

**DRAFTING THE RETAINED ACREAGE CLAUSE:
THE EFFECT OF GOVERNMENTAL AUTHORITY ON RETAINED
ACREAGE**

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DRAFTING THE RETAINED ACREAGE CLAUSE: THE EFFECT OF GOVERNMENTAL AUTHORITY ON RETAINED ACREAGE

I. INTRODUCTION.

Per Williams and Meyers, a retained acreage clause is a “lease clause authorizing the lessee to retain acreage around a producing well or acreage in a producing unit in the event of forfeiture of a lease.”¹ While the definition and purpose of the retained acreage clause may seem innocuous enough, “all things truly wicked start from innocence.”² There are dangers lurking in the shadows for a practitioner who may be unaware of the interactions between retained acreage clauses, the respective underlying agreement (i.e., oil and gas lease, farmout, or participation agreement), and language incorporating the rules of the “governmental authority having jurisdiction”.

Prior treatises and Continuing Legal Education articles have gone into various detail regarding the issues of retained acreage clauses. Specifically, I would refer you to “The Retained Acreage Clause – An Update and Its Relationship with the Implied Development Covenant”, by William Farrar in the Advanced Oil, Gas and Energy Resources Law 2002 materials and “Special (Landowner?) Clauses in the Oil and Gas Lease, with Special Emphasis Upon Continuous Development, Retained Acreage, and Pugh Clauses”, by J.T. Walker in the University of Texas Oil and Gas Seminar 1986 materials. Both articles are very informative in discussing the interaction of retained acreage with implied covenants and continuous drilling clauses, respectively.

Rather than refining the detailed points of the retained acreage clause by focusing on covenants, however, this article’s primary focus is to give an overview of drafting the retained acreage clauses in such a way that one does not create unintended consequences when drafting a retained acreage clause that is tied to the rules of the “governmental authority having jurisdiction”, i.e. the Texas Railroad Commission (the “Commission” or the “RRC”). To accomplish this, this article will: a) provide general background on the Commission’s rules, b) identify certain issues in drafting retained acreage clauses, and c) discuss some ancillary problems to certain retained acreage issues.

II. BACKGROUND OF RRC RULES AND REGULATIONS.

The Commission is one of the oldest regulatory agencies in the State of Texas, having been created in 1891 under a constitutional and legislative mandate and was, as the name suggests, originally created to prevent discrimination in railroad charges. Given the large amounts of land the railroads owned at the time, it made sense for the Commission to also regulate the emerging oil and gas industry in the late 1800’s.

Over time, the Commission’s primary mission shifted from the regulation of rail transportation to stewarding the State’s natural resources. The Commission’s primary mission is to regulate the orderly production of oil and gas, to prevent the waste of the State’s natural resources, and to protect the correlative rights of its citizens. Two of the main mechanisms for accomplishing this mission are through the use of allowables and the implementation of field rules.

1. Allowables.

“Allowables” result from an allocation formula employed by the RRC to prevent waste and protect correlative rights by “fairly distributing the available market for production from the reservoir.”³ Acreage that is assigned to a well for allowable purposes cannot be assigned to any other well, regardless if such wells are to be completed in the same reservoir. In other words, there cannot be double assignment of acreage for allowable purposes.⁴

The Commission has a wide degree of latitude in determining the formula and may base it on productive acreage, initial potential, net-acre feet, deliverability, pressure, or some varying combination thereof. Productive

¹ Williams & Meyers, *MANUAL OF OIL AND GAS TERMS*, Volume 8, Page 1066 (1992).

² Ernest Hemingway.

³ Texas Oil and Gas, *Discussions of Law, Practice and Procedure*, Railroad Commission of Texas, page 7.

