St. Mary's Law Journal

Volume 13 | Number 4 Article 1

9-1-1982

Practice before the Oil and Gas Division of the Railroad Commission of Texas Symposium - Selected Topics on Oil and Gas Law.

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ST. MARY'S LAW JOURNAL

VOLUME 13 | 1982 | NUMBER 4

PRACTICE BEFORE THE OIL AND GAS DIVISION OF THE RAILROAD COMMISSION OF TEXAS

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I. Historical Overview

In the early days of oil and gas exploration, the courts wrestled with the problem of fitting "migratory oil and gas" into traditional concepts of property law. The struggle in Texas resulted in the rule of "ownership in place" subject to the "rule of capture." Every landowner was deemed to own the oil and gas located beneath his property, as well as any oil and gas that migrated to his property as a result of legal drainage from his neighbor's land. A landowner losing his oil and gas as a result of drainage caused by wells on adjacent property had only one remedy—drill offsetting wells on his property to capture the oil and gas before it was recovered by his neighbor.[1] This remedy of offset wells was not regulated by the state. Rather the landowner had the right to drill as many wells as he felt appropriate, and at whatever location he desired.[2]

In order to ensure conservation of the state's natural resources and provide for the welfare of its citizens, an amendment to the Texas Constitution was adopted in 1917, declaring the preservation and conservation of all natural resources to be a public right and duty and enabling the Texas Legislature to pass all laws appropriate to achieve these goals.[3] Pursuant to this authority, the legislature enacted a statute in 1919 requiring conservation of oil and gas and granting jurisdiction to the already existing Railroad Commission of Texas (Commission) to make such rules and regulations as it deemed necessary to prevent the waste of natural resources.[4] This article reviews several of the more important statutes and rules promulgated by the Commission pursuant to these laws to illustrate the impact of regulation on the drilling and completion of wells and production of oil and gas in Texas today.

II. Rule 37: The Statewide Spacing Rule

A. *Introduction*

In November of 1919, as one of its initial conservation acts, the Commission adopted rule 37 prohibiting the drilling of a well nearer than 300 feet from another well or nearer than 150 feet to any property line.[5] The rule did not presume that wells drilled on a tighter spacing pattern would cause oil and gas to be wasted; however, it did contemplate that the conservation of oil and gas would be furthered by the orderly and scientific drilling and development

1. *See* Elliff v. Texon Drilling Co., 146 Tex. 575, 581, 210 S.W.2d 558, 561 (1948); Brown v. Humble Oil & Ref. Co., 126 Tex. 296, 305, 83 S.W.2d 935, 941 (1935).

2. *See* Brown v. Humble Oil & Ref. Co., 126 Tex. 296, 305, 83 S.W.2d 935, 940 (1935). *See generally* Hardwicke, *The Law Of Capture And It's Implications As Applied To Oil And Gas*, 13 Texas L. Rev. 391 (1935).

3. Tex. Const. art XVI, § 59(a).

4. 1919 Tex. Gen. Laws, ch. 155, art. 3, at 285 (presently codified as Tex. Nat. Res. Code Ann. §§ 81.051 (Vernon 1978) & 81.052 (Vernon Supp. 1982)).

5. Texas Railroad Commission, Oil and Gas Circular No. 11 (Nov. 26, 1919). *See generally* 1 W. Summers, The Law of Oil and Gas § 86 (1954).

of reserviors.[6] Because rule 37 has been changed substantially by both judicial mandate and Commission policy since its initial promulgation, attention will be devoted to the spacing rule's present operation and the impact of several recent court decisions.

B. *Basic Requirements of Rule 37*

Rule 37, as it reads today, prohibits the drilling of wells nearer than 1200 feet to any well on the same lease or unitized tract that is drilling to or producing from the same reservior, or nearer than 467 feet from any property or lease line.[7] This rule applies statewide to all "wildcat," or new fields, and to designated fields without special field rules.[8] The rule also establishes a general drilling density of one well to forty acres.[9] The Commission has specifically reserved the right to require special rules for a given field if necessary to protect life, prevent waste or prevent the confiscation of property.[10] Once special field rules have been adopted for a given field, the spacing pattern thereby established governs the development of that field rather than the statewide spacing rules. However, spacing exceptions to special field rules are still governed by the provisions of rule 37.

In order to drill a rule 37 exception well (a well which is either proposed or existing at a location in violation of the spacing rules), the operator must first obtain a rule 37 exception permit from the Commission. Three requirements must be met before the Commission can grant the exception permit. First, the party seeking the exception must give all adjacent lessees and unleased mineral owners affected by the proposed exception well a minimum of ten days notice. Second, a hearing must be held, at which all interested parties are allowed to appear and be heard. Finally, the Commission must determine that the exception is necessary to prevent waste or

6. *See* Gulf Land Co. v. Atlantic Ref. Co., 134 Tex. 59, 69, 131 S.W.2d 73, 80 (1939).

7. TEX. ADMIN. CODE ANN. tit. 16, § 3.37(a)(1) (McGraw-Hill 1980).

8. *Id.* tit. 16, § 3.37(b). Rule 37, however, does not apply to certain salt dome oil or gas fields. *Id.* tit. 16, § 3.37(*l*).

9. *Id.* tit. 16, § 3.37(b). Rule 38 regulates the density at which wells can be drilled. *Id.* tit. 16, § 3.38. The proper location of a well thus requires compliance with both rule 37 and rule 38. Rule 38 will not be discussed in this article, but it cannot be ignored by an operator attempting to obtain a permit to drill.

10. *Id.* tit. 16, § 3.37(b), (d); *see also id.* tit. 16, § 3.43 (providing for temporary field rules).

confiscation.[11]

All rule 37 exception permits expire six months from their effective date unless drilling operations have begun.[12] In the event drilling operations have not begun, the applicant may submit a request for renewal of the permit prior to its expiration; generally, such request will be granted. If a rule 37 permit is being litigated, the six-month limitation provision will be tolled until a final decree is entered disposing of the litigation.[13] If an operator is denied a rule 37 permit, he can file a new application, but approval of the second application requires proof of "changed conditions."[14] "Changed conditions" include (1) material changes in the physical condition of the producing reservoir which affect the recovery of oil and gas,[15] (2) material changes in the distribution or allocation of allowable production,[16] (3) additional permits granted by the Commission on surrounding acreage which affect the recovery of oil and gas,[17] and (4) any additional facts affecting the recovery of oil and gas which were not known at the time of the previous hearing or application.[18]

The spacing rule clearly provides that if a well is drilled in violation of this rule, or does not conform in all respects to the terms of the permit, the well must be plugged.[19] Although a well is not often intentionally drilled in violation of rule 37, this penalty must be faced by an operator if he chooses such a course of conduct.

The Commission will not grant an exception to rule 37 unless the applicant can prove that irregular spacing of a well is necessary to prevent waste or confiscation of the applicant's property.[20] Although rule 37 does not itself define "waste" or " confiscation," the Texas courts, through a number of decisions since the 1920's, have

11. Tex. R.R. Comm'n, Rule 051.02.02.037(a)(2), 6 Tex. Reg. 3911, 3912 (1981) (to be codified as TEX. ADMIN. CODE ANN. tit. 16, § 3.37(b)).

12. *Id.* 051.02.02.037(i)(1), 6 Tex. Reg. 3911, 3912 (1981) (to be codified as TEX. ADMIN. CODE ANN. tit. 16, § 3.37(i)(1)). If the exception permit is allowed to expire, a new application must be filed with the Commission, and the whole process begins anew. *Id.*

13. TEX. ADMIN. CODE ANN. tit. 16, § 3.37(i)(2) (McGraw-Hill 1980).

14. *Id.* tit. 16, § 3.37(j).

