DEALING WITH MISSING PERSONS AND HOLDOUTS:
USING RULE 37 AND MIPA FOR URBAN GAS DEVELOPMENT

Eric C. Camp
## TABLE OF CONTENTS

INTRODUCTION .................................................................................................................................................. 3  
STATEWIDE AND FIELD RULES GOVERNING HORIZONTAL WELLS .......... 4  
RULE 37 PERMITS ............................................................................................................................................. 4  
  Preventing Waste ........................................................................................................................................... 6  
  Preventing Confiscation ............................................................................................................................... 7  
  What about Economic Waste? ....................................................................................................................... 7  
  Recent Developments .................................................................................................................................... 8  
    Controversy with Economic Waste a “Preventing Confiscation” .......................................................... 8  
    Certain Urban Permitting Processes ........................................................................................................... 10  
  Railroad Commission Proposed Rule Changes to Statewide Rules 79 (Definitions) and 86 (Horizontal Drainholes) .......................................................................................................................... 12  
MIPA .................................................................................................................................................................. 14  
  Important MIPA Issues for the Urban Operator .......................................................................................... 16  
    Applicant’s Fair and Reasonable Offer to Voluntarily Pool .................................................................... 16  
    The Size of the MIPA Unit ....................................................................................................................... 19  
    Economic Terms on Which Small Tracts are Pooled .............................................................................. 21  
    Multiple Wells in a MIPA Unit? .............................................................................................................. 22  
CONCLUSION .................................................................................................................................................. 23
Dealing with Missing Persons and Holdouts: Using Rule 37 and MIPA for Urban Gas Development

I. INTRODUCTION

Advances in horizontal drilling technology have made it economical for operators to produce oil and gas in highly populated and developed areas. Operators seeking to develop these reserves in urban areas faces two unique difficulties – (i) hundreds of thousands of small lot owners and (ii) extensive local oil and gas regulations. Statewide Rules that were not written with horizontal wells in mind further complicate plans.¹

This paper focuses on Rule 37 Exception Permits (“Rule 37 Permits”) and the Mineral Interest Pooling Act (“MIPA”), two tools available to operators for dealing with mineral owners they cannot locate or who refuse to sign an oil and gas lease – pointing out when they are available, the procedures to implement them, their respective advantages and disadvantages, and recent developments. A single missing person or holdout who owns even the smallest tract or undivided mineral interest can hold up a multi-million dollar development plan. Because horizontal drilling is realistically urban development’s present and future, this paper focuses on how operators can use these tools for horizontal wells.

This paper does not exhaustively analyze Rule 37 or MIPA. The following resources were very useful in writing this paper and further discuss Rule 37 and MIPA:

- Ernest E. Smith & Jacqueline Lang Weaver, TEXAS LAW OF OIL & GAS (2d ed 1998);

- Brian R. Sullivan, P.E., Rule 37: Any Well Drilled in Violation of this Rule Shall be Plugged, 22nd Annual Advanced Oil, Gas, and Energy Resources Law Course, Chapter 6 (September 30, 2004 – October 1, 2004);

- Joe W. Christina Jr., Charles W. Gordon, IV, and Doug J. Dashiell, Horizontal Wells: Potential Problems and Practical Solutions, State Bar of Texas: Oil, Gas, & Energy Resources Law Section Report, Vol. 34, No. 4 (June 2010);

- Ronnie Blackwell, Forced Pooling Within the Barnett Shale: How Should the Texas Mineral Interest Pooling Act Apply to Units with Horizontal Wells?, Institute for Energy Law, Short Course on the Law of Shale Gas Plays, Chapter 11, Supplemental Article (June 2-3, 2010);

- Carroll Martin and D. Davin McGinnis, All for One and One for All: A Primer on Pooling in Texas, 31st Annual Ernest E. Smith Oil, Gas and Mineral Law Institute (April 1, 2005); and

¹ Smith & Weaver, TEXAS LAW OF OIL & GAS, Vol. 2, Ch. 9, § 9.8(G), at page 9-144.
II. STATEWIDE AND FIELD RULES GOVERNING HORIZONTAL WELLS

Statewide Rule 86 governs horizontal wells unless preempted by a special field rule. It defines “horizontal drainhole” as “[t]hat portion of the wellbore drilled in the correlative interval, between the penetration point and the terminus.” Under Rule 86, a horizontal drainhole’s entire length must comply with the applicable Rule 37 spacing requirements.

The Railroad Commission (“Commission”) has adopted special field rules in over 60 fields, however, that amend the requirement of the entire length of a horizontal drainhole having to comply with Rule 37’s spacing requirements. Instead, only the wellbore’s perforated intervals (or “take points”) need to comply with the spacing requirements. This has led to “no-perf zone” wells – where the operator does not perforate a portion of the horizontal drainhole so as to comply with the applicable spacing rules.

III. RULE 37 PERMITS

In most cases, a Rule 37 Permit is the most attractive option for an urban operator dealing with missing persons or holdouts. It can be inexpensive, quick (possibly less than one month from filing the application), and allow for efficient unit development, especially if granted administratively. A Rule 37 Permit can help an operator dealing with missing persons and holdouts whose tracts are within the applicable Rule 37 spacing distances. It will not, however, allow an operator to drill a well through an unleased tract.

Statewide Rule 37 governs how close a well can be to any property line, lease line, subdivision line, and another well – no operator will drill an oil or gas well nearer than 1,200 feet to any well completed in or drilling to the same horizon on the same tract or farm, and no operator will drill a well nearer than 467 feet to any property line, lease line, or subdivision line. The Commission, however, frequently issues special field rules with greater or lesser minimum distances than required under the Statewide Rule.

Special field rules for the Newark, East (Barnett Shale) Field, for example, allow for 330 foot lease line and pooled unit line spacing. The Barnett Shale field rules have no between-well spacing limitations.