⁴ 16 Texas Administrative Code (“T.A.C.”) §3.40. See also, 16 T.A.C. §3.49.

acreage is, therefore, not the only basis for determining an allowable.⁵ Indeed, in many fields in the State of Texas the allocation formula has been indefinitely suspended and they are operating under Absolute Open Flow, or AOF. The RRC has administratively suspended the allocation formulae for many fields because “each operator from that field has a market, for 100% of the deliverability... for its respective wells”.⁶ One should be aware, however, that the Commission may reinstate such allowables “...at the request of an operator from a field with a suspended allocation formula or at any time the commission deems reinstatement necessary to protect correlative rights or prevent waste.”⁷

In any event, the RRC may determine an allowable based upon non-acreage terms and a proration plat is not even required in many fields. If the rules for a particular field include both density provisions and allocation formulae based partially or entirely on acreage, only then must all operators in the field file certified plats showing the size and shape of the unit assigned to each well, and a signed statement on the respective Form P-15, Statement of Productivity of Acreage Assigned to Proration Units (the “P-15”) indicating that the acreage is considered reasonably productive.

2. Field Rules.

The second tool in the Commission’s arsenal is the “field rule”, which uses well spacing and density provisions to promote regular development in a field in such a way that the wells are not clustered together and damaging to the reservoir.⁸ Well spacing provides for the minimum distance that a well may be located with respect to lease lines, property lines, or subdivision lines (“lease line spacing”), as well as the minimum distance that a well can be located with respect to another well completed in the same reservoir on the same lease (“between well spacing”). Density provisions establish the number of acres that are required for each well in a given reservoir.⁹ While each field has its specific lease line and density provisions, lease line spacing is generally handled by the RRC under 16 T.A.C. §3.37 (“Statewide Rule 37”) and density is handled under 16 T.A.C. §3.38 (“Statewide Rule 38”).

A field, or common source of supply as determined by pressure communication,¹⁰ is regulated by the RRC under one of three different rule systems. These systems are classified as Statewide Rules, County Regular Rules, and Special Field Rules.

a. Statewide Spacing Rules.

The vast majority of fields in the State of Texas are governed by Statewide Rules. The RRC defines Statewide Field Rules as being 467 feet lease line spacing, 1,200 feet between well spacing, and forty (40) acres density for each well from a single property in a particular field. Under Statewide Rules of “467/1200”, one should be aware that density for a GAS WELL is also forty (40) acres!

b. County Regular Rules.

Under County Regular Rules (which are more commonly referred to as District Spacing Rules), special spacing is applicable only in Railroad Commission Districts 7B and 9, and McCulloch County, which is located in District 7C. Specifically, the following counties are affected:

Archer (09), Baylor (09), Brown (7B), Callahan (7B), Clay (09), Coleman (7B), Comanche (7B), Coryell (7B), Denton (09), Eastland (7B), Erath (7B), Grayson (09), Hardeman (09), Haskell (7B), Hood (7B), Jack (09), Jones (7B), Knox (09), Lampasas (7B), McCulloch (7C), Nolan (7B), Palo Pinto (7B), Parker (7B), San Saba (7B), Shackelford (7B), Somervell (7B), Stephens (7B), Stonewall (7B), Taylor (7B), Throckmorton (7B), and Wichita (09).

⁵ 16 T.A.C. §3.31(j).

⁶ 16 T.A.C. §3.31(j)(3)(B).

⁷ 16 T.A.C. §3.31(j)(3)(B).

⁸ Texas Oil and Gas, Discussions of Law, Practice and Procedure, Railroad Commission of Texas, page 4.

⁹ Id.

¹⁰ 16 T.A.C. §3.79.

District Spacing is only applicable in situations where the completions are 5,000 feet or less. If the completions are deeper than 5,000 feet, then Statewide Rules become applicable. District Spacing is often overlooked in drafting retained acreage clauses, but doing so may be a problem in that the acreage requirements differ based upon depth. Indeed, if one is unaware of the spacing rules in these counties at depths less than 5,000 feet, that person may find that tying the retained acreage to the RRC's acreage requirements would provide only two (2) acres for a well drilled between zero and 2,000 feet subsurface, only ten (10) acres for a well drilled between 2,000 and 3,000 feet subsurface, and twenty (20) acres for a well drilled between 3,000 and 5,000 feet subsurface.

c. Special Field Rules.

