Chapter 10

The Pooling Clause of The Lease

INTRODUCTION TO POOLING

When oil and gas exploration first began in the United States, there were no rules or governmental regulations regarding how the development was to occur. As seen in the picture, some fields had as many wells drilled as the land could accommodate.

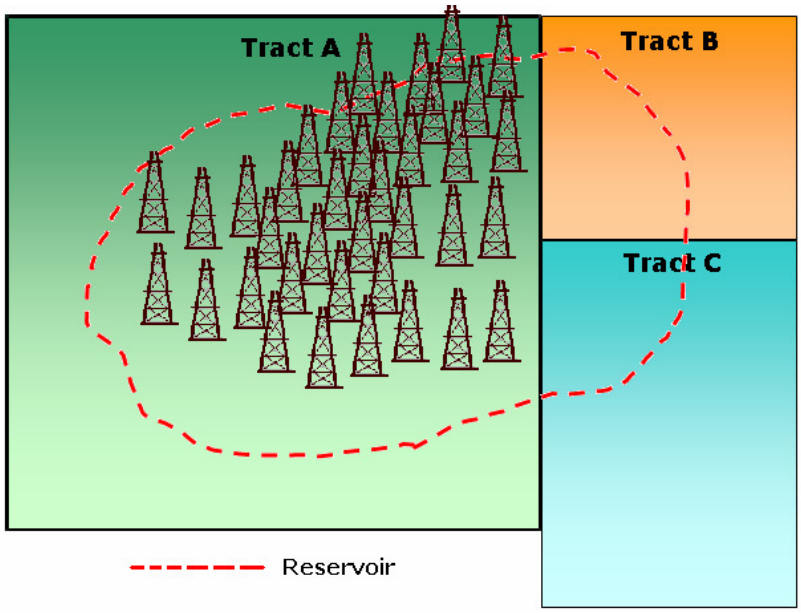
This type of drilling was promoted with the philosophy, "Pump as much oil out of the ground, as fast as you can, before someone else drills on an adjacent tract of land and beats you to the punch!" Such drilling, however, posed several problems that needed correcting.

The drilling did not concern itself with any type of orderly and efficient development of the resources. Consequently, geologic structures were often damaged. The reserves were not developed in any way that would maximize the ultimate recovery and such drilling failed to protect the rights of mineral owners, compensating them for their fair and just share of the production.

Example:

In the early days, an oil company could lease one tract of land and drill as many wells on this tract of land as was profitable (regardless of tract size).

In the diagram, the oil company has leased Tract A and drilled over 30 wells, pumping as much oil from the ground as possible. As you can see, the reservoir is larger than just Tract A and lies beneath Tracts B and C. The owners of these two tracts have not been leased, are not oil developers and will probably not drill their own wells. The drilling company would have no motivation to lease either of these tracts of land. There would be no need, since they were allowed to drill as many wells as possible on their leased land. The end result: While the



mineral owner of Tract A became wealthy beyond his wildest imagination, the owners of the minerals under Tracts B and C received no share of revenue from production.

SPACING AND UNITS

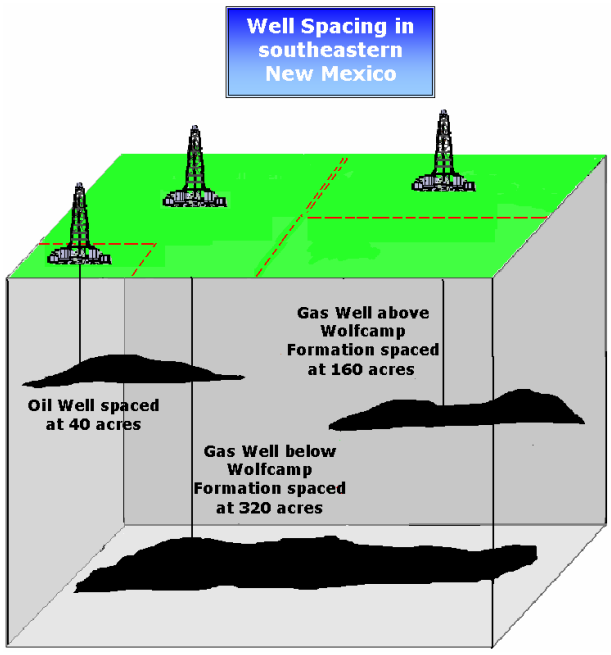
As these types of problems became clearer, rules, guidelines and governmental regulations were implemented. Several of these guidelines revolve around the words *"spacing, units" or "pooling".*

Creating units is one method used whereby the industry can, in an orderly manner; efficiently and economically develop a particular area. Creating units also help protect the rights of owners having interest in or near the field.

A unit can be defined as a distinct area of surface and subsurface which is established for the purpose of drilling and producing oil and gas. Often a unit size (number of acres) is already established by the applicable state governmental agency. The size and shape of a unit can be dependent upon the type of production (either oil or gas), the distance from existing production (whether drilling is considered wildcat or developmental drilling), the geographical location of drilling, and the geological formation or horizon being developed.