15. *Id.* tit. 16, § 3.37(j)(1).

16. *Id.* tit. 16, § 3.37(j)(2).

17. *Id.* tit. 16, § 3.37(j)(3).

18. *Id.* tit. 16, § 3.37(j)(4).

19. *Id.* tit. 16, § 3.37(e).

20. *Id.* tit. 16, § 3.37(a).

established certain specific criteria for these terms.

C. *Exceptions to Prevent Waste*

As used in rule 37, waste "means the ultimate loss of oil."[21] When applying for a rule 37 permit to prevent waste, the applicant does not have to establish that his drill site is a legal subdivision. He will not be able to establish that the well will prevent waste simply by showing that "the more wells drilled, the more oil produced."[22] The burden of proof on the applicant for a waste exception to rule 37 is best described by the Texas Supreme Court in *Railroad Commission v. Shell Oil Co.*,[23] the *Trem Carr* case:

> Upon a showing that in a particular field, or in a particular section of a field, on account of the peculiar formation of the underground structure or other unusual circumstances, a closer spacing of the wells is essential to recover the oil, undoubtedly the Commission would have authority to grant the exception, provided that it includes all those and only those coming within the exceptional situation, and providing further, that it did not unduly discriminate in any other manner against producers in other areas or fields.[24]

More recently, the court has apparently expanded its definition of waste to include economic waste. In *Exxon Corp. v. Railroad Commission*,[25] the court upheld a rule 37 permit for the prevention of economic waste, allowing BTA Oil Producers to recomplete a well in an existing wellbore even though the well was too close to existing wells drilled to the same field. BTA had drilled its Wedge No. 1 well to a 13,000 foot reservoir, and its Wedge No. 2 well to a 15,500 foot reservoir. As the deeper reservoir was nearing depletion, BTA sought approval to plug back and recomplete its well No. 2 in the 13,000 foot reservoir. The approval to recomplete required a rule 37 permit since the two BTA wells were only 265 feet apart. Both wells, however, were at a regular location from all off-

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21. Gulf Land Co. v. Atlantic Ref. Co., 134 Tex. 59, 70, 131 S.W.2d 73, 80 (1935).

22. *See, e.g.*, Hawkins v. Texas Co., 146 Tex. 511, 518, 209 S.W.2d 338, 342-43 (1948); Railroad Comm'n v. Shell Oil Co., 139 Tex. 66, 73, 161 S.W.2d 1022, 1026 (1942); Gulf Land Co. v. Atlantic Ref. Co., 134 Tex. 59, 78-79, 131 S.W.2d 73, 84-85 (1939). Testimony that additional wells will produce more oil "is not evidence that will support an exception." Hawkins v. Texas Co., 146 Tex. 511, 518, 209 S.W.2d 338, 342 (1948).

23. 139 Tex. 66, 161 S.W.2d 1022 (1942).

24. *Id.* at 74-75, 161 S.W.2d at 1027.

25. 571 S.W.2d 497 (Tex. 1978).

set wells and lease lines. Furthermore, BTA's tract of land was of such a size that it would have clearly been entitled to a new well in the productive reservoir at a regular location. Exxon protested the rule 37 permit, arguing that BTA was not entitled to an exception based on waste since it had failed to show unusual reservoir conditions.[26]

In upholding the Commission's action, the Supreme Court found economic considerations can be treated as an "unusual condition" in a reservoir for the purpose of showing waste.[27] It is difficult, however, to ascertain the extent to which the "economic waste" holding of the *Exxon* case may be applied to other fact situations. For example, in *Exxon* the proposed well did not crowd lease lines or offset wells.[28] The Commission, moreover, found that no other existing well was capable of producing the oil that would be produced by the Wedge No. 2 well.[29] The facts also supported a finding that economic considerations would not justify the drilling of a new well.[30]

Finally, the court seemed to indicate the particular equities in the case favored BTA over Exxon. There was no suggestion BTA had acted in bad faith in seeking to utilize its existing wells.[31] On the other hand, the court suggested the only purpose Exxon could have had in challenging the permit was to increase its own recovery of the reservoir reserves by imposing delays on BTA's drilling operations.[32]

D. *Exceptions to Prevent Confiscation*

The Texas Supreme Court, in *Gulf Land Co. v. Atlantic Refining Company*,[33] clearly defined the standard for granting an exception to prevent confiscation: "every owner or lessee of land is entitled to a fair chance to recover the oil and gas in or under his land, or their equivalents in kind. Any denial of such fair chance would

26. *See id.* at 498-500.
27. *See id.* at 501.
28. *Id.* at 498.
29. *Id.* at 499.
30. *Id.* at 501.
31. *See id.* at 501.
32. *See id.* at 502.
33. 134 Tex. 59, 131 S.W.2d 73 (1939).

be "confiscation" within the meaning of Rule 37 . . . . "[34] One of the primary reasons for the exception based on confiscation is the protection of the owners of small and irregularly shaped tracts who would not otherwise be able to obtain their fair share of oil and gas.[35] In *Railroad Commission v. Williams*,[36] however, the court held the right to a rule 37 exception to prevent confiscation is not vested in the land itself, but lies with the owner of the land.[37] A small tract owner, therefore, is not necessarily entitled to a first well as a matter of right. Rather, the landowner must show *he* has been denied a fair and equal opportunity to recover his fair share of the oil and gas in place beneath his tract before an exception to prevent confiscation will be granted.[38]

In *Williams*, for example, the applicant received a one half undivided interest in a 3.3 acre tract from his parents, who also owned a contiguous 37.5 acre tract. The 3.3 acre tract was later partitioned, and Williams and his former co-tenant each acquired the full interest in two adjacent 1.65 acre tracts. Williams applied for a drilling permit on a 1.65 acre portion of a 3.3 acre reconstituted tract under the Century Doctrine.[39] Williams then argued that if his predecessors in title had applied for a rule 37 permit to drill on the small tract, a permit would have been granted as a matter of law. Williams concluded, therefore, that he was entitled to such permit to prevent confiscation.

The court, however, concluded Williams' predecessors would not have been entitled to a well.[40] Since the 1.65 acre tract was capable of being adequately drained by an existing well on the contiguous 37.5 acre tract, Williams' predecessors in title would have been unable to show *they* needed an exception to prevent confiscation on

34. *Id.* at 71, 131 S.W.2d at 80.

35. *See* Dailey v. Railroad Comm'n, 133 S.W.2d 219, 221 (Tex. Civ. App.—Austin 1939, writ ref'd). *See generally* Hardwicke & Woodward, *Fair Share and the Small Tract in Texas*, 41 TEXAS L. REV. 75 (1962).

36. 163 Tex. 370, 356 S.W.2d 131 (1961).

37. *Id.* at 376, 356 S.W.2d at 135.

38. *Id.* at 378, 356 S.W.2d at 136.

39. Under the Century Doctrine, discussed *infra*, when a tract is subdivided so that none of the resulting tracts is entitled to a well, the Commission can reconstruct the original tract and grant a rule 37 exception. *See* Railroad Comm'n v. Magnolia Petroleum Co., 130 Tex. 484, 489, 109 S.W.2d 967, 970-71 (1937).

40. *See* Railroad Comm'n v. Williams, 163 Tex. 370, 376, 356 S.W.2d 131, 134 (1961).

the smaller tract.[41] Because the applicant could have no greater right to drill a well than his predecessors, the rule 37 permit was denied. To do otherwise, the court reasoned, would create valuable mineral rights in a grantee which his grantors did not have.[42] Thus, the applicant for a rule 37 permit must prove not only that the small tract is being drained, but also that the applicant and his predecessor in title have not had a fair and reasonable opportunity to recover the oil and gas beneath the small tract from wells on surrounding acreage in which either has an interest.