The third and final form of Field Rule is the Special Field Rule. Basically, under Special Field Rules, an operator may request different spacing and density requirements due to geologic variations in the field itself. To obtain Special Field Rules, the party requesting it must file an application that shows the basis for such a request and that identifies the correlative interval via well logs on file with the Railroad Commission. Special Field Rules allow an operator to create larger pooled units if the retained acreage lease provision incorporates a "governmental authority" pooling provision. They are also helpful in mitigating a lessor's claims for "failure to develop" and in increasing (or decreasing, as the case may be) allowables.

III. CONTRACT WORLD VS. THE RRC: WHEN WORLDS COLLIDE.

In order to understand the effects of the RRC's rules on a contractual retained acreage clause, one could look at the RRC almost as though it is a parallel universe. Reinforcing this idea of a parallel universe is the fact that the Commission does not have the authority to adjudicate contract rights. Rather, when the Commission has hearings or even routine administrative matters that hinge on a contract's interpretation, the RRC often handles it by "punting" the matter. In other words, the RRC will tell the parties to have a court of law adjudicate the contract and to come back with a judgment at the appropriate time.

Normally, the parallel universes peacefully co-exist. A practitioner usually understands this, and may only contact an Austin-based, RRC specialty firm when a problem arises. This may be a mistake. The reason is that when one ties the retained acreage clause to governmental authority, what happens in the regulatory universe affects the contract universe, and vice-versa. Added to this, some oil and gas operators try to cross universes on their own by incorporating the Commission's rules and regulations into their retained acreage clauses, but do not fully anticipate the consequences of doing so.

In order to avoid creating unintended consequences when drafting a retained acreage clause that is tied to the rules of the "governmental authority having jurisdiction", a practitioner should be aware of the following issues and pitfalls:

1. Knowing the Allowables.

Many pre-printed forms contain provisions in substantially the same form as the following:

If larger units than any of those herein permitted...are required under any governmental rule or order, for the drilling or operation of a well at a regular location, or for obtaining maximum allowable from any well to be drilled... any such unit may be established or enlarged to conform to the size required by such governmental order or rule.

What, exactly, does this give you?

a. Productive acreage is not always a component of the allowable.

As referenced above, the Railroad Commission has a wide degree of latitude in determining the allowable

formula. Productive acreage may be an important factor, but it is far from the only one. If the allowable is based on net-acre feet, initial potential, deliverability, or pressure, but not on productive acreage, the above retained acreage clause does not provide for additional retained acreage. In other words, if the allocation formula does not use acreage in determining the maximum allowable, the above clause will not help an operator retain additional acreage.

- b. Verify that additional acreage is actually necessary to achieve the top allowable.

On a cautionary note, a practitioner would be well advised to consult the allocation formula for the proposed field if the client intends to retain additional acreage based on the “maximum allowable”. An operator should also be careful in determining whether the acreage permitted under the “maximum allowable” is indeed necessary to achieve its top allowable rates. If the technical evidence clearly shows that the well is draining eight (80) acres, but the client operator is claiming three hundred twenty (320) acres under the maximum allowable, that client may open itself up to claims that it did not act in good faith in retaining the full 320 acres.

2. Knowing the Field Rules.

Furthermore, it is important to have an understanding of the field rules associated with the lease or agreement and to understand how they interact with the retained acreage clause. A practitioner should be aware that not all “maximum allowable” clauses like the one referenced in Section 1, above, will result in greater retained acreage than what is otherwise provided for in the lease.

- a. Area field rules may not necessarily grant additional acreage under “maximizing allowables” language.