For instance, in southeastern New Mexico the applicable spacing would be as follows:

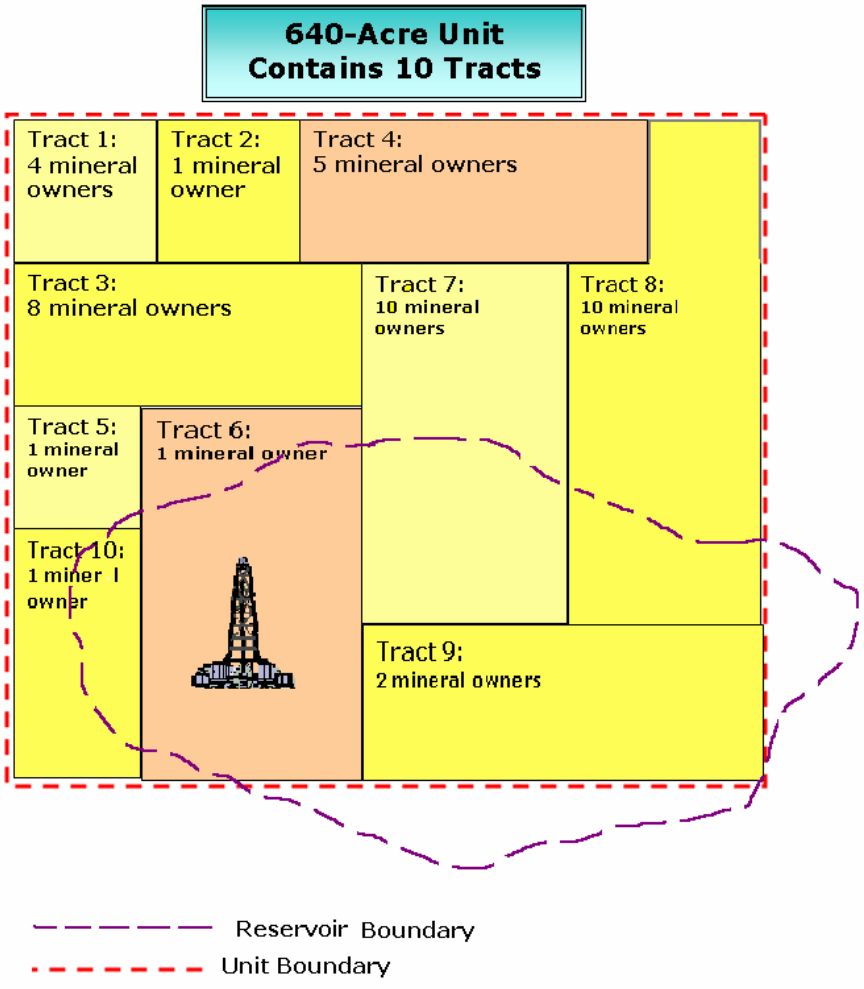
- Wildcat gas wells drilled in southeast New Mexico above the Wolfcamp formation are spaced at 160 acres.
- Wildcat gas wells drilled in Southeast New Mexico below the Wolfcamp formation are spaced at 320 acres.
- Wildcat oil wells drilled in Southeast New Mexico drilled at any depth are spaced at 40 acres.[1]



POOLING

The concept of developing these units no longer allowed an oil company to over drill on a single tract of land or single lease. Unit sizes now embraced as large of an area as was reasonable in order to include potential owners of the reservoir. As units are formed, the unit boundary often involves more than one lease and every party owning an interest inside the unit boundary receives his or her proportionate piece of the production pie. Including each of these leases into a unit is referred to as *"pooling"* the leases.

Pooling can be defined as the combining of all of the various types of oil and gas interests within a unit boundary, for the purpose of creating a drilling unit.



Units can involve many separate tracts of land (as seen in the illustration) and each of the tracts of land can represent many undivided mineral interest owners.

As you can see, the reservoir lies beneath 5 tracts of land; however, since the unit boundary contains all 10 tracts of land, everyone inside the boundary will receive their proportionate part of production. If, as in the example drilling takes place on a single tract, it is as if drilling has taken place on any and all of the leases because they have been pooled into the unit.

In a case as shown, the type of product (either oil or gas), the state and location of the well, and the horizon, will determine the size of the unit. In this case the unit size is 640 acres.