Perhaps the most common ground for granting rule 37 permits is that an exception location is necessary to obtain a commercially productive well. For example, an operator may be relatively certain an exception location will result in a well capable of commercial production. If the operator is forced to drill in a regular location, he may face an unreasonable risk that this site will yield a noncommercial well. That risk may be so great as to prevent him from drilling a well at all, thereby resulting in confiscation of his interests in the oil and gas beneath his land. Although at least one opinion seems to implicitly recognize this justification for a spacing exception,[43] there is apparently no court decision expressly adopting this particular economic factor as a valid consideration in determining confiscation.

E. *The Voluntary Subdivision Rule*

The right to a rule 37 exception to prevent confiscation is subject to the "voluntary subdivision rule."[44] Rule 37 provides that

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41. *Id.* at 379, 356 S.W.2d at 137.

42. *Id.* at 380, 356 S.W.2d at 137.

43. *See* Imperial Am. Resources Fund, Inc. v. Railroad Comm'n, 557 S.W.2d 280, 286-88 (Tex. 1977). In the *Imperial* case, the applicant sought to locate its well at a more favorable location which required rule 37 exception. The applicant, however, further alleged that if it were required to drill at a regular location, it would suffer confiscation through drainage. *See id.* at 281. The exception permit was granted by the Commission, which concluded that the exception was "necessary to afford applicant a reasonable opportunity to recover . . . hydrocarbons underlying applicant's lease . . . and . . . to protect applicant's correlative rights and prevent confiscation of applicant's property." *Id.* at 283. The trial court upheld the validity of the Commission's action and the supreme court affirmed, concluding that there was substantial evidence to support the granting of the exception. *See id.* at 286.

44. *See generally* Comment, *The Voluntary Subdivision Rule*, 40 TEXAS L. REV. 254 (1961).

every owner of land can apply for an exception to prevent the confiscation of his property.[45] The voluntary subdivision rule prevents the granting of such exceptions where the landowner has segregated property for the purpose of obtaining additional drilling rights he would not have had in the absence of such segregation.[46] A mineral owner may have adequate acreage for the drilling of one well at a regular location but would like to drill more wells than allowed under the applicable spacing rules. In the absence of the voluntary subdivision rule, such owner could sell the mineral rights under his land to different persons, creating in each of those individuals a valuable right to a well for the prevention of confiscation. The right to a rule 37 exception in this situation would circumvent the spacing pattern and destroy the orderly development of oil and gas reservoirs. The voluntary subdivision rule is designed to prevent this frustration of conservation goals.

On May 29, 1934, the Commission adopted the "Rule of May 29th," or what has come to be known as the "voluntary subdivision rule."[47] As originally promulgated, the Rule of May 29th simply provided that subdivisions of property created subsequent to the adoption of the original spacing rule would not be considered in determining whether or not such subdivision was being confiscated under the terms of rule 37.[48]

In *Gulf Land Co. v. Atlantic Refining Co.*, however, the Texas Supreme Court found the rule uses the term "subdivision" to define tracts of land that do not have a right to a rule 37 exception to prevent confiscation and that such term does not strictly apply to all subdivisions of land occurring after May 29, 1934.[49] The court stated that "a tract will be regarded as a subdivision within the meaning of the Rule of May 29th . . . if it was subdivided out of a larger tract after Rule 37 became effective,"[50] provided the subdivided tract is of such a shape and size that a permit to drill a well thereon requires an exception to rule 37.[51] The key to this holding is the determination of "when" rule 37 becomes effective for pur-

45. *See* TEX. ADMIN. CODE ANN. tit. 16, § 3.37(a) (McGraw-Hill 1981).
46. *See id.* tit. 16, § 3.37(g).
47. *See* Gulf Land Co. v. Atlantic Ref. Co., 134 Tex. 59, 66, 131 S.W.2d 73, 78 (1939).
48. *See id.* at 66, 131 S.W.2d at 78.
49. *See id.* at 72, 131 S.W.2d at 81.
50. *Id.* at 72, 131 S.W.2d at 81.
51. *Id.* at 72, 131 S.W.2d at 81.

poses of the voluntary subdivision rule.

Today, the Commission has specifically defined when rule 37 attaches by the language of the rule itself.[52] Under rule 37, the segregation of a tract of land (which results in a subdivided tract of such a size or shape that a rule 37 exception is required to drill a well thereon) in contemplation of oil and gas development is a voluntary subdivision, as is the fee conveyance of a small or irregularly shaped tract after the discovery of oil and gas in surrounding reservoirs that prove to exist beneath the subdivided tract.[53] Generally, the date of attachment of the voluntary subdivision rule is the date of discovery of a given field for which a permit is sought,[54] or any lateral extensions of the same field even though the lateral extension is not determined to exist until a later date.[55]

F. *The Common Ownership and Control Doctrine*

In *Railroad Commission v. Humble Oil & Refining Co.*,[56] the Texas Supreme Court held the voluntary subdivision rule does not apply to a tract of land unless that land has at one time been under common ownership and control with surrounding lands.[57] The common ownership and control doctrine, as applied in *Humble Oil*, is only applicable when a person's interests in two adjacent tracts are identical and complete.[58] In this situation, those adjacent tracts of land will thereafter be treated as one tract for purposes of rule 37.[59] For example, if *A* owns a tract of land subject to an oil and gas lease and he later acquires title to an adjacent tract, the two tracts have not come under common ownership and control because of the outstanding lease on the first tract.[60] Likewise, if during the term of the lease, *A* sells an undivided interest in the minerals under the second tract and the lease on the first tract

52. *See* TEX. ADMIN. CODE ANN. tit. 16, § 3.37(g)(3)-(7) (McGraw-Hill 1980).
53. *Id.* tit. 16, § 3.37(g)(2)(A)-(B).
54. *Id.* tit. 16, § 3.37(g)(3)-(4).
55. *Id.* tit. 16, § 3.37(g)(5)-(7).
56. 151 Tex. 51, 245 S.W.2d 488 (1952).
57. *Id.* at 56, 245 S.W.2d at 490. *See generally* Meyers, *"Common Ownership And Control" In Spacing Cases*, 31 TEXAS L. REV. 19 (1952).
58. *See* Railroad Comm'n v. Humble Oil & Ref. Co., 151 Tex. 51, 56, 245 S.W.2d 488, 490 (1952).
59. *See id.* at 56, 245 S.W.2d at 490.
60. *See id.* at 55-56, 245 S.W.2d at 490.

subsequently expires, the tracts have not come under common ownership and control by reason of the joint ownership of the minerals.[61] No case has discussed what effect the opinion in *Railroad Commission v. Williams* has on the common ownership and control doctrine. It may be that under *Williams* a landowner or lessee may be faced with a claim of common ownership and control when all of the interests are not identical.[62]

G. *The Century Doctrine*

The "Century Doctrine," as announced in *Railroad Commission v. Magnolia Petroleum Co.*,[63] provides a method by which the owner of a voluntarily subdivided tract can obtain a rule 37 permit to drill a well for the prevention of confiscation. The Century Doctrine applies when an applicant for a rule 37 permit shows that even though his tract of land is a voluntary subdivision, the original tract (the last legal subdivision) from which his tract was segregated is entitled to independent oil and gas development.[64] In this situation, the subdivided tracts are reconstructed as the single tract from which they were segregated.[65] The applicant must further show that the original tract would have supported a regular location, or that the owner of the tract would have had the right to a rule 37 exception for the prevention of confiscation.[66] Finally, the applicant's most important burden of proof is to establish, based on engineering and/or geological evidence, that the location of such a well would have been, and should now be, on the applicant's

61. *See id.* at 55, 245 S.W.2d at 490.