For instance, if the lease is located in any of the counties within Railroad Commission Districts 7B and 9, and McCulloch County (District 7C), as referenced above, and is drilling a well less than 5,000 feet in depth, the client would not be able to retain *any* additional acreage based on the maximum allowable. The District Spacing Rules in these counties provide for only two (2) acres for a well drilled between zero and 2,000 feet subsurface, ten (10) acres for a well drilled between 2,000 and 3,000 feet subsurface, and twenty (20) acres for a well drilled between 3,000 and 5,000 feet subsurface. The client should know that some field rules actually provide *less* acreage than what may be seen in a typical retained acreage clause in many leases that allow forty (40) acres for an oil well and three hundred twenty (320) acres for a gas well.

- b. Example of how field rules may affect retained acreage.

By way of further example, a client had a lease in Grimes County that had the following language in its clause:

If larger units than any of those allowed under the terms of this Lease are required under any governmental rule or order in order to obtain the maximum allowable from any well to be drilled, such units may be established or enlarged to conform to the size required under such governmental rule.

As many clients do, this particular operator wanted to retain as much acreage as possible. The client was in the midst of drilling a horizontal well in the Giddings (Austin Chalk, Gas) Field (34773550) and was relying upon the Commission rule for Horizontal Wellbores, 16 T.A.C. §3.86 (“Statewide Rule 86”) to take advantage of additional acreage based upon the horizontal displacement of the well. The problem arose in that the client did not fully understand the interaction of the field rules with the “maximum allowable” language. The client’s landman asserted that it was operating under Statewide Rules of “467/1200” and that it could only obtain the 160 acres allowed under the field rules plus the additional acreage under Statewide Rule 86 for its 5,000 foot lateral. This, however, did not compute. Why?

As referenced above, it is because, under Statewide Rules, the density for both oil *and* gas wells is 40 acres. A quick review of the field rules for the Giddings (Austin Chalk) Field reflected that, while the lease line spacing and

between well spacing were indeed “467/1200”, the field rules were actually *Special Field Rules* rather than Statewide Rules. In not fully analyzing the Special Field Rules, the client almost missed the biggest issue of all – the allocation formula allowed the retention of more acreage.

Under the client’s original line of thinking, it hoped to obtain a unit of 160 acres, as allowed in the density provision of the Special Field Rules, PLUS an additional 240 acres allowed under Statewide Rule 86 based on the length of the well’s lateral, for a total of 400 acres. In Docket No. 03-0200424, dated effective January 12, 1993, the Commission changed the acreage allocation formula for the Giddings (Austin Chalk) Field. The field rules and proration schedule showed that instead of the basic acreage allotment allowed under Statewide Rule 86, the allowable was determined by the following formula: $A = ((L \times .11488) + 160) \times 1.5$. Thus, with a 5,000 foot lateral, the client was actually able to retain 1100 acres (i.e., $((5,000 \text{ feet} \times .11488) + 160) \times 1.5$), rather than 400 acres. Had the client or its landman actually reviewed the field rules and attending proration schedule, he or she would have discovered this discrepancy.

If a practitioner chooses to tie the retained acreage clause to governmental acreage requirements, he or she should review and know the field rules that will be applicable. Otherwise, as in the example above, additional acreage may be lost that the client was contractually entitled to retain.

3. Pre-printed forms.

a. Prescribed or permitted.

Many of the pre-printed lease forms contain clauses that tie retained acreage or pooled units to “governmental authority”. In drafting a retained acreage clause, a practitioner should be cautious of language that ties the retained acreage or pooled units to language such as “prescribed by governmental authority.” The intent of these governmental authority clauses is understandable. If the governmental authority, such as the Railroad Commission, allows a larger unit size under its rules, the operator should be able to take advantage of such allowances to create a bigger unit. An example of this is Statewide Rule 86, which allows additional acreage for allowables based upon the length of the horizontal drilling laterals.

b. Example of lost retained acreage due to “prescribed” terminology.