POOLING CLAUSE OF THE LEASE

If your company wished to form a drilling unit, they could not automatically pool their lease or leases into the unit unless they had permission from the lessor to do so. The pooling clause of the lease gives this permission and should include the following provisions:

1. Permission from the Lessor to pool their interest
2. The acreage limitation of the unit size
3. Permission for the enlargement of the unit based on governmental regulations
4. The need for filing a unit designation in the county records
5. Explanation that drilling on one lease is as if drilling has taken place on all leases
6. Explanation that royalty will be paid proportionally based on the acreage contribution from the lease

Pooling or Unitization Clause

1 Lessee is hereby granted the right at any time and from time to time to unitize the leased premises or any portion or portions thereof, as to all strata or any stratum or strata, with any other lands as to all strata or any stratum or strata, for the production primarily of oil or primarily of gas with or without distillate. 2 However, no unit for the production primarily of oil shall embrace more than 80 acres, or for the production primarily of gas with or without distillate more than 320 acres; 3 provided that if any governmental regulation shall prescribe a spacing pattern for the development of the field or allocate a producing allowable based on acreage per well, then any such unit may embrace as much additional acreage as may be so prescribed or as may be used in such allocation of allowable. 4 Lessee shall file written unit designations in the county in which the leased premises are located. 5 Operations upon and production from the unit shall be treated as if such operations were upon or such production were from the leased premises whether or not the well or wells are located thereon. The entire acreage within a unit shall be treated for all purposes as if it were covered by and included in this lease except that the royalty on production from the unit shall be as below provided, and except that in calculating the amount of any shut in gas royalties, only the part of the acreage originally leased and then actually embraced by this lease shall be counted. 6 In respect to production from the unit, Lessee shall pay Lessor, in lieu of other royalties thereon, only such proportion of the royalties stipulated herein as the amount of his acreage placed in the unit, or his royalty interest therein on an acreage basis bears to the total acreage in the unit.

Example 1:

Your company owns a lease covering 160 acres in the SW/4 of Section 7. The lease will expire on August 8th unless operations begin either on or before that date; however, the lease is pooled into a 640-acre drilling unit and operations begin August 1st on a well located in the NE/4 of the section. Since operations did not begin on your lease, will the lease terminate on August 8th?

Answer: No, according to the language covered in item #5, if your lease was pooled into the unit, operations upon any lease within the unit are considered as if operations were on your company's lease.

Example 2:

Your company owns a lease covering 160 acres in the SW/4 of Section 7. The royalty negotiated by the lessor at the time the lease was taken was for 3/16 of oil or gas sold. The lease was pooled into a 640-acre unit, a commercially productive well was drilled, and a royalty payment is due to your lessor. Is the lessor to be paid $3/16^{th}$ out of all production?

Answer: No, according to the language covered in item #6 the lessor is to be paid his or her $3/16^{th}$ royalty based on his or her acreage contribution to the total amount of acreage in the unit. In other words, your lessor is contributing 160 acres to a unit size that equals 640 acres with a royalty due of $3/16^{th}$. Your lessor's royalty would be calculated as follows: 160 / 640 X 3/16 = 4.6875% of all production.

Example 3:

Your company owns a lease covering the same 160 acres in the SW/4 of Section 7; however, your lessor only owns an undivided 25% of the minerals in and to this tract of land. The lease provides for a royalty of $3/16^{th}$. If the lease was pooled into the same unit, what royalty is due this lessor?

Answer: 160 / 640 X 25% X $3/16^{th}$ = 1.17187%

VOLUNTARY POOLING

When a unit is formed, it becomes necessary that all interests within the unit boundary be pooled. If a unit boundary were formed and only a portion of the leases were pooled, severe consequences would result. The good news is that most leases taken today contain pooling clauses and allow the oil company the right to *voluntarily pool* these leases into a proposed unit boundary. Such a unit would be called a voluntary unit.

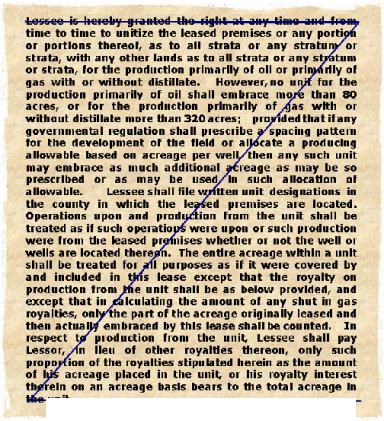
The following is the Ohio Revised Code Section 1509.06, which allows for voluntary pooling if the oil and gas leases provide for such pooling:

> The owners of adjoining tracts may agree to pool such tracts to form a drilling unit which conforms to the minimum acreage and distance requirements of the division of oil and gas under section 1509.24 or 1509.25 of the Revised Code. Such agreement shall be in writing, a copy of which shall be submitted to the division

of oil and gas with the application for permit required by section 1509.05 of the Revised Code.

Older leases that predate spacing legislation might not contain the pooling clause and would require a separate pooling agreement between the lessor and lessee.