---

2 16 TEX. ADMIN. CODE § 3.86.
3 Oil and Gas Field Rules for the Newark, East (Barnett Shale), Field Number 65280200, available at http://webapps.rrc.state.tx.us/DP/fieldSelectAction.do.
4 16 TEX. ADMIN. CODE § 3.37.
5 Oil and Gas Field Rules for the Newark, East (Barnett Shale), Field Number 65280200, available at http://webapps.rrc.state.tx.us/DP/fieldSelectAction.do.
Rule 37 is not absolute; the Commission can grant exceptions. Rule 37 Permits have proven crucial for urban gas development where drill sites are limited and holdouts are plentiful. To put the recent increase in the use of Rule 37 Permits in perspective, from 1919 through 2005, the Commission granted a total of nearly 12,000 Rule 37 Permits. In the Barnett Shale formation alone, the Commission granted almost 3,000 Rule 37 Permits through March 2, 2010.

Once the operator files an application for a Rule 37 Permit, the Commission sends notice by first class mail to all affected persons within the spacing distance. For lease line and between well exceptions, Rule 37 presumes affected parties are:

- a unit’s designated operator;
- record lessee for tracts that have no designated operator; and
- unleased mineral interest owners.

For between well exceptions, mineral owners of tracts adjacent to the proposed well are also affected parties. Operators can serve parties they cannot locate by publication.

Statewide Rule 37 only requires that an affected party have 10 days to file a protest after receiving the notice. The Barnett Shale field rules, however, give affected parties at least 21 days notice before their protests are due.

Notice is critically important in a Rule 37 case. Rule 37 provides, “No well drilled in violation of this section … shall be permitted to produce … and any such well so drilled in violation of said section or on the Commission’s own order shall be plugged.” The Commission has held that failure to give proper notice renders the drilling permit void ab initio (from the beginning). Notice is so important because if the Commission grants a Rule 37 Permit, affected parties, including unleased mineral interest owners, inside the spacing distance

---

6 Bruce M. Kramer, *Pooling for Horizontal Wells: Can They Teach an Old Dog New Tricks?*, Institute for Energy Law, Short Course on the Law of Shale Gas Plays, Chapter 11, Supplemental Article (June 2-3, 2010).

7 See Rule 37 Case No. 0259923: *Application of Chesapeake Operating, Inc. for an Exception to Statewide Rule 37 for its King B Unit, Well No. 1H, Newark, E. (Barnett Shale) Field, Johnson County, Texas, and Rule 37 Case No. 0259926: Application of Chesapeake Operating, Inc. for an Exception to Statewide Rule 37 for its King B Unit, Well No. 3H, Newark, E. (Barnett Shale) Field, Johnson County, Texas (Consolidated)* (Proposal for Decision circulated on March 30, 2010) Proposal for Decision at 12.

8 16 TEX. ADMIN. CODE § 1.46.


10 16 TEX. ADMIN. CODE § 3.37(e).

11 Oil & Gas Docket No. 06-0229019: *Complaint of Long Trusts Regarding Whether Proper Notice Was Given by Union Pacific Resources Co. of its Application for a Rule 37 Exception for the Barksdale Estate Gas Unit, Well No. 8, Oak Hill (Cotton Valley) Field, Rusk County, Texas* (Final Order served on September 12, 2002) Final Order.
will receive no compensation for the oil and gas that will almost certainly be drained from their tracts. An operator seeking a Rule 37 Permit should consider erring on the side of too much notice because the Commission may issue harsh penalties if anyone ever successfully challenges the notice – after the operator has spent millions of dollars drilling its well.

There are two ways the Commission can administratively grant a Rule 37 Permit. If the Commission receives no notice of protest from an affected party by the deadline or receives written waivers of objection from all affected parties who protested the application, it will administratively grant the Rule 37 Permit.

If the operator cannot obtain an administratively approved Rule 37 Permit because an affected party has protested the application and refused to waive its protest, then the Commission will schedule a hearing on the application. Notice of the hearing will go to all affected parties, including those that did not timely protest the application. At the hearing the operator will bear the burden of proving by preponderance of the evidence that the Rule 37 Permit is necessary to either prevent waste or confiscation (protect correlative rights).

When deciding whether to go forward with a protested Rule 37 Permit hearing, an operator should remember that if the Commission denies the application, the Commission will not entertain a new Rule 37 Permit application for the same well absent “changed conditions.”

12 Once an operator obtains a Rule 37 Permit, however, it needs to act on it quickly. The Rule 37 Permit will expire two years from its effective date unless the operator commences good faith drilling operations. If the Rule 37 Permit is in litigation, the two year period begins anew on final adjudication and decree from the last court of appeal.

a. Preventing Waste

To establish entitlement to a Rule 37 Permit based on “preventing waste,” the operator must prove that:

- the exception well will recover substantial oil or gas that wells in the field would not otherwise recover, and
- unusual underground conditions exist such that a closer spacing of wells is essential to recover the additional oil or gas.

The unusual underground conditions must be peculiar to the subject tract, as opposed to conditions equally applicable elsewhere in the field. Because shale formations contain generally the same geological conditions throughout their respective fields, it is unlikely this would be a successful basis for a Rule 37 Permit on a shale well. The author is not aware of a

12 16 TEX. ADMIN. CODE § 3.37(j).
13 Smith & Weaver, TEXAS LAW OF OIL & GAS, Vol. 2, Ch. 9, § 9.5(A), at 9-41.
14 Railroad Comm’n v. Shell Oil Co., 161 S.W.2d 1022, 1026 (Tex. 1942).
single Rule 37 Permit granted for a shale well based on “preventing waste” and Operators applying for a shale well usually do not even argue “preventing waste” as a ground for their Rule 37 Permits.

b. Preventing Confiscation

To establish entitlement to a Rule 37 Permit to “prevent confiscation,” an operator must show that absent the applied-for well, it will be denied a reasonable opportunity to recover its fair share of hydrocarbons currently in place under the lease. This requires proving that:

- drilling a well at a regular location will not afford the operator a reasonable opportunity to recover its fair share of hydrocarbons currently in place; and
- the proposed irregular location is reasonable.

Every landowner or lessee has a basic right to a fair and reasonable chance to recover the oil and gas under its property. Denying that fair chance is confiscation within Rule 37’s meaning.

c. What about Economic Waste as Confiscation?