62. *Compare* Railroad Comm'n v. Williams, 163 Tex. 370, 356 S.W.2d 131 (1961) *with* Railroad Comm'n v. Humble Oil & Ref. Co., 151 Tex. 51, 245 S.W.2d 488 (1952). In *Williams*, the applicant sought an exception to drill on a 1.65 acre tract which was created by partitioning a 3.3 acre tract he and another had owned as tenants in common. Railroad Comm'n v. Williams, 163 Tex. 370, 374, 356 S.W.2d 131, 133-34 (1961). Williams had acquired his interest in the 3.3 acre tract from his parents, who once owned the full interests in the 3.3 acre tract and an adjoining 37.5 acre tract. *Id.* at 372-74, 356 S.W.2d at 132-33. Under *Humble Oil*, it would seem that Williams one-half interest in the 1.65 acre tract was neither identical nor complete with his parents' interest in the 37.5 acre tract. The supreme court, moreover, simply assumed without deciding that William's parents' conveyance of a ½ interest in the 3.3 acre tract created a separate tract that remained separate until partitioned. *Id.* at 375, 356 S.W.2d at 134,

63. 130 Tex. 484, 109 S.W.2d 967 (1937).

64. *See id.* at 488, 109 S.W.2d at 970-71.

65. *See* Railroad Comm'n v. Williams, 163 Tex. 370, 379, 356 S.W.2d 131, 137 (1961).

66. *See id.* at 379, 131 S.W.2d at 137.

tract. In *Humble Oil and Refining v. Lasseter Co.*,[67] the Austin Court of Civil Appeals explained the doctrine as follows:

> Where, independently of the voluntary segregation, the larger tract, including the segregated tract, is entitled to an additional well in order to protect the vested rights of owners of such larger tract to recover their fair share of the oil thereunder in place, the permit to drill on the segregated tract will be upheld. And this, although the application be made to drill only upon the voluntarily segregated tract and only by the owners of that tract, and be contested by the owners of the remaining portion of the larger tract.[68]

Once it is determined that the Century Doctrine applies, two more difficult questions arise: where should the well to prevent confiscation be located, and who has the right to production from such well? The Texas Supreme Court answered these questions in *Ryan Consolidated Petroleum Corp. v. Pickens*,[69] holding that the well should be at a location on the larger tract as a whole that would best prevent the drainage of the larger tract in light of the evidence presented.[70] The court further held that the Commission does not have the power to unitize the segregated tracts; therefore, the oil produced from such well belongs entirely to the owners of the minerals under the segregated tract upon which the well is located.[71] The owners of the other segregated tracts cannot share in the production from the well on the reconstituted tract, but can obtain a rule 37 permit to drill on their segregated tract only on a showing that such well will prevent waste. Since 1965, with the adoption of the Mineral Interest Pooling Act, discussed later in this article, the non-drill site landowner may have a way to force pool into the adjoining well.[72]

67. 120 S.W.2d 541 (Tex. Civ. App.—Austin 1938, writ dism'd).

68. *Id.* at 542; *accord* Railroad Comm'n v. Magnolia Petroleum Co. 125 S.W.2d 398, 401 (Tex. Civ. App.—Austin 1939, writ ref'd).

69. 155 Tex. 221, 285 S.W.2d 201 (1955), *cert. denied*, 351 U.S. 933 (1956).

70. *Id.* at 227-28, 285 S.W.2d at 205-06.

71. *Id.* at 230, 285 S.W.2d at 207.

72. *See id.* at 229, 285 S.W.2d at 206 (citing Gulf Land Co. v. Atlantic Ref. Co., 134 Tex. 59, 131 S.W.2d 73 (1939)). At the time *Ryan* was decided, the Mineral Interest Pooling Act, Tex. Nat. Res. Code Ann. §§ 102.001-102.112 (Vernon 1978), had not been adopted. The Act is discussed *infra*, and should be considered as a possible remedy for the party who does not acquire the right drill on his tract under the Century Doctrine.

H. *Proration of Production*

The drilling of rule 37 wells on small tracts has historically presented a problem of how to allocate production to such wells.[73] The issue has focused on the right of a small tract owner to drill a "profitable" well versus the right of offsetting owners to prevent unreasonable confiscation of oil and gas beneath their land. Many in the industry and legal profession speculated that the decisions of the Texas Supreme Court in *Atlantic Refining Co. v. Railroad Commission*,[74] the *Normanna* case, and *Halbouty v. Railroad Commission*,[75] the *Port Acres* case, would cause rule 37 to decline in importance since the small tract owners could no longer receive more than their proportionate share of oil and gas under the proration system.[76] Due to the increased demand for natural gas and the resultant increase in allowable production, however, rule 37 has continued to be a source of controversy since profitable wells can be drilled on small tracts even when such tracts will receive a reduced allowable.

73. *See, e.g.*, Railroad Comm'n v. Mackhank Petroleum Co., 144 Tex. 393, 190 S.W.2d 802 (1945); Marrs v. Railroad Comm'n, 142 Tex. 293, 177 S.W.2d 941 (1944); Railroad Comm'n v. Humble Oil & Ref. Co., 193 S.W.2d 824 (Tex. Civ. App.—Austin 1946, writ ref'd n.r.e), *aff'd per curiam*, 331 U.S. 791, *reh. denied*, 332 U.S. 786 (1947).

74. 162 Tex. 274, 346 S.W.2d 801 (1961).

75. 163 Tex. 417, 357 S.W.2d 364, *cert. denied*, 371 U.S. 888 (1962).

76. Prior to these two decisions, many field rules included a proration formula for production on the basis of ⅓ per well and ⅔ per surface acre. As explained by the supreme court in the *Normanna* case:

> The ⅓-⅔ formula means that ⅓ of the total field allowable must be divided equally among all the wells in the field and that ⅔ of the total field allowable will be divided among all the wells on a per acre basis. Under this formula a well on a .3 acre tract would be allowed to produce many times more gas per acre than would a well on a 320 acre tract . . . .

Atlantic Ref. Co. v. Railroad Comm'n, 162 Tex. 274, 277, 346 S.W.2d 801, 803 (1961). In *Normanna*, the Texas Supreme Court invalidated this formula as applied to the Normanna Field. *Id.* at 289, 346 S.W.2d at 811. Similarly, in *Halbouty*, the court invalidated a ⅓-⅔ proration formula applied by the Commission in the Port Acres Field. Halbouty v. Railroad Comm'n, 163 Tex. 417, 434-35, 357 S.W.2d 364, 375-76, *cert. denied*, 371 U.S. 888 (1962).

III. Rule 10: Restriction of Production of Oil and Gas from Different Strata

A. *Introduction*

Oil and gas exist underground in layers of porous rock, referred to as strata or reservoirs. A single well may encounter one or more strata of oil and gas and, in many instances, those separate strata are produced through separate strings of tubing within a single wellbore. There are, however, certain well conditions which make such production either mechanically infeasible or uneconomical. In such situations an operator will seek to produce through a single string, thereby causing the separate strata of oil and gas to be commingled downhole prior to recovery at the surface. Some fields are made up of literally tens or hundreds of small lenticular sands, limestone, dolomites or other oil or gas bearing rock separated by tens or hundreds of small non-porous shales or non-oil and gas bearing rock.

Statewide rule 10 regulates downhole commingling by generally prohibiting production from different strata through the same string of casing.[77] This rule was promulgated in response to a legislative directive to prevent "oil and gas and water from escaping from the strata in which they are found into another strata."[78] While the Commission's practice was to grant exceptions to this general rule upon a proper showing that waste would be prevented, the express language of rule 10 until recently prohibited *all* downhole commingling.