Compulsory Pooling, Mandatory Pooling or Force Pooling

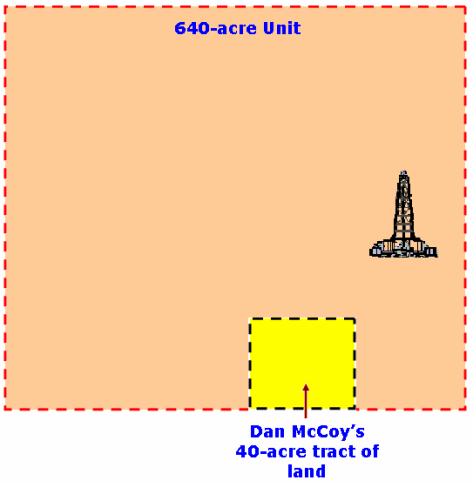

Lessee is hereby granted the right at any time and from time to time to unitize the leased premises or any portion or portions thereof, as to all strata or any stratum or strata, with any other lands as to all strata or any stratum or strata, for the production primarily of oil or primarily of gas with or without distillate. However, no unit for the production primarily of oil shall embrace more than 80 acres, or for the production primarily of gas with or without distillate more than 320 acres; provided that if any governmental regulation shall prescribe a spacing pattern for the development of the field or allocate a producing allowable based on acreage per well, then any such unit may embrace as much additional acreage as may be so prescribed or as may be used in such allocation of allowable. Lessee shall file written unit designations in the county in which the leased premises are located. Operations upon and production from the unit shall be treated as if such operations were upon or such production were from the leased premises whether or not the well or wells are located thereon. The entire acreage within a unit shall be treated for all purposes as if it were covered by and included in this lease except that the royalty on production from the unit shall be as below provided, and except that in calculating the amount of any shut in gas royalties, only the part of the acreage originally leased and then actually embraced by this lease shall be counted. In respect to production from the unit, Lessee shall pay Lessor, in lieu of other royalties thereon, only such proportion of the royalties stipulated herein as the amount of his acreage placed in the unit, or his royalty interest therein on an acreage basis bears to the total acreage in the

In most cases, mineral owners will sign a lease that allows for pooling. However, from time to time, mineral owners refuse to lease, or strike through the pooling clause. In both instances, the oil company has no power to force these parties into the unit. The problem that results from this scenario can be enormous.

Example:

Your company owns a 40-acre lease signed by Dan McCoy. At the time of the lease's execution a royalty rate of 3/16th was negotiated but the only way Mr. McCoy would sign the lease was if the pooling clause was stricken.


Dan McCoy



Mr. McCoy's tract of land falls within a 640-acre spacing unit. A producing well is drilled and it is now time to pay Mr. McCoy his share of production. Since you had no right to pool his interest into the unit what royalty should he be paid?

Answer: Under normal conditions the pooling clause will allow you to pay him based on this acreage contribution (40 acres) to the total acres in the unit (640 acres) or his proportionate share of production. His royalty calculation would be:

40 / 640 X 3/16th = 1.17187%

But Dan McCoy struck the pooling clause from the lease. In this case, he is to receive his entire royalty amount of 3/16th (18.75%) of all production. Your company cannot proportionality reduce his interest.

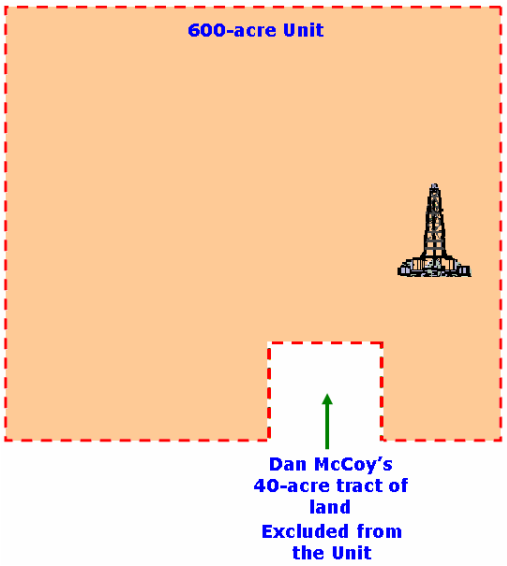
You must pay him his full royalty of *18.75%.*

That would be devastating to your company. If the only lease your company owned in the unit was the McCoy lease, your ownership in the unit would be this 40 acre tract of land or 6.25% of the unit. Your company would receive 6.25% of all revenue, but you must pay your burdens.

Dan McCoy's royalty is not pooled with the other leases and cannot be proportionately reduced. You must pay him a full 18.75% royalty. The liability to your lessor is three times larger than the amount you will receive from production.

Your Company's Unit Ownership	**=**	**40/640 = 6.25%**
Your Company's Revenue out of Production	**=**	**40/640 = 6.25%**
Less the Dan McCoy Royalty Burden	**=**	**- 18.75%**
Your Company's Net Profits out of Production	**=**	**A Negative 12.50%**

So, what is normally done? Is this tract of land excluded from the unit as illustrated? Is the unit outline drawn around Dan McCoy's tract of land? Is the unit size changed to a 600-acre unit?

