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The Austin Court of Appeals Determines that PSA Wells Do Not Require Pooling Authority

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Horizontal drilling in the last decade materially altered oil and gas production in Texas. Horizontal wells allow producers to unlock vast mineral resources otherwise inaccessible to traditional vertical drilling.[1] Commentors have even credited horizontal drilling as the "heart" of a "revolutionary reorientation in global energy markets, decreasing the United States' energy dependence on foreign suppliers."[2] While technology for, and development of, horizontal drilling rapidly matured, the law lags behind.[3] Important questions about horizontal drilling remain unanswered by Texas courts. Among them: can a mineral lessee may drill a horizontal well that crosses lease lines *without pooling authority*?

According to the Austin Court of Appeals in *R.R. Comm'n of Tex. & Magnolia Oil v. Opiela*, No. 03-21-00258-CV, 2023 WL 4284984 (Tex. App.—Austin June 30, 2023, no pet. h.), the answer is "yes."

Background: Pooling vs. Allocation Wells and Production-Sharing Agreements (PSA)

Neighboring tracts are sometimes pooled together so that drilling operations on any particular tract are treated as occurring on all the tracts within the pooled unit. Importantly, before an operator can drill on pooled tracts, the Texas Railroad Commission (the "Commission") must determine whether the operator has both a valid lease and pooling authority.

Horizontal wells often cross lease lines. Like vertical wells, operators may pool multiple tracts for horizontal wells. This presents a problem when a lessee is unable to form a pooled unit. Texas does not allow compulsory pooling outside of limited exceptions. Without an exception to the pooling requirements, the lessee may be at a dead-end. The Commission has responded to this concern by permitting horizontal wells that cross lease lines without pooling authority. These non-pooled horizontal wells fall within two categories: (1) wells under production-sharing agreements ("PSAs") and (2) allocation wells.

PSAs are simply agreements between lessees and royalty owners that determines how production will be allocated among the tracts.[4] At least 65% of the mineral and working interest owners must consent to the PSA for the Commission to issue a permit. An allocation well, on the other hand,

horizontally crosses lease boundaries that have not been pooled and where no agreement exists among the royalty owners for production sharing.[5] Both PSA-wells and allocations wells have become prevalent throughout Texas.

While the Commission permits these alternatives to pooling, Texas courts have not yet fully addressed whether these wells are legal under Texas law. Opponents of PSAs and allocation wells argue that drilling a horizontal well that crosses lease lines is an act of pooling regardless of what one calls it.[6] The lessors in *Opiela* argued that these actions were pooling, such that the Commission would need pooling authority to issue a permit to drill.

The Austin Court of Appeals Finds No Pooling Requirement Necessary for PSA Wells

Specifically, the lessors in *Opiela* filed suit challenging a permit that allowed Magnolia Oil & Gas Operating LLC ("Magnolia") to drill a horizontal well into a tract with minerals leased, in part. The lessors argued that the Commission erred by failing to consider their lease's anti-pooling clause, which prohibited pooling "in any manner whatever." Since the lessors did not consent to pool or to a PSA (and thus lacked pooling authority), lessors urged the Commission should not have permitted Magnolia to drill. This placed squarely before the Court whether a PSA well should be treated as pooling under Texas law.

The trial court reversed the Commission's order denying plaintiff's complaint, finding that the Commission erred by (1) finding that Magnolia showed a good-faith claim to drill, (2) adopting and applying rules for PSA wells without complying with the requirements of the Administrative Procedure Act, and (3) failing to consider the pooling clause in the plaintiff's lease.[7]

The court first answered whether the Commission has the power to issue permits for multi-tract horizontal wells without pooling authority.[8] After considering the history and relationship between pooling and PSAs, the court determined that PSA wells are not the same as pooling and, therefore, do not require pooling authority.[9] To do so, the Court evaluated property interests involved, as well as production divisions between PSAs and pooled wells.

For pooling, the court determined the lessee cross-conveys property interest to the tracts within the pool. Finding "a portion of the royalty interest from each of the *other* tracts in the pool."[10] In other words, "production from any tract in the pool is treated as production from every tract in the pool."[11] "Proceeds from production from one of the pooled tracts are shared by all owners of the tracts in proportion to the individual tract's proportion of the pooled acreage."[12]

The court reasoned PSA wells, by contrast, do not have a cross-conveyance of interest. Nor do PSA wells have to follow the production allocation requirements for pooled tracts. Instead, parties reach private agreements in PSAs for how production will be shared.[13] For these reasons, the court found that PSA wells and pooling are not the same and, therefore, the Commission did not err by failing to consider the plaintiff's lease's anti-pooling clause.[14]

Next, the appellate court found the evidence failed to show that 65% of the interest owners agreed to the PSA. Without evidentiary support for the threshold requirements for a PSA, the appellate court affirmed the trial court's conclusion that the Commission erred in finding that Magnolia showed a good-faith claim of right to drill.[15] Because the appellate court determined remand was necessary, it did not reach the question of whether the Commission violated the Administrative Procedure Act.[16]

Finally, Magnolia requested in the alternative that the appellate court render a judgment granting the permit as an allocation well.[17] Magnolia contended that, even if the record lacked evidence to show that 65% of the interest owners joined the PSA, the well could still meet all requirements of an allocation well. The court noted that it did not have the power to make such a ruling since the Order on appeal does not pertain to an allocation well permit.[18]

Impact

While the Austin Court of Appeals did not answer all the questions surrounding PSAs and allocation wells, the case represents a major step forward for providing legal framework around horizontal drilling. And the appellate court's decision should put operators' minds at ease at least for now, as the holding preserves the Commission's current approach to PSAs and hints that allocation wells will be treated in the same manner.

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[1] Ernest E. Smith, Applying Familiar Concepts to New Technology: Under the Traditional Oil and Gas Lease, A Lessee Does Not Need Pooling Authority to Drill A Horizontal Well That Crosses Lease Lines (Reprint, First Published 2017), 3 Oil & Gas, Nat. Resources & Energy J. 553, 554 (2017).

[2] Benjamin Holliday, *New Oil and Old Laws: Problems in Allocation of Production to Owners of Non-Participating Royalty Interests in the Era of Horizontal Drilling*, 44 ST. MARY'S L. J. 771, 773 (2013), cited in Brief of Amicus Curiae Pioneer Natural Resources Co., in Support of Appellants.

[3] Smith, 3 O.N.E. J. at 554–55.

[4] Smith, 3 O.N.E. J. at 564.

[5] *R.R. Comm'n of Tex. & Magnolia Oil v. Opiela*, No. 03-21-00258-CV, 2023 WL 4284984, at *1 (Tex. App.—Austin June 30, 2023, no pet. h.) (citing Clifton A. Squibb, *The Age of Allocation: The End of Pooling As We Know It?*, 45 Tex. Tech L. Rev. 929, 930 (2013)).

[6] Smith, 3 O.N.E. J. at 556.

[7] *Opiela*, 2023 WL 4284984, at *1.

[8] *Id*. at *7.

[9] *Id*.

[10] Smith, 3 O.N.E. J. at 561.

[11] Smith, 3 O.N.E. J. at 561.

[12] *Opiela*, 2023 WL 4284984, at *7.

[13] *Id*. at *8.

[14] *Id*.

[15] *Id*. at *12.

[16] *Id*. at *10.

[17] *Id*. at *12.

[18] *Id*.

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