

SUBJECT: Regulation of commingled reservoirs by the Railroad Commission

COMMITTEE: Energy Resources —favorable, without amendment

VOTE: 4 ayes — West, Farabee, Crownover, Howard

0 nays

3 absent — Corte, Crabb, Gonzalez Toureilles

WITNESSES: For — Jamie Nielson, Ben Sebree, Texas Oil & Gas Association;
(*Registered, but did not testify*: Morris Burns, Permian Basin Petroleum Association).

Against — Martin Fleming, Texas Independent Producers & Royalty Owners Association

On —Michael McElroy

BACKGROUND: The Natural Resources Code allows the Railroad Commission (RRC) to adopt and enforce rules for the production of oil and gas. The RRC regulates operations of oil and gas reservoirs and requires operators to obtain permits to drill wells used to reach and produce from reservoirs.

The RRC normally regulates by field, an area of oil and gas production with at least one common reservoir for the entire area. A common reservoir is a pool or accumulation of oil or gas produced by more than one well. To conserve oil and gas, the RRC controls the placement of wells and the amount of gas a well or common reservoir may produce.

Sec. 86.081(b) authorizes the RRC to permit production by commingling oil, gas, or both, from multiple separate reservoirs through one well where the RRC, after notice and opportunity for hearing, has found it would prevent waste, promote conservation, or protect correlative rights. The RRC can prorate, allocate, and regulate the production of such commingled reservoirs as if they were a common reservoir.

A case pending before the Texas Supreme Court, *Seagull Energy E&P, Inc. v. RRC*, challenges the RRC's authority to treat multiple separate

reservoirs as one common reservoir. The plaintiff-operator disputes the RRC's authority to regulate the placement and number of wells in fields where commingling is approved. In this case, the RRC did not approve a permit to allow the plaintiff to produce gas from its reservoirs from two separate wells concurrently based on a determination that it was necessary to prevent abuse of correlative rights, which would have harmed the property rights of adjacent landowners. The plaintiffs were allowed, however, to produce gas from each well at different times. Oral arguments were made before the Supreme Court in fall 2004, and a decision is pending.

DIGEST: HB 2440 would amend section 86.081(b) to allow the RRC to regulate "all activities" under its jurisdiction and associated with treating commingled accumulations of oil and/or gas as if those accumulations were a single common reservoir.

The bill would take immediate effect if finally passed by a two-thirds record vote of the membership of each house. Otherwise, it would take effect September 1, 2005, and would apply to all activity occurring after the effective date, regardless of whether the authorization occurred before, on or after the effective date.

SUPPORTERS SAY: HB 2440 would clarify RRC's authority to regulate all activities connected to multiple reservoirs in which the agency has allowed commingled production. The RRC has prevailed both in the district court and in the court of appeals in the *Seagull* case pending in the Supreme Court, and the bill simply would codify what has been practice at the RRC and in the industry for decades. If the authority of the RRC were not clarified, it could create much confusion and potentially lead to many other lawsuits and class-action royalty litigation.

The industry relies on spacing standards set by the RRC. If law and practice changed for commingled fields, reliance on RRC regulations would be destroyed, and operators could drill more than what was within their tracts of land. Operators could build wells tapping every reservoir under their tracts, regardless of how it affected adjacent landowners. Reliance on current practice protects people's property rights and prevents operators from being able to drain their neighbor's reserves.

When the RRC treats separate reservoirs as one field, those reservoirs are regulated as one field for RRC purposes. Operators have a right to the oil and gas under the field, but the RRC may regulate that production.

The RRC does not decide arbitrarily to treat multiple separate reservoirs as a single reservoir or single field for RRC purposes. It happens on the request of operators in the field. They present to the RRC evidence that it is the best and fairest approach or would prevent waste.

The correlative rights of adjacent landowners are the real property rights that could be taken if RRC authority were not clarified.

The state passed legislation to respond to previous case law that was unfair. It allowed operators to produce hundreds of times the amount of gas beneath their own property because operators could compete in every reservoir. They inevitably were obtaining gas from adjacent landowners.

The Natural Resources Code says operators have a right to all oil and gas under their tracts, or the equivalent in kind. However, operators do not have an absolute right to produce from or place a well in every particular reservoir. They have a right to produce what is under their land or to drain the equivalent from their neighbors. It is important to resolve this controversy and clarify the RRC's authority under the commingling statutes.

**OPPONENTS
SAY:**

Sec. 86.081 deals with proration, but this bill would be inserting provisions designed for dealing with permitting. These are two very clearly separate principles. The right to a permit is a property right, but there is no legal right to a particular allowable under proration. An operator merely has the right to be treated like everyone else. If it were appropriate to give this new authority to the RRC, it should be in an upfront manner and involve a constitutional amendment so the RRC could be authorized to give and take away these property rights.

There has not been a clear-cut case defining the authority of the RRC to treat multiple separate reservoirs as one common reservoir.

In spite of the characterization that this is a practice that has been going on for years, this seemingly simple change in the law has to do with how the RRC treats the difference between regulation of production through proration, and honoring property rights through permitting. The RRC,

statutory law, and the state courts have long held that separate reservoirs are entitled to separate permits whether or not that production is commingled under proration for production purposes.

It is a mischaracterization of law to say this bill just confirms what has been practice. Texas oil and gas law is rooted in mining law, which provides that if you have a mineral deposit beneath your property, you may seek a shaft to produce those minerals. Under Texas law you have a right to have a shaft or well to produce from each of the accumulations of oil or gas under your property. This right was affirmed by the Supreme Court in earlier case law. The court has held that the entire Texas statutory system for regulating oil and gas was set up to contemplate that the RRC would treat separate reservoirs individually for permitting purposes, so that an operator would have a permit for a well in each reservoir beneath a tract. Case law rejected the argument that production from one reservoir could be used to deny the right of an owner to a well in another reservoir and held that the RRC could regulate the flow of production and proration to make sure no one got an unfair advantage. But it was improper for the RRC simply to deny the right to the well down to the deposit of minerals as a basis for trying to regulate the rights.

The proper approach is for operators to receive permits to place wells in each separate accumulation. The RRC then could regulate that production to make sure that no one got an unfair advantage. Other cases have reaffirmed the concept that a property owner has a right to a well in each separate reservoir beneath the owner's land.

In 1981, the Legislature allowed the RRC to combine separate reservoirs for proration purposes. That is the only such authority granted to the RRC. When separate reservoirs are combined and commingled as one field, as the RRC recently decided, it takes away a property owner's right to a well in each of the separate reservoirs beneath the land. This would allow the RRC to give and take away property rights, which likely is unconstitutional. The Supreme Court has held that the validity of the RRC's regulatory scheme depends upon the RRC's obligation to grant a property owner an exception permit to complete a well in a separate reservoir beneath the owner's land.

OTHER
OPPONENTS
SAY:

This matter should be resolved by the Supreme Court before any further action is taken to change the law. The *Seagull* case contains a good set of facts that permanently should clarify the controversy.