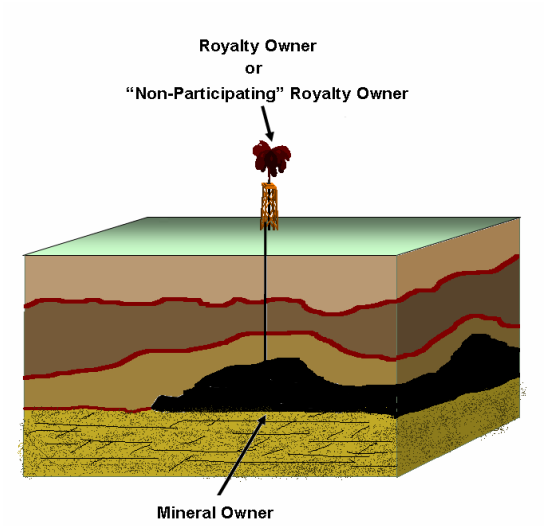


In a case like this, if Dan McCoy refused to sign any type of unit designation, his lease cannot be voluntary pooled. When voluntary pooling efforts fail, many states have statutes and regulations in place that will forcibly pool all leases in the unit. This would be termed "forced pooling, compulsory pooling" or "mandatory pooling". To date, 26 states have statutes that allow the compulsory pooling of leases into a unit. If this were to happen in the illustration, the Dan McCoy lease would not be excluded from the unit, instead his lease would be forced into the unit through compulsory pooling. The unit boundary would not be re-drawn nor would the acreage change from a 640-acre unit to a 600-acre unit.

How is Compulsory Pooling Done?

Compulsory pooling or forced pooling can only be done by holding a hearing with the state regulatory agency. Any mineral owner, in the area proposed to be pooled, can participate in the hearing. At this time Dan McCoy could present evidence showing why he should not be pooled. Based on hearing the testimony presented, an order will be issued that sets out the commissions findings. Generally, a mandatory pooling order will be issued if the regulatory agency believes that such action would effectively protect everyone's rights and would provide for the effective development, use and conservation of oil and gas. The orders related to both unleased mineral owners and mineral owners who have not consented to voluntary pooling will vary from state to state.

Non-participating Royalty owners in Texas and New Mexico



The person owning *royalty* can often be different from the person who owns the *minerals.* In most cases, they are the same person. When they are different, the royalty can be referred to as *"non-participating royalty"*. Since such a royalty owner would own no minerals they would not have the right or would *not be able to participate* in the execution of leases, receive bonus or rental payments.

Royalty can be defined as the monetary benefit that one would receive out of the production of a commercial oil and

gas well.

In Texas and New Mexico, a non-participating royalty owner's interest is covered by the oil and gas lease *except* if the lease is pooled with other leases and becomes a part of a pooled unit.[2]

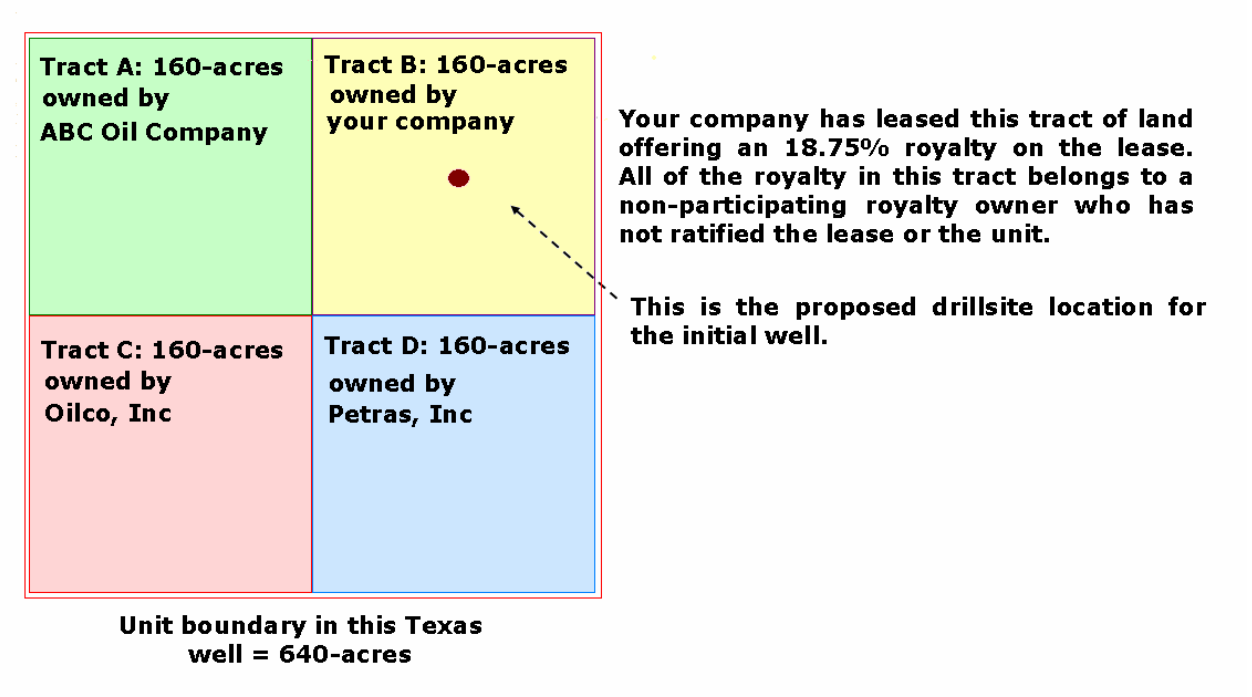
This situation could prove disastrous to an oil and gas company, especially if the drillsite location is to be located on the non-participating royalty owner's tract of land. The Texas Supreme Court's decision in Brown v. Smith states that a mineral owner with executive rights to lease does not have the right to pool any interest owned by the non-participating royalty owner without their approval. Courts in Texas have consistently upheld this principal in law.[3]

In Texas and New Mexico, if this non-participating royalty owner fails to ratify the lease or sign some sort of unit designation, his or her interest cannot be pooled in the unit. There are two different outcomes for this scenario.