Conflicting authority exists as to whether “economic waste” can be considered when deciding whether to grant a Rule 37 Permit to “prevent confiscation.” For many years the general rule was that “economic waste” was not a ground for granting Rule 37 Permits. At least twice since 1994 the Commission has rejected operators’ arguments that it is “confiscation” to deny a Rule 37 Permit without which the operator could not drill an economic well.

Contrary authority, however, exists to this position. In a 1995 Rule 37 Case, the Commissioners specifically inserted the following in their Final Order which had not been in the Examiners’ Proposal for Decision: “The Commission may consider economic factors in its determinations upon a proper showing.”

15 Preventing confiscation is not a ground for granting a Rule 37 Permit on a voluntary subdivision tract. 16 TEX. ADMIN. CODE § 3.37(g).

16 Rule 37 Case No. 0251216: Application of Chesapeake Operating, Inc. for an Exception to Statewide Rule 37 to Drill Well No. 1H on the Ramey Unit, Newark, East (Barnett Shale) Field, Tarrant County, Texas (Final Order served on April 14, 2009) Proposal for Decision at 5, available at http://www.rrc.state.tx.us/meetings/ogpfd/ogpor37/0251216-mjh.pdf.

17 Id.

18 Gulf Land Co. v. Atlantic Refining Co., 131 S.W.2d 73, 80 (Tex. 1939).

19 Id.


21 Rule 37 Case No. 0206334: Application of Enron Oil & Gas Company for an Exception to Statewide Rule 37 to Drill Its No. 17 Well, Frank Reed 117 Lease, Sawyer (Canyon) Field, Sutton County, Texas (Proposal for Decision
A narrow exception allowing a proposed well’s economic viability in determining whether to grant a Rule 37 Permit is the “existing wellbore doctrine.” Under this doctrine, the Commission may grant a Rule 37 Permit to allow an operator to use an existing wellbore to recover reserves that would otherwise go unrecovered because a new well would be uneconomic. The existing wellbore must have been drilled in good faith and not to later bolster a Rule 37 exception.

d. Recent Developments

i. Controversy with Economic Waste as “Preventing Confiscation”

The issue in the Barnett Shale has been whether forcing an operator to have no-perf zones around unleased tracts is confiscation when the operator has leased the tracts around the unleased tract. Until recently, based on the Commission’s 2009 Ramey case, the consensus answer seemed to be no. In August 2010, however, the Commission seemed to rethink its position on this issue and may have embraced an expanded definition of “confiscation.”

The operator in Ramey obtained a regular drilling permit for a well with a 1,839 foot horizontal lateral. To hold some leases, the operator made a “business decision” to drill the lateral to a total of 3,553 feet – 1,714 feet longer than the permit allowed. Prior to perforating the well, the operator filed its fourth amended permit application seeking a Rule 37 Permit because there were 15 unleased “window tracts” within 330 feet of the wellbore – all small residential lots. The closest tract was 41 feet from the wellbore and three other tracts were within 100 feet of the wellbore.

The operator in Ramey argued that it was entitled to a Rule 37 Permit to prevent confiscation. The operator asserted that it had a 196.51 acre unit with several hundred lessors who want to participate in production of the Barnett Shale well. The operator argued that the only feasible economic means to allow for production from the lessors is through a Rule 37 Permit allowing it to perforate and produce the lateral it already drilled. According to the operator, without a Rule 37 Permit, the lessors would be denied a reasonable opportunity to recover their fair share of reserves.

The Examiners recommended that the operator’s application be denied and the Commissioners agreed. The Examiners noted that regular locations existed on the unit which would “recover a significant amount of reserves from the [Barnett Shale].” The Operator acknowledged these regular locations but claimed that drilling those wells would not be economic. The Examiners also stated that the applicant’s voluntary creation of a pooled unit in a residential subdivision cannot be used as a basis for obtaining an exception to Statewide Rule 37 on the basis of confiscation.

22 Exxon Corp. v. Railroad Comm’n, 571 S.W.2d 497, 501-02 (Tex. 1978).
The Examiners’ Opinion contained the following significant statements:

• Exceptions to Rule 37 are not granted to eliminate risk for an operator or to provide it with the best possible well. An exception to Rule 37 to prevent confiscation is granted to provide a reasonable opportunity to recover the oil and gas reserves on an operator’s lease which cannot be recovered from a regular location.

• The operator’s witnesses claim they need the applied-for irregular location to allow them to have a commercial well. However, [no] operator is guaranteed a well that meets its self-imposed criteria for economic viability – each mineral interest owner is entitled to a fair and equal opportunity to recover its fair share of the hydrocarbons under its tract. Economic requirements:
  
  o vary from company to company (applicant to applicant);
  o are not evenly applied;
  o are not specific to the property rights on a given tract; and
  o are subject to unpredictable external market fluctuations in the price of oil and natural gas.

• An operator’s economic requirements therefore cannot be the basis for granting an exception to Statewide Rule 37 to protect correlative rights.

The Examiners cited prior Rule 37 cases to support the above statements.

It took over a year before another contested Barnett Shale Rule 37 case resulted in a Proposal for Decision and Final Order at the Commission – the Eden Southeast case. The Eden Southeast case’s facts are similar to the Ramey case. The Eden Southeast operator had obtained a permit to drill a well with a long horizontal lateral and no-perf zones at least 330 feet away from all the unleased tracts. The operator drilled that well but did not complete it. Instead, the operator sought a Rule 37 Permit to remove the no-perf zones and allow it to produce the entire horizontal drainhole. Because of surface restrictions, the operator argued that there were no regular locations it could drill economically. The protestants argued that the operator could drill an “S-curved” regular well and produce its reserves without the need for a Rule 37 Permit. After an extensive technical discussion about the operator’s projected reserves and economic models for various wells, the Examiners recommended that the Commission grant the Rule 37 Permit as necessary to prevent confiscation. This case was so surprising because it completely ignored all the Ramey case’s arguments against using an operator’s economic models as a basis for granting a Rule 37 Exception Permit on the grounds of preventing confiscation. The Commissioners adopted the Examiners’ Proposal for Decision granting the Rule 37 Permit.