If a client wants to maximize the amount of acreage that may be retained, a practitioner should be wary of using the term “prescribed”. Our earlier discussion of field rules and background information is meant to tie into how this terminology may affect you. This is illustrated by the following example:

Two Couyons Drilling Company (“Two Couyons”) is a Louisiana oil and gas company which wishes to break into that fancy Newark, East (Barnett Shale) play up in the Fort Worth area. The new person in charge of land has been able to procure a sizable lease, line up rig availability, and even has the permit and financial assurance requirements at the Commission squared away. Two Couyons Drilling Company is planning on drilling a horizontal well with a horizontal displacement of 3,500 feet.

The subject lease, however, includes the following language:

...provided, however, that should governmental authority having jurisdiction *prescribe or permit* the creation of units larger than those specified, units thereafter may conform substantially in size with those *prescribed* by governmental regulations.

The Newark East (Barnett Shale) field allows an operator 320 acres under the Special Field Rules, plus optional units of 20 acres. However, Statewide Rule 86 also allows horizontal wells to take advantage of additional acreage based upon the horizontal displacement of the well. With a 3,500 foot horizontal wellbore displacement, the operator would normally be allowed an additional 200 acres, resulting in a total retained acreage of 520 acres.

c. Jones v. Killingsworth.

In our example, however, Two Couyons is limited to retainer of 320 acres instead of 520 acres because its retained acreage clause asserts that the unit must conform to the unit “*prescribed*” by governmental regulations. In *Jones v. Killingsworth*, 403 S.W.2d 325, 326-327 (Tex. 1966), the court encountered a clause such as the one referenced above and limited the retained acreage to the lower of the “prescribed” or “permitted” acreage. In other words, if Commission rules such as Statewide Rule 86 grant additional acreage based on the length of the horizontal drainhole (i.e. additional acreage is “permitted”), but the minimum acreage “prescribed” by the RRC is the basic density of the field rules, such language would prevent the retainer of the additional 200 acres obtained pursuant to Statewide Rule 86.

Therefore, if one is not fully cognizant of the Commission’s rules on a matter such as this, use of language such as “prescribed” may be perilous at best. Perhaps a simpler method to deal with this issue is to replace the term “prescribed” with “prescribed or permitted” every time it is used, such that relevant portion of the retained acreage clause reads as follows:

...provided, however, that should governmental authority having jurisdiction *prescribe or permit* the creation of units larger than those specified, units thereafter may conform substantially in size with those *prescribed or permitted* by governmental regulations.

4. Unit Terminology and Defining Units!

One of the most prevalent methods of creating unintended consequences in retained acreage clauses is failing to properly define the “units” in the underlying lease, farmout, participation, or other agreements. Defining a unit should be a straightforward issue, but failing to do so can have dramatic effects.

Please understand that the term "Unit" has different meanings in the regulatory context. It is important to take note of the following and to distinguish the differences between them when drafting the retained acreage clause:

a. Drilling Unit.

A “drilling unit” is “the acreage assigned to a well for drilling purposes” and is the acreage submitted with the RRC Form W-1 drilling permit to show sufficient acreage for density requirements.¹¹ It is a regulatory term of art with limited purposes and it is not even required for permits on vertical wells anymore.¹²

b. Proration Unit.

A “proration unit” is “the acreage assigned to a well for the purpose of assigning allowables and allocating allowable production to the well.”¹³ The actual configuration of a proration unit depends on situations where, as discussed above, acreage is used as part of the allowable calculation. Not all allowables use acreage as a factor.

c. Pooled Unit.