This policy, coupled with several court challenges to rule 10 required the Texas Legislature to grant the Commission authority to commingle oil and gas from multiple stratigraphic or lenticular accumulations of hydrocarbons when necessary to prevent waste, promote conservation or protect correlative rights.[79] As a result, rule 10(b) was promulgated to provide an exception to the general prohibition whenever necessary to prevent the wasting of the state's natural resources.

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77. Tex. Admin. Code Ann. tit. 16, § 3.10 (McGraw-Hill 1981).

78. Tex. Nat. Res. Code Ann. §§ 85.202(a)(5), 86.042(6) (Vernon 1978). Rule 10 is a broader prohibition than envisioned by these statutes. For example, the statutes would not prevent production by downhole commingling *unless* cross-flow would occur.

79. *Id.* §§ 85.046(b), 86.012(b) (Vernon Supp. 1982).

B. *Basic Requirements of Rule 10*

Rule 10(a) prevents oil or gas from escaping from the strata in which it naturally occurs into another strata by prohibiting the production of oil or gas, or oil and gas from different strata through the same string of casing.[80] For example, if an operator discovers a productive gas zone in a well at 8,000 feet and another production zone at 10,000 feet, the operator must separate the zones from each other mechanically in the wellbore before producing gas from the two zones. Normally an operator dually completes such a well by running a different string of production tubing to each interval, thereby producing the oil or gas from each zone separately and avoiding downhole commingling. Without separate tubing, the gas from the zone with the highest pressure may move through the wellbore and actually enter the zone with the lower pressure, causing the loss of hydrocarbons that are otherwise recoverable. This phenomenon is called "cross-flow."

Production by downhole commingling will not always result in such waste, however, and whether cross-flow will occur is one of the most important factors considered by the Commission in an application for an exception to rule 10. In addition, numerous producing formations in Texas are made up of many individual sand or porosity stringers that do not economically justify separate completions.[81] There are other situations in which different strata have been separately produced in a well but the downhole commingling of these zones would prolong the economic life of the well and increase the ultimate net recovery from each zone.

Consequently, under rule 10(b) the Commission may grant exceptions to its general prohibition by allowing the downhole commingling of oil or gas from different strata if commingling will prevent waste, promote conservation or protect correlative rights.[82] An initial rule 10 exception for the commingling of certain strata may be granted only after notice and a hearing at which all interested persons may be heard.[83] Subsequent exceptions for different wells

80. TEX. ADMIN. CODE ANN. tit. 16, § 3.10(a) (McGraw-Hill 1981).

81. Running separate production tubing is a costly process and involves the danger of damaging the well. In fact, operators sometimes find that it is cheaper and safer to drill and complete two separate wells than to separately produce two zones from a single well.

82. TEX. ADMIN. CODE ANN. tit. 16, § 3.10(b)(1) (McGraw-Hill 1981).

83. *Id.* tit. 16, § 3.10(b)(1).

producing from the same strata will be issued administratively if no protests are entered by offset operators.[84]

C. *Commission Review of Rule 10 Applications*

Rule 10 is a relatively short and simple regulation. In most cases, applications for exceptions to the rule are not contested. Nonetheless, the Commission reviews each application carefully, whether or not it is protested, primarily considering four issues:

> (1) whether the commingling of oil or gas from different strata will increase the ultimate recovery of hydrocarbons;
> (2) whether the downhole commingling will result in cross-flow between the strata that might permanently damage either reservoir or otherwise cause waste;
> (3) whether the mineral ownership is the same as to both two zones; and
> (4) whether the commingling will cause a mineral owner to be deprived of his correlative rights to oil and gas in place.

The applicant for an exception to rule 10 must address these issues to the satisfaction of the Commission, thereby establishing that the downhole commingling of oil or gas is necessary to prevent waste, promote conservation or protect correlative rights.[85]

D. *Rule 10 and Proration*

The Natural Resources Code defines waste as, among other things, the loss resulting from operating a well in a manner that "tends to reduce the total ultimate recovery of oil or gas from any pool."[86] In order to prevent waste and achieve greater ultimate recovery, the Commission prorates the production of oil and gas within the State of Texas.[87] Prior to June 16, 1981, the conservation statutes authorized the Commission to prorate production from "pools" or "common sources of supply," but said nothing about the proration of production from commingled reservoirs. The Commission has historically prorated production from sepa-

84. *Id.* tit. 16, § 3.10(b)(2).
85. *Id.* tit. 16, § 3.10(b)(1).
86. TEX. NAT. RES. CODE ANN. § 85.046(a)(6) (Vernon Supp. 1982); *see also id.* § 85.046(a)(1)-(10).
87. *See id.* §§ 85.053, 85.054, 85.055 (Vernon 1978); *see also* TEX. ADMIN. CODE ANN. tit. 16, §§ 3.31, 3.52 (McGraw-Hill 1981).

rate sources of supply that were being produced by the downhole commingling of oil or gas as if those strata were one common reservoir of hydrocarbons. In 1977, however, the Commission's authority was challenged, resulting in one Texas Supreme Court decision and two legislative enactments.

E. *The Boonsville Story*

1. Background

On November 1, 1957, the Commission designated as the Boonsville (Bend Conglomerate Gas) Field a large accumulation of lenticular and multi-stratigraphic reservoirs of gas for the purpose of prorating production from those strata.[88] This action effectively resulted in an exception to rule 10 by allowing production from the many strata through a single string of casing. In addition, the Commission, consistent with its historical practice, prorated the production from such separate accumulations as if it were from a single source of supply.

On August 1, 1975, the Commission suspended proration in the Boonsville Field "until conditions change sufficient to require reinstatement."[89] With the removal of proration, every well in the field could produce at capacity, and it became profitable to drill wells on small, "legally subdivided" tracts that would otherwise have a limited allowable had the acreage proration formula been in effect. Less than three years after proration had been suspended, the operators in the field that had initially requested suspension asked the Commission to reinstate proration claiming that the wells on small tracts were recovering more than their fair share of gas in place. On July 31, 1978, the Commission reinstated proration in

88. *See* Docket No. 9-36,420, Combining 27 Fields in Jack and Wise Counties, Texas, and Adopting Operating Rules for the Combination Designated Boonsville (Bend Conglomerate Gas) Field, Jack and Wise Counties, Texas (Nov. 1, 1957).

89. Letter from Billy D. Thomas (Senior Staff Geologist, Railroad Commission of Texas) to all operators in the Boonsville (Bend Conglomerate Gas) Field, Wise, Jack and Parker Counties, Texas (July 1, 1975); *see* Gage v. Railroad Comm'n, 582 S.W.2d 410, 412 (Tex. 1979).

the Boonsville Field on a 100% acreage allocation formula.[90]

2. Boonsville Proration Challenged in Court

The owners of wells on the small tracts, "the Gage group," appealed the Commission's reinstatement of proration in the Boonsville Field claiming that the Commission did not have statutory authority to prorate production from separate reservoirs on a consolidated basis. The Travis County District Court affirmed the Commission order. The Texas Supreme Court, in *Gage v. Railroad Commission*,[91] reversed the district court, holding that "the commission had no statutory authority to combine several common reservoirs into a single field for proration purposes. Instead, the legislature had only authorized the commission to prorate the daily gas production from '*each common reservoir*' in order to prevent waste or to adjust correlative rights."[92]

The opinion in the *Gage* case did not prohibit the downhole commingling of oil and gas. Rather, the decision was based on previous holdings of the court that the Commission lacked statutory authority to combine several common reservoirs into a single field for proration purposes.[93] Since the Commission lacked authority to combine separate zones, the court found the Commission necessarily lacked authority to prorate any zones artificially connected by downhole commingling.[94] As a result of the court's limited interpretation of the Commission's powers, all wells producing from these zones would be able to produce at full capacity if downhole commingling in separate zones was allowed. Consequently, the Commission began denying all requests for rule 10 exceptions in

90. *See* Docket No. 9-67,936, Special Order Reinstating Amended Allowable Allocation and Amending Field Rules 2 and 3 for the Boonsville (Bend Conglomerate Gas) Field, Jack, Wise, Parker, and Denton Counties, Texas (July 31, 1978).