Two months later, Commission issued another Barnett Shale Rule 37 Permit Proposal for Decisions in the Carter SE Unit case.\textsuperscript{24} Interestingly, the unleased interest owner protestant in this case wanted to participate as a working interest owner in the well. The operator, however, was only interested in leasing the unleased tract, not in letting the owner of the unleased tract participate as a working interest owner in the well. Like in Eden Southeast, the Examiners weighed the rights of the unleased tract owner against the rights of the operator and its lessors and recommended that the Commission grant the Rule 37 Permit. And again, the Examiner made no mention of the rationale from the Ramey case. The Commissioners adopted the Examiners’ Proposal for Decision granting the Rule 37 Permit.

The most recent Barnett Shale Rule 37 Case was the TWU B case decided in November of 2010.\textsuperscript{25} The facts of TWU B are similar to the other Barnett Shale Rule 37 cases with an operator seeking to remove no-perf zones around “window tracts.” Here, 14 protestants based their protests on the Commission’s Ramey case – (i) that the operator’s case was mostly about economics; (ii) that an operator is not guaranteed a well that meets its self-imposed criteria for economic viability; and (iii) that the operator created its own voluntarily pooled unit, only to later complain that the unit could not be developed without a Rule 37 Permit. Like in Eden Southeast and Carter SE Unit, the Examiner weighed the rights of the unleased tract owner against the rights of the operator and its lessors and recommended that the Commission grant the Rule 37 Permit. And again, the Examiner made no mention of the rationale from the Ramey case. The Commissioners adopted the Examiners’ Proposal for Decision granting the Rule 37 Permit.

\textit{ii. Certain “Urban Permitting Processes”}

An operator’s best case scenario is for the Commission to administratively grant its application for a Rule 37 Permit. One large operator developed an “urban permitting process” for its Barnett Shale wells that has recently come under fire at the Commission.\textsuperscript{26} This “urban permitting process” contains several steps and is only possible if the field in question has special rules allowing no-perf zones.

First, the operator obtains a well permit to drill the length of the horizontal drainhole it deems appropriate. In filing for this initial application, the operator leaves no-perf zones at least 330 feet around any unleased tract. Because no tracts are within 330 feet of a take point along


\textsuperscript{25} Rule 37 Case No. 0265651: Application of XTO Energy, Inc. for a Rule 37 Exception for the TWU B Unit, Well No. 1H, Newark, East (Barnett Shale) Field, Tarrant County, Texas (Final Order issued on December 14, 2010) Proposal for Decision, available at http://www.rrc.state.tx.us/meetings/ogpfd/ogpor37/0265651-jmd_PDF.

\textsuperscript{26} See Rule 37 Case No. 0259923: Application of Chesapeake Operating, Inc. for an Exception to Statewide Rule 37 for its King B Unit, Well No. 1H, Newark, E. (Barnett Shale) Field, Johnson County, Texas, and Rule 37 Case No. 0259926: Application of Chesapeake Operating, Inc. for an Exception to Statewide Rule 37 for its King B Unit, Well No. 3H, Newark, E. (Barnett Shale) Field, Johnson County, Texas (Consolidated) (Proposal for Decision circulated on March 30, 2010) Proposal for Decision at 6-15.
the proposed horizontal drainhole, no Rule 37 problem exists under the current field rules. As such, the Commission administratively approves the regular permit.

Next, the operator files an amended permit application removing the no-perf zones from the horizontal drainhole. Now take points are within 330 feet of certain unleased tracts and the Commission sends those owners notice of the Rule 37 exception application.

If an affected party files a protest, the operator then amends the plat before the Commission calls a traditional Rule 37 hearing – this time to add a no-perf zone around only the protestant’s tract. The operator’s position is that this moots any protest filed to the application because the field rules no longer deem the protestant to have standing based on the second amended plat’s no-perf zone. The Commission would then administratively approve the permit as regular because the protestants were no longer within 330 feet of the lateral’s nearest take point and the other affected parties did not timely object to the notice of application.

The operator would then repeat the process and amend the application again to remove the no-perf zones. Until a 2009 letter ruling from a Hearing Examiner, the operator would send notice of the newly amended application to only those affected parties that protested the prior no-perf zone application. The operator’s position was that affected parties who had not protested the prior application had waived their right to protest a later Rule 37 exception application for that well. The operator would keep repeating this process until finally the last affected party missed a deadline to protest some later version of the same Rule 37 Permit. At that point, the operator believed it should be entitled to an administratively granted Rule 37 Permit. The Hearing Examiner stated, however, that an affected party does not waive its right to notice of future Rule 37 Permit applications or amended applications simply by not timely protesting one application. Thus, all affected parties are to receive notice of all no-perf zone applications.

Recently the Commission further curtailed this “urban permitting process” of filing, withdrawing, re-filing, amending, and re-amending Rule 37 Permit applications. In a recent case the protestants were not challenging Rule 37 or no-perf zones, but rather the “urban permitting process” described above. The Examiners’ Proposal for Decision stated “There is no provision in Statewide Rule 37 or the Commission’s Rules of Procedure which allow an applicant to revise its permit application to avoid a protest after a Notice of Hearing is issued by the Commission.”27 The protestants waived their protests before a Final Order, but the Proposal for Decision indicates at least one Examiner’s position on an “urban permitting process” involving no-perf zones and amending Rule 37 applications. The Examiner that issues this Proposal for Decision recently left the Commission so it is unclear whether the current Examiners will adopt the same position.

For awhile it appeared that using no-perf zones to obtain Rule 37 Permits without a hearing may have turned the Commission off to no-perf zones altogether. In 2009, Forest Oil Corporation applied to amend the Field Rules for the Hardwood (Cotton Valley) Field in

---

27 Id., at 8.
Harrison County. Forest asked the Commission to adopt the special “take points” language for horizontal wells, as adopted in the Barnett Shale and numerous other fields in recent years. This is the language that, in practice, led to no-perf zones. The Examiner recently denied this part of the application on the grounds that no-perf zones were a way of circumventing Rule 37 and can actually create waste by leaving small gas pockets in place that will never be economical to be drilled. Forest filed exceptions to the Proposal for Decision that vehemently argued the take point rule and no perf zones are significant advancements in waste prevention that allow the drilling of wells to produce minerals that would not otherwise be produced due to the state’s increasingly urban environment and fractionalized mineral ownership.