A “voluntary pooled unit” or “pooled unit” is “the acreage formed by joining separately owned tracts, usually to constitute a drilling or prorationing unit”.¹⁴ This is the Pooled Unit Declaration filed in the official public records of the county where the land is located. Please note that a Voluntary Pooled Unit filed at the courthouse as a Unit Declaration is NOT the same thing as the pooled unit filed at the Railroad Commission on the appropriate Form P-

¹¹ 16 T.A.C. §3.38.

¹² 16 T.A.C. §3.5(h).

¹³ 16 T.A.C. §3.38.

¹⁴ Ernest E. Smith & Jacqueline Lange Weaver, Texas Law of Oil and Gas, §10.1(B).

12, Certificate of Pooling Authority (the “P-12”). They could, in fact, cover the same acreage and unit (see Section IV(1), below), but filing a Form P-12 is part of the regulatory universe. A Pooled Unit Declaration filed at the courthouse is part of the contractual universe. They do not necessarily touch, and one does NOT take the place of the other.

d. Force Pooled Unit.

A “forced pooled” unit is the joining of separately owned tracts under Chapter 102 of the Texas Natural Resources Code, or the Mineral Interest Pooling Act (“MIPA”). MIPA authorizes the Commission to force pool adjacent tracts and interests under limited circumstances in order to achieve proration units of the size called for in the applicable field rules. The circumstances in which MIPA may be used are extremely limited, but MIPA may be beneficial to a client operator if the pre-conditions outlined in Chapter 102 of the Texas Natural Resources Code are met and an incalcitrant mineral interest owner is preventing development in the hopes of extracting egregious sums of money.

If an underlying lease fails to define its unit terminology, or, for instance, incorrectly ties the retained acreage to a drilling unit instead of a proration unit with acreage allocation in the allowables, an unsuspecting client operator may find that it does not have the retained acreage that it once thought it was entitled to.

IV. ANCILLARY ISSUES TO RETAINED ACREAGE CLAUSES TIED TO GOVERNMENTAL AUTHORITY

A practitioner should also be aware of certain matters that may occur *after* the drafting of the retained acreage clause in order to avoid certain problems. After the ink has dried, so to speak, the practitioner should be aware of the following issues:

1. Form P-12 versus Unit Declaration.

In addition to properly defining the underlying “unit”, a practitioner should consider the *size* of the unit reflected at the Railroad Commission versus the size of the pooled unit filed at the courthouse. The units filed at both the Railroad Commission and the courthouse do not *have* to cover the exact same acreage, but it is advisable to make sure that they do.

a. Matching the Form P-12 acreage with the Unit Declaration Acreage.

Technically, one could have a pooled unit declaration covering particular lands filed at the RRC on its Form P-12, but have a different pooled unit declaration filed at the courthouse that has more than the lands reflected on the Form P-12. The Commission’s rules do not specifically mandate that the units be identical, but requires that an operator have at least a “good faith claim to the right to produce the minerals in the tracts that will be penetrated by the well bore.”¹⁵

On a prior occasion, a client operator mismatched its units and almost got caught in the netherworld between the regulatory and contract universes. Specifically, the client enlarged the size of its pooled unit at the courthouse in compliance with the underlying leases and *Expando Production Co. v. Marshall*, 407 S.W.2d 254 (Tex.Civ.App., 1966), but did not file a duplicate of that unit acreage on an amended Form P-12 at the RRC. One extremely disgruntled non-operating working interest owner later, the Commission opened a complaint file.

b. Continuing Good Faith Claim necessary when the Form P-12 and Pooled Unit Declaration are Inconsistent.

In its complaint correspondence, the RRC required evidence of the continuing good faith claim of the client to operate the properties listed on the Form P-12. Fortunately for the client, the good faith claim was satisfied by language in the pooling provision of its leases that held that:

¹⁵ Quoting correspondence from Colin Lineberry, Director of the Hearings Section, Railroad Commission of Texas.