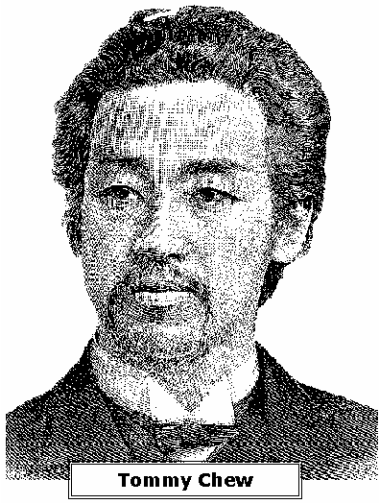
- First, if the drillsite is located on this tract of land, the non-participating royalty owner will receive his or her royalty in whole and not proportionately reduced by the other acreage in the unit. This would have the same result as the Dan McCoy illustration.
- Secondly, if the drillsite is located on another tract of land, the non-participating royalty owner is not entitled to receive any royalty benefits from production. They do have the right, however, to sign a ratification or unit designation even after the well is drilled and completed. At this point, their royalty payment would be based on their proportionate part of the unit.[4]
- One court allowed a non-participating owner to collect royalty payments from a well that was drilled 13 years before he signed the ratification to the lease.[5]
- Another court granted a non-participating royalty owner the right to ratify only portions of a lease. In this case, the lease covered a larger tract of land and the non-participating royalty owner could pick and choose what portions of the lease he wished to ratify. On wells that were not located on lands burdened by his royalty interest, the owner received royalty payments based on his proportionate part of the unit. On wells that were located on lands burdened by his royalty interest, the owner received his full royalty interest.[6]

Example:

Study the scenario below as it relates to a unit boundary in Texas.



Your company leased Tract B from the mineral owner, Ronald Chew; however all of the non-participating royalty is owned by Ronald's son, Tommy Chew. Tommy Chew has refused to sign a ratification of the lease or a designation of the unit.



Since your company owns 25% of the unit, they would be responsible to pay 25% of the costs for drilling the well. If the well was drilled and completed in the NE/4 of the section, according to what you have learned, what percent of the revenue would your company be able to keep?

- *A full **25%***,
- 25% - 4.6875% royalty burden = ***20.3125%***
- 25% - 18.75% royalty burden = ***6.25%***?

Since this is a Texas well with the drillsite located on the non-participating royalty owner's tract of land and since they have not signed a ratification of the lease or a unit designation, their royalty interest is not pooled with the other leases. You must pay them their full royalty, not proportionately

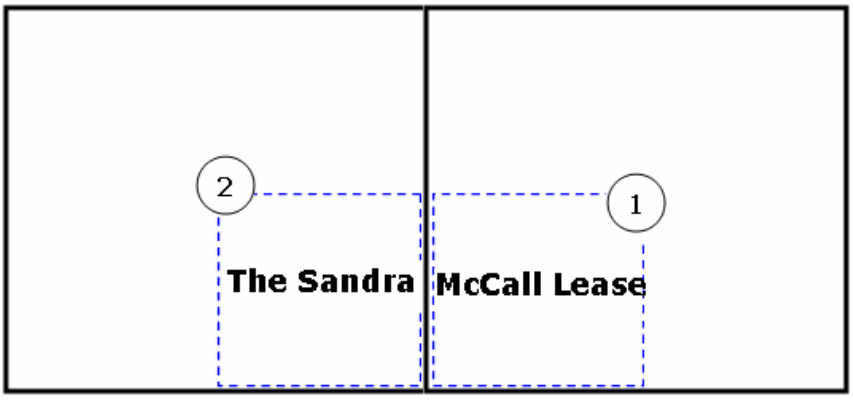
reduced by the unit size (a full 18.75% royalty out of production). Your company would get to keep what is left over (25% - 18.75% = 6.25%).