The Commissioners recently overruled the Examiner in the *Hardwood (Cotton Valley)* field rules case and adopted special field rules to allow no-perf zones. The Commissioners agreed with the operators that no-perf zones help prevent waste. The Commission’s move to amend Statewide Rule 86 to allow no-perf zones demonstrates that it appears no-perf zones are here to stay.

iii. Railroad Commission Proposed Rule Changes to Statewide Rules 79 (Definitions) and 86 (Horizontal Drainholes)

On December 14, 2010, the Commission issued a proposal to amend Statewide Rules 79 and 86 “to update and modernize the regulatory approach to new and evolving technologies regarding horizontal drilling and unconventional resource development in Texas.”

With respect to Rule 79, Definitions, the proposed changes include adding the following definitions:

- **Correlative Interval**: The depth interval designated by field rules, by new field designation, or, where a correlative interval has not been designated by the Commission, by other evidence submitted by the operator showing the producing interval for a field.

- **Field**: A subsurface area designated by the Commission in which all producing wells are governed by the same set of rules. The vertical limits of a field are generally defined by a correlative interval approved by the Commission. The lateral extent of a field is generally determined over time by development of wells with substantially similar geologic characteristics and at least potential natural resource pressure communication from well to well. A field is frequently, by not necessarily, equivalent to a geologic reservoir.

The most significant changes are proposed to Rule 86, horizontal drainholes. The proposed changes include defining the terms “deviation box,” “horizontal wellbore completion

---

28 Oil & Gas Docket No. 06-0263967: *The Application of Forest Oil Corporation to Amend the Field Rules for the Hardwood (Cotton Valley) Field, Harrison County, Texas*, Proposal for Decision at 1.

interval,” “non-perforated zone or NPZ,” “Rule 37 distance,” and “take point,” among others. Substantively, the proposed Rule 86 incorporates many of the concepts from special field rules developed in the last few years.

For purposes of this article, the significant changes in the proposed Rule 86 are that it:

- allows no-perf zones in horizontal wells;

- clarifies the Commission’s position that it considers no-perf zone wells to be exceptions to Rule 37, requiring payment of an exception fee of $200 per no-perf zone;

- incorporates the concept of a “deviation box” that gives operators a 10% deviation on both sides of the horizontal drainhole from the lease line spacing rules if the as-drilled well varies from the permitted well. Thus, in the Barnett Shale with 330 foot lease line spacing, an operator could drill a well that deviates from its permitted location by up to 33 feet on either side of the horizontal drainhole without having to seek a Rule 37 Permit for unleased tracts affected by said deviation.

- requires operators who file a new plat or otherwise designate a no-perf zone after notice of the application has been mailed out but prior to final Commission action on the application to provide notice of the proposed change in the application, including a copy of the changed plat, by certified mail with proof of delivery, to each entity that was entitled to notice of the application immediately prior to the no-perf zone designation. The Commission may not grant the application until proof of such notice has been on file with the Commission for at least 10 days.

- requires operators who seek to remove all or part of a designated no-perf zone after the Commission has granted a permit with no-perf zones for a horizontal drainhole well to file an application for an amended permit and, if necessary, an application and associated fee for an exception to Rule 37 and give notice of the amended permit to all Rule 37 “affected parties.”

- requires operators with no-perf zone wells to notify the appropriate Commission district office at least 24 hours prior to each perforation activity and file completion reports with the Commission that include (i) the as-drilled horizontal drainhole, (ii) the location of each take point on the horizontal drainhole, (iii) the boundaries of any wholly or partially unleased tracts within a Rule 37 distance of the horizontal drainhole, and (iv) notations of the shortest distance from each wholly or partially unleased tract within a Rule 37 distance from the horizontal drainhole to the nearest take point on the horizontal drainhole.

- requires operators of no-perf zone wells to submit with the completion report a log, including the entire log header, that identifies the locations of the perforations and all

---

30 *Id.*
other take points for all horizontal drainholes with no-perf zones. The perforation log must be created and maintained by a third party. The log is a public records and the operator may not designate the log as confidential.

To unleased mineral interest owners, the proposed rule would result in them receiving notice of Rule 37 Permit applications by certified mail, rather than by regular mail, and the notices would include a plat of the proposed well, rather than only the written survey line and lease line descriptions presently included in the notice.

The proposed amendments to Statewide Rules 79 and 86 will be published in the Texas Register on January 21, 2011, and the period for public comments will end on March 22, 2011 at noon.

IV. MIPA

Thanks to the Finley case, MIPA is an operator’s newest tool in urban gas development.\textsuperscript{31} Unlike a Rule 37 Permit, MIPA can solve the problem of missing persons and holdouts in drillsite tracts. But MIPA also has many disadvantages from the operators’ standpoint:

- cases are time-consuming and expensive;
- small tracts are being forced into the unit with unfavorable business terms; and
- the pool’s ultimate size and shape may be small and inconvenient for the operators’ area wide development plans.

The Texas Legislature enacted MIPA on March 4, 1965, to protect small tract owners after the Texas Supreme Court’s ruling in the Normanna case, which invalidated prorationing formulas favorable to small tract owners.\textsuperscript{32} According to leading commentators, “[t]raditionally, the MIPA has been construed as limited in function to protect owners of small tracts rather than a broad act designed to protect correlative rights generally or as an act allowing owners of large tracts more flexibility in development.”\textsuperscript{33} MIPA’s plain language, however, does not limit its use to small tracts force pooling their way into larger pools.\textsuperscript{34}


\textsuperscript{32} Atlantic Refining Co. v. Railroad Commission, 346 S.W.2d 801 (Tex. 1961).

\textsuperscript{33} Smith & Weaver, TEXAS LAW OF OIL & GAS, Vol. 3, Ch. 12, § 12.1(B) at page 12-5.