... Production, drilling or reworking operations anywhere on an oil and/or gas unit which includes all or part of the leased premises shall be treated as if it were production, drilling or reworking operations on the leased premises, except that the production on which Lessor's royalty is calculated shall be that proportion of the total oil or gas unit production which all or part of the acreage covered by this lease is included in the oil or gas unit bears to the total gross acreage in the unit (emphasis added).

In other words, the pooling provision provided the good faith claim even though, technically speaking, portions of the Form P-12 Unit were not actually included in the courthouse unit and vice-versa. The client would have had difficulty with the RRC if the pooling provisions had more stringent language. Due to this possibility, it is advisable for an operator to have the acreage retained around a well correspond to the Form P-12 filed at the Railroad Commission. One should anticipate this distinction in the underlying agreement to insure that the retained acreage clause is compatible with the units in the regulatory context.

2. Changes in Gas-Oil Classification.

Another issue to be aware of is the potential change in the production characteristics of an existing well and how such a change affects the acreage that a client operator is allowed to retain. The RRC defines what is an “oil well” and what is a “gas well” by the Gas to Oil Ratio, or the “GOR”. Specifically, the GOR is defined as the ratio of “2,000 cubic feet of gas per barrel of oil produced”.¹⁶ If a well, originally classified as a gas well, ends up producing less than 2000 cubic feet of gas per barrel of oil produced, then the Commission may change its classification to an oil well, and vice-versa. This may be especially important if the client operator wishes to drill or recomplete another well on its retained acreage.

a. The Commission’s GOR Classification may result in lost acreage under the Lease.

Practically all of the time, the retained acreage will differ upon whether it pertains to a gas well or an oil well. For example, if the field rules call for 160 acres for gas and 40 acres for oil, and the previously classified gas well passes under the GOR threshold and produces more oil, then the well will be reclassified as an oil well. Under many leases, the retained acreage would be reduced to the acreage allowed for oil under the field rules, i.e. 40 acres. The reverse may be that the client operator has an oil well and 40 acres, but the gas ratio goes up in the production and it is then classified by the RRC as a gas well. Unless the lease allows the lessee to revise retained acreage upwards (which most do not), then in the second scenario the client operator could not produce that well because it did not have enough acreage, i.e. the operator had 40 acres but needed 160 acres to produce. Everybody loses in that situation.

b. Example of a situation where the client operator almost lost retained acreage due to GOR changes.

With respect to GOR, a client had an underlying lease with a retained acreage clause that required the operator to designate units of “Developed acreage” around each oil and gas well producing oil and gas, respectively, in paying quantities. The Lease defined “Developed acreage” as being:

...the acreage required under the spacing rules of the Railroad Commission of the State of Texas in order to obtain a maximum allowable for each oil well and each gas well, but such acreage shall in no event exceed forty (40) acres for each oil well and one hundred sixty (160) acres for each gas well situated on the leased premises, which is then capable of producing gas and/or oil in paying quantities.

The client operator had five wells completed in the Westhoff (Combined Associated) Field. Of these five, three were initially designated as gas and two were designated as oil. The Westhoff (Combined Associated) Field is somewhat unique because the field rules allow eighty (80) acre units for *both* oil and gas.

¹⁶ 16 T.A.C. §3.49.

The reason the RRC allows eighty (80) acres for both oil and gas wells is that the field's properties fluctuate in terms of GOR. In other words, one could have the "XYZ Well" and it produces a mix of both oil and gas. For a couple of months, the mix of oil and gas trends more to the oil side, and the RRC classifies it as an oil well. Then, the production fluctuates and the mix of oil and gas trends more to the gas side and it is reclassified as a gas well at the RRC. Presumably, this is the reason why the RRC gave the same amount of acreage for both oil and gas wells. If it is eighty (80) acres for both, there is no confusion for RRC purposes if the GOR changes. However, one can see how this might be a big problem for retained acreage in a lease.