91. 582 S.W.2d 410 (Tex. 1979).

92. *Id.* at 413 (emphasis by the court).

93. *See id.* at 413; *see also* Railroad Comm'n v. Grafford Oil Corp., 557 S.W.2d 946 (Tex. 1977); Railroad Comm'n v. Shell Oil Co., 380 S.W.2d 556 (Tex. 1964); Benz-Stoddard v. Aluminum Co. of America, 368 S.W.2d 94 (Tex. 1963). In *Grafford*, decided two years before *Gage*, the court held the Commission could not prorate production from separate zones that were being produced on a consolidated basis. *See* Railroad Comm'n v. Grafford Oil Corp., 557 S.W.2d 946, 953 (Tex. 1977). The Commission apparently ignored the court's holding in *Grafford* since the Commission's practice of prorating production from separate strata was not changed until after the *Gage* decision.

94. *See* Gage v. Railroad Comm'n, 582 S.W.2d 410, 414-15 (Tex. 1979).

order to maintain the integrity of its statewide proration system.

3. Legislative Reaction

When the *Gage* decision was rendered, rule 10 was a total prohibition of downhole commingling and contained no provision authorizing the Commission to grant exceptions. Following *Gage*, the Texas Legislature enacted Senate Bill 257[95] which amended sections 85.046 and 86.012 of the Texas Natural Resources Code by adding the following clause to each:

> Notwithstanding the provisions contained in this section or elsewhere in this code or in other statutes or laws, the Commission may permit production by commingling oil or gas or oil and gas from multiple stratigraphic or lenticular accumulations of oil or gas or oil and gas where the commission, after notice and hearing, has found that producing oil or gas or oil and gas in a commingled state will prevent waste, promote conservation or protect correlative rights.[96]

Subsequent to the passage of Senate Bill 257, the Commission amended rule 10 to allow exceptions when commingling would prevent waste, promote conservation or protect correlative rights.[97] The amendment further provided that "commingled production pursuant to [an exception to] this rule shall be considered production from a common source of supply for purposes of proration and allocation."[98]

In October of 1979, and as a result of Senate Bill 257, the Commission called a hearing to reconsider the Boonsville proration order. The Commission's final order reinstated proration on a 100% acreage allocation formula,[99] and once again the small tract owners appealed the Commission order claiming that Senate Bill 257 did not grant authority to the Commission to *prorate* production from separate reservoirs on a consolidated basis. On April 17, 1981, the District Court of Travis County reversed the Commission order insofar as it prorated the Boonsville Field.[100] This decision was based

95. 1979 Tex. Gen. Laws, ch. 300, §§ 1-2, at 673-75.

96. TEX. NAT. RES. CODE ANN. §§ 85.046, 86.012 (Vernon Supp. 1982).

97. *See* TEX. ADMIN. CODE ANN. tit. 16, § 3.10(b) (McGraw-Hill 1981).

98. *Id.* tit. 16, § 3.10(c).

99. *See* Docket No. 9-72,922, Final Order Adopting Rules and Regulations for the Boonsville (Bend Conglomerate Gas) Field, Wise County, Texas (Oct. 20, 1980).

100. *See* Mote Resources, Inc. v. Railroad Comm'n, No. 315,152 (Dist. Ct. of Travis County, 200th Judicial Dist., April 17, 1981).

on the court's interpretation that Senate Bill 257 granted authority to the Commission to allow downhole commingling for *production purposes*, but did *not* grant authority to the Commission to *prorate* the production obtained as a result of downhole commingling. While the Commission has perfected its appeal, no decision has been rendered in that case.[101]

After the Travis County District Court reversed the Commission, the parties seeking proration in the Boonsville Field went back to the legislature in an attempt to plug the gap found to exist in Senate Bill 257 by the district court. As a result of that effort, Senate Bill 1146 became law on June 16, 1981, amending sections 85.053, 85.055 and 86.081 of the Natural Resources Code to grant the Railroad Commission authority to prorate production from commingled zones as if they were a single pool.[102] Since Senate Bill 1146 was the result of a compromise reached in the legislature, however, the Commission's proration authority is restricted. Among other things, the Commission is specifically denied the power to extend the vertical or areal limits of fields with Commission established discovery dates between January 1, 1940 and June 1, 1945,[103] by the exercise of its commingling and allocation powers should there be proof of completion in a separate accumulation lying outside the presently defined field.[104] Furthermore, in setting an allowable the Commission must use an allocation formula of not less than two factors, rather than permitting an allowable based upon, for example, 100% acreage for the field.[105]

On July 8, August 18 and August 19, 1981, the Commission held

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101. *See* Mote Resources, Inc. v. Railroad Comm'n, No. 315,152 (Dist. Ct. of Travis County, 200th Judicial Dist., April 17, 1981), *appeal docketed*, No. 13,514 (Tex. Civ. App.—Austin, June 15, 1981). Because the Commission perfected its appeal, the judgment of the district court was effectively superseded. Accordingly, the Commission continued to enforce its proration formula. On June 17, 1981, however, the Austin Court of Civil Appeals enjoined the Commission's enforcement of its proration order pending disposition of the Commission's appeal. *See* Mote Resources, Inc. v. Railroad Comm'n, 618 S.W.2d 877 (Tex. Civ. App.—Austin 1981, no writ).

102. *See* 1981 Tex. Sess. Law Serv., ch. 688, §§ 1-3, at 2578-80 (Vernon).

103. *See* Tex. Nat. Res. Code Ann. §§ 85.053(b)(i), 85.055(d)(i), 86.081(b)(i) (Vernon Supp. 1982).

104. *See id.* §§ 85.053(b)(ii), 85.055(d)(ii), 86.081(b)(ii). This restriction applies to all fields with Commission-established discovery dates between January 1, 1940 and June 1, 1945. While there may be other reservoirs affected by this limitation, the thrust of such provision was that it apply primarily to the Boonsville Field.

105. *See id.* §§ 85.053(b)(iii), 85.055(d)(iii), 86.081(b)(iii).

hearings to determine the appropriate allocation formula for the Boonsville Field pursuant to Senate Bill 1146. On July 20, 1981, the Commission adopted an interim proration formula pending a final order in the hearing, based 90% upon acreage and 10% upon well deliverability.[106] No final order has yet been entered by the Commission in this proceeding.

IV. THE TEXAS FORCED POOLING STATUTE

A. *Historical Background*

Among the states with significant oil and gas production during the first 60 years of this century, Texas was one of the last to adopt a forced pooling statute. Texas has historically been one of the last bastions of the small wildcatter and, partly as a result, a powerful lobby of small tract mineral interest owners had repeatedly repelled the attempts of larger companies to pass such a law. Prior to 1961, such small tract owners were at a great advantage in this state because allowable production of oil and gas was generally allocated, in part, on a per well basis. Under a ⅓ per well, ⅔ per acre gas proration formula, an owner of a small tract could drill a well and produce gas in quantities exceeding the recoverable reserves underlying his acreage. The per well formulas for oil wells were 75% acreage-25% per well, and 50% acreage-50% per well.[107]

On March 8, 1961, the Texas Supreme Court issued the famous *Normanna* decision. Because of that opinion and those that followed it, producing reservoirs could not be prorated with a formula that gives small tracts more than their fair share of oil and gas in place.[108] The *Normanna* decision ignited a new legislative force and within four years the Texas Legislature adopted the Mineral Interest Pooling Act (MIPA).[109] Since it became effective on August 29, 1965, the MIPA has been amended twice, first in 1971,[110]

106. *See* Docket No. 9-76,824, Interim Order (July 20, 1981).