\textsuperscript{34} TEX. NAT. RES. CODE § 102.011.
MIPA has the following limitations:

- it does not apply to reservoirs discovered and produced before March 8, 1961;
- a MIPA Unit can be no larger than 160 acres for oil or 640 acres for gas, plus 10 percent tolerance, despite the size of a standard proration unit in the applicable field;
- a tract with sufficient acreage to create a proration unit in the applicable field cannot invoke MIPA to pool its interest with another tract that has sufficient acreage to create a proration unit;
- the Commission only has the authority to pool acreage that “reasonably appears to lie within the productive limits of the reservoir;” and
- MIPA does not apply to lands owned by the State of Texas.\(^{35}\)

If MIPA is available, the requirements are:

- there must be two or more separately owned tracts;
- lying within a common reservoir;
- for which field rules have been established;
- where separately owned interests in oil and gas are within an existing or proposed proration unit;
- the interest owners have not agreed to voluntarily pool their interests;
- at least one interest owner has drilled or proposes to drill a well within the proration unit; and
- the applicant must make a fair and reasonable offer to voluntarily pool the other tract before submitting a MIPA application.\(^{36}\)

After the applicant meets all the above conditions, the Commission “shall establish a unit and pool all of the interests in the unit.”\(^{37}\) Once established, a MIPA Unit may not be “modified or dissolved subsequently without the consent of all mineral interest owners affected,” except as

\(^{35}\) Id., at § 102.004.

\(^{36}\) TEX. NAT. RES. CODE §§ 102.011, 102.013.

\(^{37}\) Id., at § 102.011.
necessary to enlarge the unit under the MIPA’s muscle-in provisions.\(^{38}\) A MIPA Unit automatically dissolves:

- one year after its effective date if no production or drilling operations have been had on the unit;
- six months after completing a dry hole on the unit; or
- six months after production ceases from the unit.\(^{39}\)

**a. Important MIPA Issues for the Urban Operator**

From *Finley* through today, four primary concerns have arisen for operators seeking to force pool small tracts into larger units:

- the requirement that the applicant have made a fair and reasonable offer to voluntarily pool;
- the MIPA Unit’s size;
- the economic terms on which small tracts are pooled; and
- whether an operator can drill multiple wells in a MIPA Unit.

**i. Applicant’s Fair and Reasonable Offer to Voluntarily Pool**

The applicant must set forth “in detail” the voluntary pooling offers made to the other owners in the proposed unit.\(^{40}\) MIPA gives little guidance about what is fair and reasonable, but an offer by an interest owner in an existing unit to share on the same yardstick basis as the existing owners in the unit will be considered fair and reasonable.\(^{41}\) The Texas Supreme Court has provided the following generic guideline for determining whether an offer is fair and reasonable:

\[
[T]he offer must be one which takes into consideration those relevant facts, existing at the time of the offer, which would be considered important by a reasonable person in entering into a voluntary agreement concerning oil and gas properties.\(^{42}\)
\]

\(^{38}\) *Id.*, at § 102.081.

\(^{39}\) *Id.*, at § 102.082.

\(^{40}\) Smith & Weaver, *TEXAS LAW OF OIL & GAS*, Vol. 3, Ch. 12, § 12.3[B][1][a], at page 12-24.1.

\(^{41}\) *TEX. NAT. RES. CODE* § 102.013(c).

\(^{42}\) *Carson v. Railroad Comm’n*, 669 S.W.2d 315, 318 (Tex. 1984).
The Commission must judge an offer’s fairness from the forced pooled party’s viewpoint.\(^{43}\)

The offer may not contain:

- an operator’s preferential right to purchase mineral interests in the unit;
- a call on or option to purchase production from the unit;
- operating charges that include district or central office expenses other than reasonable overhead charges; or
- a prohibition against nonoperators questioning the unit’s operation.\(^{44}\)

Beginning with \textit{Finley}, most Barnett Shale MIPA applicants have given unleased tracts three options to voluntarily pool their interests – lease, participate, or farmout. In \textit{Finley}, the final offer to voluntarily pool given to small tract owners contained the following options:

- lease to Finley for \$2,100/acre and a 20\% royalty;
- participate in the well under a JOA with a non-consent penalty; or
- farmout the interest to Finley and retain a 20\% overriding royalty with an option at payout to convert the override to a 25\% working interest.\(^{45}\)

The Examiners found Finley’s voluntary pooling offer to be fair and reasonable and noted that the lease option was as good or better than the terms offered to other owners in the unit area.\(^{46}\) The Commissioners agreed.

In \textit{Texas Steel “A,”} XTO’s final offer to voluntarily pool gave small tract owners the following options:

- lease to XTO for \$15,000/acre and a 25\% royalty;
- participate in the well under a JOA with a non-consent penalty; or

\(^{43}\) \textit{Windsor Gas Corp. v. Railroad Comm’n}, 529 S.W.2d 834, 837 (Tex. Civ. App.—Austin 1975, writ dism’d as moot).

\(^{44}\) \textsc{Tex. Nat. Res. Code} § 102.015.

\(^{45}\) Oil & Gas Docket No. 09-0252373: \textit{Application of Finley Resources, Inc. for the Formation of a Unit Pursuant to the Mineral Interest Pooling Act for the Proposed East Side Unit, Newark, East (Barnett Shale) (65280200) Field, Tarrant County, Texas} (Final Order served on August 25, 2008) Proposal for Decision at 3, 9, available at \url{http://www.rrc.state.tx.us/meetings/ogpfd/ogpomipa/FinleyOriginalPFD05-12-08.pdf}.

\(^{46}\) \textit{Id.}, Amended Proposal for Decision at 13, available at \url{http://www.rrc.state.tx.us/meetings/ogpfd/ogpomipa/FinleyAmendedPFDIssued08-05-08.pdf}. 

Page 17 of 24
• farmout the interest to XTO and retain a 20% overriding royalty with an option at payout to convert the override to a 25% working interest.47

The Examiners found that XTO’s voluntary pooling offer was fair and reasonable and, like in Finley, they noted that the lease option was comparable or better than the terms granted to other owners in the unit area. The Commissioners agreed.48

In Rosen Heights, XTO’s final offer to voluntarily pool gave small tract owners the following options:

• lease to XTO for $2,400/acre and a 25% royalty;
• participate in the well under a JOA that with a non-consent penalty; or
• farmout the interest to XTO and retain a 20% overriding royalty with an option at payout to convert the override to a 25% working interest.49

The Examiners found that XTO’s voluntary pooling offer was not fair and reasonable because:

• the bonus price offered under the lease option was substantially lower than what other lessors had received in the proposed unit;
• the low bonus price made the royalty unreasonable; and
• the unit’s size would include acreage not contributing to the well’s production, thereby diluting the property owners’ interests whose acreage was contributing to the well’s production.