LEASED LANDS THAT FALL OUTSIDE THE POOLED UNIT

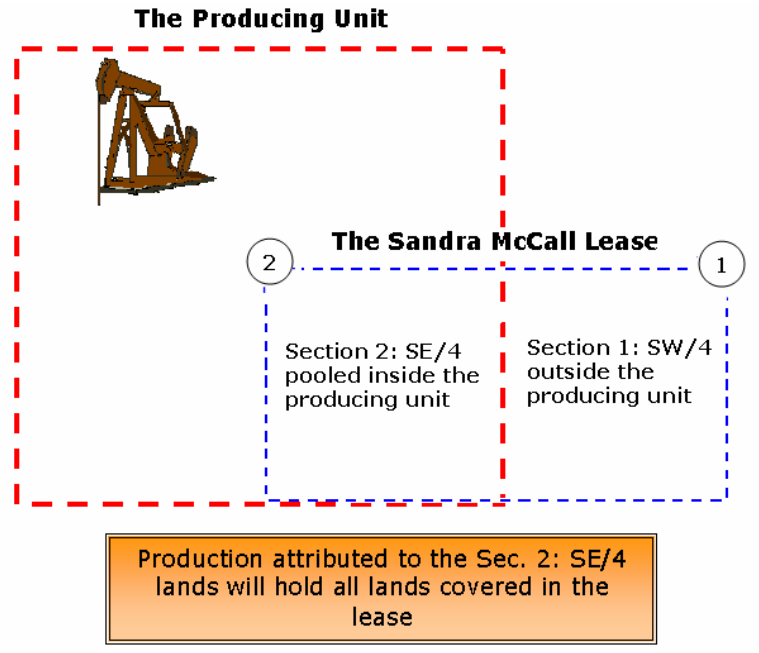
From time to time, only portions of a lease will be pooled into a unit. After the primary term of the lease, what happens to those lands that were not pooled?

Example 1:

Sandra McCall signed an oil and gas lease with your company covering the SE/4 of Section 2 and the SW/4 of Section 1. The lease contains pooling language and allows your company to pool either all or a portion of the lands covered on the lease into a unit.



A unit is formed covering only lands in Section 2 and a commercial well is drilled in the NW/4 of the section. Of course, the Section 2 lands are held by production from the unit, but what is that status of those lands that are outside the unit?



After the primary term of the Sandra McCall lease, does Section 1: SW/4 terminate?

Unless a pugh clause has been added to the lease, the effect of pooling only a

portion of the oil and gas lease into a producing unit will continue the entire lease into the secondary term. In the example, production attributed to the Section 2 lands would hold the entire lease by the unit production.

LEASED LANDS THAT FALL OUTSIDE A POOLED UNIT AND TERM MINERAL INTERESTS

It is not uncommon to see mineral ownership derived through some sort of a *term mineral conveyance* or *term mineral reservation*. Term mineral conveyances or reservations can often pose problems to oil and gas personnel when portions of the term interests fall outside a pooled unit. Since statutes vary from state to state and the following is a general overview of the subject, one should consult with an attorney or a particular state legal source when specific questions arise.

Generally, the holder of a term interest can sign an oil and gas lease, but that lease, or portions thereof, *will not continue* beyond the expiration date of the term mineral interest. This is the issue that creates the challenge. Unless the conveying document provides for the continuation of the lease past the expiration date, a lease will not transfer to the reversionary mineral owner and two leases should be taken, one from the holder of the term interest and the other from the holder of the reversionary interest.

Carlos Santino conveyed a 10-year term mineral deed to Robert Murray dated April 7, 1997.

On April 7, 2007 the minerals will revert back to Carlos Santino.

Any oil and gas lease signed by Robert will not continue beyond the expiration date of the term mineral interest.

In the illustration, if your company leased Robert Murray and drilled a producing well on the leased lands, at the end of the 10 year term, the minerals would revert back to Carlos Santino.

Even though your company had drilled a producing well on the lands, the lease would no longer cover the mineral interest. In other words, unless the term mineral conveyance gave permission for Robert Murray to encumber the reversionary interest, his lease would not cover the future interest of Carlos Santino.

In *RLM Petroleum Corp. v. Emmerich*, the Oklahoma court found that unless language in the deed expressly gives the term mineral interest holder the right to encumber both the term mineral interest and the future reversionary interest with

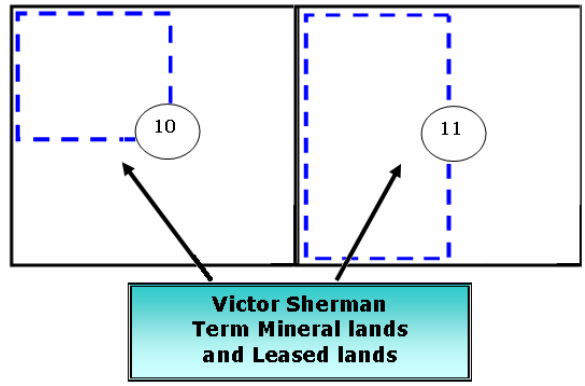
an oil and gas lease, the oil and gas lease will terminate upon the expiration of the term mineral interest.[7]

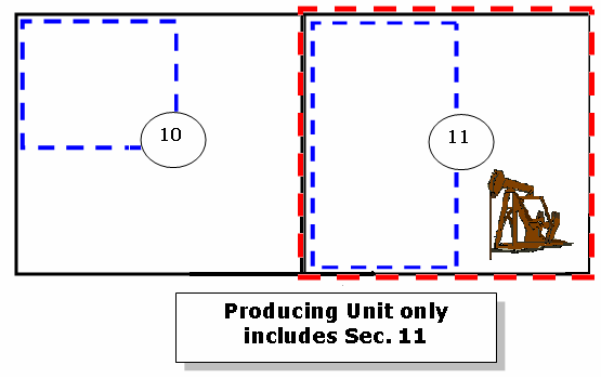
The ownership of minerals can be conveyed or reserved for a specified term (i.e. 5 years or 10 years). They can also be conveyed or reserved with the following language: "conveyed or reserved for a fixed term and as long thereafter as oil or gas is produced."