107. *See generally* Smith, *The Texas Compulsory Pooling Act* (pt. 1), 43 TEXAS L. REV. 1003, 1003-07 (1965).

108. *See* Atlantic Ref. Co. v. Railroad Comm'n, 162 Tex. 274, 289, 346 S.W.2d 801, 811 (1961).

109. 1965 Tex. Gen. Laws, ch. 11, §§ 1-2, at 24-26 (originally codified as Tex. Rev. Civ. Stat. Ann. art. 6008c, recodified as TEX. NAT. RES. CODE ANN. §§ 102.001-102.112 (Vernon 1978)).

110. *See* 1971 Tex. Gen. Laws, ch. 903, § 1, at 2793-94.

and again in 1977[111] when the act was codified as chapter 102 of the Natural Resources Code. The MIPA has been described as "an Act to encourage voluntary pooling,"[112] and is not an attempt by the state to usurp control of the development of hydrocarbons in Texas.

B. *Application of MIPA*

By definition, the MIPA is strictly limited to the pooling of interests in oil and gas.[113] The statute is also restricted to the pooling of interests in fields "discovered and produced" after March 8, 1961,[114] the date of the *Normanna* decision.

1. MIPA and State Owned Mineral Interests

The development of most state owned lands for production of oil and gas has always been under the general supervision of the Commissioner of the General Land Office and the School Land Board.[115] The MIPA is expressly not applicable to lands owned by the state or lands in which the state has a direct or indirect interest.[116] Furthermore, the statute has no effect on the exclusive authority of the General Land Office to control such lands.[117] If, however, the General Land Office either seeks to pool under the MIPA or consents to the same, land in which the State of Texas has an interest may be pooled under the provisions of this statute.[118]

Exxon Corporation v. First National Bank of Midland[119] is the only reported case in which the courts have construed the applicability of the MIPA to state owned lands. The plaintiffs, surface owners of Relinquishment Act[120] lands, brought suit to set aside an order of the Railroad Commission which pooled their lands under the MIPA. Plaintiffs claimed that the consent of the General Land

111. *See* 1977 Tex. Gen. Laws, ch. 871, art I, § 1, at 2570-74.

112. Address by Walter Koch, Mineral Law Section Meeting, Texas State Bar Convention (July 2, 1965), *quoted in* Smith, *The Texas Compulsory Pooling Act* (pt. 1), 43 TEXAS L. REV. 1003, 1009 (1965).

113. *See* TEX. NAT. RES. CODE ANN. § 102.002(1) (Vernon 1978).

114. *Id.* § 102.003.

115. *See* TEX. NAT. RES. CODE ANN. § 52.001-52.296 (Vernon 1978 & Supp. 1982).

116. *Id.* § 102.004(a).

117. *Id.* § 102.004(b).

118. *Id.* § 102.004(d).

119. 529 S.W.2d 110 (Tex. Civ. App.—El Paso 1975, writ ref'd n.r.e.).

120. TEX. NAT. RES. CODE ANN. §§ 52.171-52.186 (Vernon 1978 & Supp. 1982).

Office was not valid because the office failed to follow the statutory procedures for the voluntary pooling of the state lands. The court, however, held that the General Land Office consent was valid, and that the provisions of the Natural Resources Code governing the voluntary pooling of state lands[121] were inapplicable to the state in a proceeding under the MIPA.[122]

2. Jurisdictional and Notice Prerequisites to Invocation of MIPA

Section 102.011 must be read carefully to determine whether or not the Commission has authority to issue a pooling order applicable to any given set of facts. The following list is a practical attempt to break-down the provisions of section 102.011 so that the practitioner can determine whether or not his client can successfully invoke the authority of the Commission.[123]

(1) The applicant must have made a "fair and reasonable offer to pool voluntarily."
(2) The Commission must have adopted temporary or permanent field rules for the reservoir in which the interests to be pooled lie. This requirement will often necessitate that an applicant request the adoption of temporary field rules before making the application to force pool.[124]
(3) There must exist two or more separately owned tracts of land embraced within a common reservoir.
(4) There must also be separately owned interests in oil and gas in the existing or proposed proration unit.
(5) The owners must not have agreed to pool their interests.
(6) At least one of the owners of the right to drill must have drilled or propose to drill.
(7) There must be a proper application by a person specified in section 102.012 of the Code.
(8) Finally, the Commission's approval of the application must avoid the drilling of unnecessary wells, protect correlative rights or pre-

121. *Id.* §§ 52.151-52.153.

122. *See* Exxon Corp. v. First Nat'l Bank of Midland, 529 S.W.2d 110, 114 (Tex. Civ. App.—El Paso 1975, writ ref'd n.r.e.).

123. Section 102.011 requirements are not the only prerequisites to forced pooling under MIPA. Section 102.011 is of particular importance, however, as it deals with the authority of the Commission in a MIPA proceeding.

124. An application for temporary field rules under rule 43 requires notice and a hearing. *See* TEX. ADMIN. CODE ANN. tit. 16, § 3.43 (McGraw-Hill 1980).

vent waste.[125]

A forced pooling applicant must also comply with the notice requirements in the MIPA. The statute requires 30 days personal notice to all interested parties before the hearing is held, and the Commission requires notice by publication at least 30 days prior to the hearing.[126]

C. *MIPA Applies Only After Voluntary Efforts Have Failed*

The Texas forced pooling statute is unique in that its primary emphasis is to encourage parties to pool their interests on a voluntary basis. Based on the low number of reported cases, it appears that the statutory intent has been accomplished during the sixteen years since the enactment of this law. Section 102.011 provides that the Commission has authority to establish a pooled unit only when the parties have *not* agreed to pool their interests.[127] In order to enforce this requirement, section 102.013 requires the applicant to set forth in detail the nature of the voluntary pooling offers that have been made to other interest owners in the proposed unit.[128] The applicant is not only required to make a voluntary offer before pursuing his MIPA remedy, but that offer must also be "fair and reasonable."[129] If the Commission finds that the applicant has not made a "fair and reasonable" offer, it must dismiss the application.[130]

Defining precisely what constitutes a "fair and reasonable" offer has been an extremely difficult task. In *Railroad Commission v. Coleman*,[131] there is dicta to the effect that in order for an offer to be fair and reasonable it must allocate production with some consideration of factors other than surface acreage alone.[132] Two years later, however, the statute was amended to provide that an offer by an owner within an existing proration unit "to share on the same yardstick basis" as the other owners within the existing unit shall

125. *See* TEX. NAT. RES. CODE ANN. § 102.011 (Vernon 1978).
126. *See id.* § 102.016.
127. *Id.* § 102.011.
128. *See id.* § 102.013.
129. *Id.* § 102.013(b).
130. *Id.* § 102.013(b).
131. 445 S.W.2d 790 (Tex. Civ. App.—Texarkana 1969), *modified*, 460 S.W.2d 404 (Tex. 1970).
132. *See id.* at 796-97.

be considered fair and reasonable.[133] In *Windsor Gas Corp. v. Railroad Commission*,[134] the court held a voluntary pooling offer containing a 2:1 risk factor was not fair and reasonable under the applicable facts. The applicant's offer was such that the offeree had to invest a great deal of initial capital to finance the drilling of eight wells, or allow the applicant to recover twice that sum from offeree's share of production as a risk factor penalty. The court concluded that this all-or-nothing alternative did not comply with the MIPA's fair and reasonable standard.[135]

Perhaps the clearest means of defining a fair and reasonable offer is to recognize what does *not* qualify. Section 102.015 recites four specific provisions which, if found in an offer to pool, pooling agreement, or pooling order, will cause the application to be denied as failing to meet this statutory requirement.[136] These prohibitions are generally added verbatim to any offers to pool. It is important to note that an offer under the MIPA does not have to be the *only*, or even the *most*, fair and reasonable offer that can be made. The fair and reasonable standard, however, is significant because it requires the parties first attempt to pool on a voluntary and reasonable basis. The Commission is without jurisdiction to act under the MIPA until the applicant has established that voluntary efforts to pool have failed and that a fair offer has been tendered by the applicant to the offeree.[137]

D. *Limitations on the Size of a Unit Created Under MIPA*

There are three statutory limitations on the size of a unit cre-

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133. *See* 1971 Tex. Gen. Laws, ch. 903, § 1, at 2794 (presently codified as TEX. NAT. RES. CODE ANN. § 102.013(c) (Vernon 1978)).

