement)

So What?

- New cases are valuable lease-busting tools for lessors and top lessees
- Also valuable for buyers in knocking down purchase price in large lease acquisitions during due diligence
- Complicates matters for title examiners

Upshot

- New cases raise more questions than they answer
- No standard retained acreage or gov't authority clause, like NPRI interpretation cases
- Standard of contract construction is to give effect to plain language and harmonize entire agreement