Bonus prices for all the tracts in the unit ranged from $230/acre to $25,000/acre and the average price was $5,715.33. Without addressing the Examiners’ arguments, the Commissioners disagreed and concluded the offer was fair and reasonable.50


In both Texas Steel “B” and TWU A, XTO’s final offers to voluntarily pool gave small tract owners the following options:

- lease to XTO for $2,400/acre and a 25% royalty;
- participate in the well under a JOA with a non-consent penalty; or
- farmout the interest to XTO and retain a 20% overriding royalty with an option at payout to convert the override to a 25% working interest.\(^{51}\)

In both cases the Examiners found that XTO’s voluntary pooling offers were fair and reasonable, even though, unlike in Finley and Texas Steel “A,” the bonus was substantially lower than bonuses granted to other owners in the unit area. Instead, the Examiners noted that the lease offer was in line with the prevailing bonus price for leases in the relevant market on the day XTO made the offer. The Commissioners agreed.

It appears that under current law a lease offer is “fair and reasonable” if the bonus and royalty are consistent with the prevailing market terms in the relevant area.

\(\text{ii. The Size of the MIPA Unit}\)

The size of a MIPA Unit is critically important to urban operators. Recent Barnett Shale MIPA cases, however, have provided little guidance on the allowed size of a MIPA Unit. Under MIPA, the Commission can only pool into a unit acreage that “reasonably appears to lie within the productive limits of the reservoir.”\(^{52}\) In no event, however, can the unit exceed 160 acres for an oil well or 640 acres for a gas well plus 10 percent tolerance. The compulsory unit must contain the “approximate acreage” of the standard proration unit in the field rules.\(^{53}\) The standard proration unit for gas in the Barnett Shale is 320 acres, but an operator is permitted to form 20 acre optional proration units.\(^{54}\) The intent behind this limitation was to assure that the compulsory pooling act did not become a compulsory unitization act, resulting in fieldwide units.\(^{55}\)


\(^{52}\) TEX. NAT. RES. CODE § 102.018.

\(^{53}\) Smith & Weaver, TEXAS LAW OF OIL & GAS, Vol. 3, Ch. 12, § 12.3[B][1][a], at 12-24.

\(^{54}\) Oil and Gas Field Rules for the Newark, East (Barnett Shale), Field Number 65280200, available at http://webapps.rrc.state.tx.us/DP/fieldSelectAction.do.

\(^{55}\) Smith & Weaver, TEXAS LAW OF OIL & GAS, Vol. 3, Ch. 12, § 12.3[B][1][a], at 12-24.
In Finley, Finley sought to form a 96.32 acre MIPA Unit outside downtown Fort Worth. In the Examiners’ initial Proposal for Decision, they recommended that the Commission deny the application because the field rules allowed for 20 acre drilling units so Finley did not require such a large unit to drill a well. The Commissioners disagreed and granted the application to form the 96.32 acre MIPA Unit.

In Texas Steel “A,” XTO sought to form a 312.90 acre MIPA Unit in south Fort Worth. One reason the Examiners recommended denying the application was that XTO presented no evidence that the proposed well would “effectively and efficiently” drain the entire unit. The Commissioners agreed with the Examiners to deny the permit, but only on the grounds that XTO had a regular location from which to drill a well in the unit (not on the “effectively and efficiently” ground.)

In Rosen Heights, XTO sought to form a 262.19 acre MIPA Unit in north Fort Worth. One reason the Examiners recommended denying the application was that the proposed well would not drain all the acreage in the proposed unit. The Commissioners, without explanation, overruled the Examiners and granted the application but excluded a 7.66 acre tract they concluded the unit well could not drain. As such, the Commissioners approved forming a 254.52515 acre unit.

In Texas Steel “B,” XTO sought to form a 270.88 acre MIPA Unit in south Fort Worth. The Examiners again found no evidence that the proposed well would “effectively and efficiently” drain the entire unit. This time, however, instead of recommending that the


Commission deny the application outright, they recommended redrawing the MIPA Unit to be 500 feet on both sides of the horizontal drainhole. Testimony from XTO’s engineers led the Examiners to believe that the horizontal drainhole would only “effectively and efficiently” drain that part of the unit. The Commissioners agreed with the Examiners’ result of limiting the MIPA Unit to 500 feet on all sides of the horizontal drainhole but again struck the “effectively and efficiently” language. Instead, the Commissioners excluded the additional acreage from the MIPA Unit because other wells at normal locations could drain it.63

In TWU “A,” XTO sought to form a 230.9830 acre MIPA Unit in east Fort Worth.64 The Examiners found no evidence that the proposed well would drain the entirety of the proposed unit. The Examiners recommended that the MIPA application be denied because they believed XTO could seek Rule 37 permits for three wells in the proposed unit that would more effectively and efficiently drain the entire unit than the MIPA well.

iii. Economic Terms on Which Small Tracts are Pooled

MIPA provides little guidance on how the Commission should pool an unleased mineral interest owner into a MIPA Unit. It simply requires that the pooling order give each owner a “fair share” of the unit’s production.65

The Commission first answered this question in the Finley case and its answer has stayed essentially the same since then. Taking their cue from how some other states treat unleased mineral interest owners when they are forced pooled, the Examiners proposed, and the Commissioners later ordered, pooling the unleased mineral interests as royalty interests (equal to the fair market royalty rate at the time of the order) and as working interests (equal to the difference of 100% and the royalty interest being pooled).66 The force pooled parties would not receive a bonus. The operator would pay them their royalty share from first production and deduct their proportionate production costs from their working interest. The Commission also ordered that their working interest share bear a zero risk penalty given the low risk of dry holes or marginal wells in the area.