The client operator's underlying lease put it in an untenable position. To obtain the maximum allowable for either oil or gas, it needed at least eighty (80) acres. While fields such as the Westhoff (Combined Associated) Field are AOF and the maximum allowable is temporarily suspended at the Railroad Commission, the RRC may reinstate them at any given time. The forty (40) acres retained under the lease for an oil well would not allow the client to achieve the maximum allowable for oil in this field because it would need eighty (80) acres.

Further, while the client could, under the lease, retain at least eighty (80) acres for the gas wells, the GOR for the gas wells could change at any given time and the wells could be reclassified as oil well(s). So under this retained acreage clause, the instant that the given gas well was reclassified as an oil well, the retained acreage dropped to forty (40) acres and prevented the client operator from achieving the maximum allowable for those wells too.

c. Hunt Oil Company v. H.E. Dishman.

The court in *Hunt Oil Company v. H.E. Dishman*, 352 S.W.2d 760, (Tex.App.-Beaumont 1961), addressed a situation such as this where a gas well experienced a change in the GOR. The court opined that, without adherence to the rework provisions of the lease, the change in GOR triggered the dissolution of the gas unit, and the parties were entitled to retain only the 40 acres allocated to an oil well. Phrased another way, changing classification from a gas well to an oil well resulted in lost acreage.

Specifically, the court held that the:

...agreement made no express provision controlling a well that would change from oil to gas or from gas to oil production. In this situation we think the problem should be considered as though two different locations were producing—one as a gas well of 320 acres and the other an oil well of 40 acres. If the gas well in this example should cease production and no effort was made to renew its life, the 320 acres would revert to the lessor. Likewise, if such an oil well ceased production and no effort was made to renew it, the 40 acres would likewise revert. That the wells occupied the same location should not require a different solution under the facts before us.... Consequently we hold that after the end of gas production in Dishman-Lucas No. 4 and failure to attempt reworking operations looking to further gas production, Hunt lost its determinable fee in the 320 mineral acres, except the 40 acre area for the well as an oil well.... Hunt argues that if a well originally holding 320 acres may later be cut to 40 acres under the settlement agreement, then a well holding 40 acres should likewise upon later production of gas, cover 320 acres. We are not persuaded by this argument.

The court's language, coupled with the above-referenced real world example, produces a quandary. What does a practitioner do if the client is intending to drill in an area known for its GOR threshold issues? The best proactive solution may be to draft future leases' retained acreage clause in such a way that the well will retain the higher acreage allocated for gas, even if the well produces oil. While many lessors have an ingrained resistance to such a method, explaining the conflict between GOR and retained acreage may show the lessor how such a method works to his or her benefit through continued production and continued payment of royalty, regardless of the well's classification at the Railroad Commission.

However, what does one do if the "horse has already left the barn"? In our example, the solution for the client was to obtain an amendment to the underlying lease that allowed eighty-acre units for both oil and gas wells. As you may be fully aware, though, some lessors are less than sympathetic and could validly and legally work a client perator out of a lease based on a retained acreage clause like the one in the example. In other circumstances,

practitioners have attempted to get around this issue by stating in their agreement that the lessor agrees to “re-lease” the additional acreage or by asserting that the operator shall have the right to assign additional acreage around the well for regulatory purposes only. The effect and validity of either of these approaches, however, are problematic and do not adequately address the overall problem.

As referenced above, perhaps the best solution is a proactive one, wherein the drafter creates a retained acreage clause that retains the higher acreage allocated for oil or gas, even if the well produces the other. Otherwise, avoiding this pitfall requires vigilance, knowing the production statistics, and knowing how the RRC rules on GOR may reach over into the contract world.

V. CONCLUSION.

This article was intended to give you a brief overview of retained acreage clauses that tie themselves to the rules of the “governmental authority having jurisdiction”. In sum, today’s practitioner cannot simply insert stock language related to governmental rules and regulations. Rather, one must understand the nuances of the Commission’s rules and proactively draft around the pitfalls that may occur because of said nuances.