When this language is added, in order for this option to take affect and move the term mineral into a "secondary term", there must be either oil or gas production in paying quantities, not only during the term of the deed, but at the date of expiration of the term or there must be diligent operations in place. If not, the minerals will revert back to the other party.

Example:

In the illustration, Chester Morrow conveyed to Victor Sherman all of his interest in Section 10: NW/4 and Section 11: W2 (those lands shown in the dotted area). Your company leased both tracts of land on the same lease.





The only portion of the lease that was pooled into the drilling unit was the W2 of Section 11. The drilling unit comprised all of Section 11 and a producing well was drilled in the SE/4 of the section.

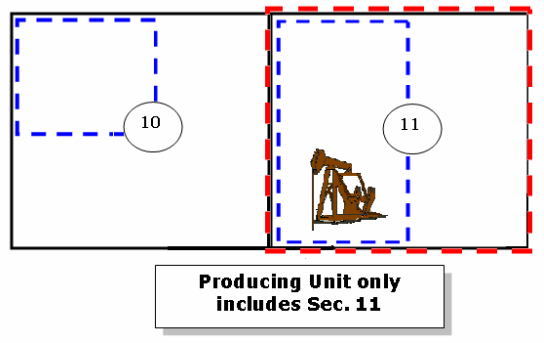
No other wells were drilled on the other lands prior to March 3, 2011.

Would production from the well in Section 11 perpetuate the mineral ownership to Victor Sherman as to the lands in Sections 10 and would the production from the unit hold those lands outside the unit?

_____ Yes _____ No

Answer: This answer becomes a little tricky. Since these lands are tied to a term mineral and potential reversionary interest, in states like Kansas, only the acreage included in the spacing unit would perpetuate into the secondary term. Since the lands in Section 10 fall outside the production unit, they would revert back to Chester Morrow. If your company did not have a lease from him on this tract of land, these lands would not carry into the secondary term.[8]

If this same scenario happened in Texas, since the well was not located on *any of the lands* covered in the granting clause of the conveying deed, the minerals would not perpetuate into the secondary term. *All* of the lands would revert back to Carlos. If your company did not have a lease from him these lands would not be covered nor would they be held by production from the unit.



On the other hand, if the well *was located anywhere* on the "conveyed lands" (as shown in the following illustration) then, in Texas, as long as there was production on March 3, 2011, all lands covered in the lease would perpetuate into the secondary term and the lands located in Section 10 would be held by production from the unit.

In Oklahoma, production can simply be on lands pooled with those involving the term mineral interest; however, actual marketing of the production must have taken place on or before the expiration date of the term mineral interest. In Oklahoma, the production attributed to those leased lands inside the unit would continue the entire lease into the secondary term.[9] However, the Oklahoma statutory pugh clause would apply to this situation since the lease was executed after May 25, 1977 and the spacing unit contained 160 acres or more. The lands outside the unit would automatically expire 90 days after the primary term of the lease.

Footnotes:

[1]A Comparative Review of Oil and Gas Law in Texas, Oklahoma, Arkansas, New Mexico, Mississippi & Louisiana, Landman Oil & Gas law, Special Section, December 2002, George Snell, Timothy Dowd, Tom Daily, Gregory Nibert, John McDonald and Richard Revels, p. 97-100.

[2]Oil and Gas Law 2001: Nationwide Comparison of Laws on Leasing, Exploration and Production, George A. Snell, III.

[3]Brown v. Smith , 141 Tex. 425, 174 S.W.2d 43 (1943).

[4]Oil and Gas Law 2001: Nationwide Comparison of Laws on Leasing, Exploration and Production, George A. Snell, III.

[5]DeBenavides v. Warren, 674 S.W.2d 253 (Tex. Civ. App.–San Antonio 1984, writ ref'd, n.r.e.).

[6]MCZ, Inc. v. Triolo, 708 S.W.2d 49 (Tex. Civ. App–Houston [1 st Dist.] 1986, writ ref'd n.r.e.).

[7]RLM Petroleum Corp. v. Emmerich, 1995 OK 50, ¶2, 896 P.2d 531.

[8]An Introduction to Kansas Oil & Gas Law, 1988 Washburn Law School Oil & Gas Law Series, David E. Pierce, November, 1988, p. 51.

[9]Ibid, p. 51-52.