In Finley, this meant that the unleased mineral interest owners received a 1/5 royalty and a 4/5 carried working interest with no risk penalty. A 1/5 royalty was the prevailing rate for the other leased tracts in the unit. In the subsequent MIPA cases where the Commission force

63 Id., Final Order at 1-3.

64 Oil & Gas Docket No. 09-0261248: Application of XTO Energy, Inc., pursuant to the Mineral Interest Pooling Act for the proposed TWU A Pooled Unit, Well No. 1H, Newark, East (Barnett Shale) Field, Tarrant County, Texas (Final Order served December 14, 2010) Proposal for Decision at 2.

65 TEX. NAT. RES. CODE § 102.017.

pooled small tracts into a MIPA Unit, it has ordered the same type of formula except with 1/4 royalty and 3/4 carried working interest with no risk penalty.

Several arguments exist that this formula is not fair and reasonable to the operators:67

- If an operator made a voluntary pooling offer to an unleased tract owner that was fair and reasonable, then why not force pool the unleased party under those terms?

- In a Receivership Lease context, the missing person’s interest is leased under the same or comparable terms as the other undivided interest owners who voluntarily leased because these are considered fair and reasonable - why treat MIPA force pooled interests differently?

- From a policy standpoint, if MIPA is supposed to encourage voluntary pooling, then why reward parties who refuse fair and reasonable offers with more compensation than had they voluntarily pooled?

- Why should an unleased mineral interest owner lease if they would be better off being force pooled into a MIPA Unit?

These seem to be valid questions, but so far the Commission has consistently applied the mixed royalty interest and carried working interest formula adopted in *Finley*.

iv. Multiple Wells in a MIPA Unit?

Whether an operator can drill multiple wells in a MIPA Unit is another important issue without a clear yes or no answer.68 MIPA limits a MIPA Unit to a proposed or existing proration unit.69 A proration unit is limited to a single wellbore.70 The question is then – can an operator drill multiple wells in a MIPA Unit after it is established?

In the *Finley* and *Texas Steel “B”* cases, the Commission’s Final Orders stated that the MIPA Unit was established for and limited to the Barnett Shale formation.71 The Orders did not

---


68 *Id.*, at 20-22.

69 TEX. NAT. RES. CODE § 102.011.

70 16 TEX. ADMIN. CODE § 3.40.

71 Oil & Gas Docket No. 09-0252373: *Application of Finley Resources, Inc. for the Formation of a Unit Pursuant to the Mineral Interest Pooling Act for the Proposed East Side Unit, Newark, East (Barnett Shale) (65280200) Field, Tarrant County, Texas* (Final Order served on August 25, 2008) Final Order at 2, available at [http://www.rrc.state.tx.us/meetings/ogfd/oppomipa/FinleySignedFinalOrder.pdf](http://www.rrc.state.tx.us/meetings/ogfd/oppomipa/FinleySignedFinalOrder.pdf); Oil & Gas Docket No. 09-0261248: *Application of XTO Energy, Inc., pursuant to the Mineral Interest Pooling Act for the proposed Texas Steel “B” Pooled Unit, Well No. 1H, Newark, East (Barnett Shale) Field, Tarrant County, Texas* (Final Order served...
expressly address whether the operator could drill additional wells in the MIPA Units. The *Rosen Heights* Final Order, however, contained a provision that the MIPA Unit was established for and limited to the proposed wellbore. Limiting a MIPA Unit to a single well is likely why the Commission limited the *Steel “B”* MIPA Unit to 500 feet on both sides of the horizontal drainhole. The Commission’s rationale for limiting a MIPA Unit to a single well is that it is only authorized to approve a MIPA Unit where necessary to prevent the drilling of unnecessary wells, prevent waste, or protect correlative rights. According to the Commission, including acreage that the well will not “effectively and efficiently drain” is unnecessary to accomplish these goals.

Arguments exist, however, that limiting a MIPA Unit to a single well has the opposite effect and does not protect correlative rights or prevent waste. By limiting the wells an operator can drill in a unit, the Commission may inadvertently limit the amount of oil and gas produced from the MIPA Unit. This debate will certainly continue in later MIPA cases. Interestingly, as of August 2010, three wells have been drilled and are producing from the 95.32 acre East Side Unit created in the *Finley* case.

V. CONCLUSION

An operator’s options for dealing with missing persons and holdouts vary depending on whether the party is a missing person or holdout and whether the problem tract is a drillsite tract. A Rule 37 Permit can help with non-drillsite tracts, missing persons, and holdouts. If MIPA applies, it can help with drillsite tracts, non-drillsite tracts, missing persons, and holdouts.


76 Id.
Once an operator knows its options, the next step is weighing their costs and benefits. Obtaining a Rule 37 Permit can be quick (within a month from application) and inexpensive if no affected party protests. If someone protests, however, the operator will need to schedule a hearing on the application, obtain a waiver or lease from the protestant, or insert no-perf zones around the protestant’s tract. Rule 37 hearings are expensive and risky considering the controversy as to whether operators can use “economic waste” as a ground for a Rule 37 Permit. MIPA can help an operator develop a unit when it cannot obtain a Rule 37 Permit, but obtaining a MIPA Unit is a long, expensive process. Given all the unanswered questions about how MIPA will be and should be applied, the operator may not end up with the unit it wants.

Statewide Rules were not written with horizontal wells in mind.\textsuperscript{77} In the last 10 years, the Railroad Commission has had the unenviable task of interpreting these rules in today’s world of drilling horizontal, urban wells. In response, the Commission has allowed operators to use MIPA to force pool small tract owners into larger units for the first time. It has also granted special field rules to assist in developing horizontal wells. Some operators argue that the Commission has not gone far enough; some landowners argue it has gone too far. Interpreting dated conservation rules in today’s world is not an exact science. The state’s conservation laws have not kept up with technology. As such, we need to determine what works and what does not, and then update the laws accordingly to protect everyone’s correlative rights and encourage development.

\textsuperscript{77} Smith & Weaver, TEXAS LAW OF OIL & GAS, Vol. 2, Ch. 9, § 9.8(G), at 9-144.