134. 529 S.W.2d 834 (Tex. Civ. App.—Austin 1975, no writ).

135. *Id.* at 837.

136. Section 102.015 provides:

> A pooling agreement, offer to pool, or pooling order is not considered fair and reasonable if it provides for an operating agreement containing any of the following provisions:
>
> (1) preferential right of the operator to purchase mineral interests in the unit;
>
> (2) a call on or option to purchase production from the unit;
>
> (3) operating charges that include any part of district or central office expense other than reasonable overhead charges; or
>
> (4) prohibition against nonoperators questioning the operation of the unit.

TEX. NAT. RES. CODE ANN. § 102.015 (Vernon 1978).

137. *See id.* § 102.013(b).

ated under the MIPA. The first is that a unit can never exceed 160 acres for an oil well or 640 acres for a gas well, plus a 10% tolerance.[138] While the statute may be ambiguous as to whether the 10% tolerance provision applies to oil units, the Commission has generally interpreted this language to authorize the formation of 176 acre oil pooled units under appropriate circumstances.

The second limitation is that the Commission may only pool acreage that, "at the time of its order, reasonably appears to lie within the productive limits of the reservoir."[139] This limitation often causes the MIPA hearings before the Commission to result in highly technical proceedings wherein the agency finally determines exactly which acreage is productive.

The final limitation is actually an attempt to protect large tracts from being force pooled, while at the same time recognizing the problems encountered by small tracts. This provision, referred to as the "Muscle-In" clause,[140] is applicable when a mineral interest owner has productive acreage that equals or exceeds the standard proration unit. The owner of the large tract will not be required to pool his interest with the interest of an owner whose adjacent tract is smaller than the standard proration unit unless the owner of the small tract has not been offered a fair and reasonable opportunity to pool and has requested to pool under the MIPA.[141] If these two conditions are met, the small tract owner can muscle his way into a unit which the Commission shall create on a fair and reasonable basis. This section also grants the Commission authority to provide for a larger allowable if the unit created exceeds the standard proration unit size for the reservoir.[142]

The statute is ambiguous as to whether or not a section 102.014 unit can exceed the acreage sizes specified in section 102.011. Despite the conclusions of a most noted and respected commentator to the contrary,[143] Commission practice has been that these statu-

138. *Id.* § 102.011.

139. *Id.* § 102.018.

140. *See* Smith, *The Texas Compulsory Pooling Act* (pt. 2), 44 TEXAS L. REV. 387, 394 (1966).

141. TEX. NAT. RES. CODE ANN. § 102.014(a) (Vernon 1978).

142. *See id.* § 102.014(b).

143. *See* Smith, *The Texas Compulsory Pooling Act* (pt. 2), 44 TEXAS L. REV. 387, 394-95 (1966). Dean Smith concluded that the only reasonable interpretation was that the "muscle in" provision allowed larger units than the 160/640 acre limitation. *See id.* at 395.

tory limitations cannot be exceeded. The Texas Supreme Court has provided one guideline for the application of section 102.014. In *Broussard v. Texaco, Inc.*,[144] Texaco was the common lessee on two adjoining large tracts of land. Texaco had developed the tracts, but had left small portions of each tract unassigned to a proration unit. Texaco successfully force pooled the 26 acres in one tract with 15 acres in the other, and the mineral owner protested. The Commission's action was sustained by the trial court, but on direct appeal[145] the Texas Supreme Court reversed, holding that the operator of a large tract cannot assign acreage to proration units so as to create a leftover "small tract" which retains the right to be force pooled with an adjacent large tract.[146]

E. *Who May Apply for Pooling*

An unfortunate situation has resulted from the 1977 enactment of Natural Resources Code. The terms of the predecessor statute, article 6008c, clearly provided that as to a proposed unit, a royalty owner could not apply for pooling.[147] Likewise, the terms of the Act creating the Natural Resources Code provided that *no* substantive changes were to be made by the enactment of the Code.[148] The terms of subsection 102.012(1), however, unequivocally state that *any* owner of an interest in oil and gas can apply for pooling

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144. 479 S.W.2d 270 (Tex. 1972).

145. Article 1738a of the Texas Revised Civil Statutes provides for direct appeal from the trial court to the Supreme Court when an interlocutory or permanent injunction is granted or denied on the basis "of the validity or invalidity of any administrative order issued by any State Board or Commission . . . . " TEX. REV. CIV. STATE ANN. art. 1738a (Vernon 1962).

146. *See* Broussard v. Texaco, inc. 479 S.W.2d 270, 276 (Tex. 1972).

147. *See* 1971 Tex. Gen. Laws, ch. 903, § 1, at 2793-94. As amended in 1971, subsection 2(a) of article 6008c provided that "any working interest owner or any owner of an unleased tract *other than a royalty owner*" could seek to force pool. *Id.* (emphasis added) Before the 1971 amendment, subsection 2(a) provided that any owner who had drilled or proposed to drill on an existing or proposed proration unit could invoke MIPA. *See* 1965 Tex. Gen. Laws, ch. 11, § 2(a), at 24-25. In Railroad Comm'n v. Coleman, 460 S.W.2d 404 (Tex. 1970), the supreme court held that this language did not include the owner of a royalty interest since such an owner could not drill or propose to drill. *See id.* at 407; *see also* Northwest Oil Co. v. Railroad Comm'n, 462 S.W.2d 371, 376-77 (Tex. Civ. App.—Beaumont 1971, writ ref'd n.r.e.).

148. *See* 1977 Tex. Gen. Laws, ch. 871, art II, § 15, at 2697. Section 15 provides that "it is the intent of the legislature that each provision of this code be interpreted to have the same meaning as the statutes from which it is derived." *Id.*

with respect to a proposed unit.[149] While the present language of subsection 102.012(1) is unmistakably a clerical error in the placing of numerical divisions, the repercussions to practitioners not familiar with article 6008c are obvious.

The legislative intent is that section 102.012 should not change the substantive law of the original statute. In fact, subsections 102.012(2) and (3) are surplusage if the Code really means what it seems to say.[150] Accordingly, section 102.012 should be interpreted as follows:

> The following interest owners may apply to the commission for the pooling of mineral interests:
>
> (1) the owner of any interest in oil and gas in an existing proration unit; or
> (2) with respect to a proposed unit:
> (a) the owner of any working interest; or
> (b) any owner of an unleased tract other than a royalty owner.

The complications that result from unintentional changes in the law through the codification process may have significant and far reaching consequences in the oil and gas industry. The simple and obvious solution to this problem is for the legislature to recognize this error by amending the section 102.012 so that the practitioner does not have to rely on prior statutes in order to comply with the provisions of the Natural Resources Code.

F. *Content and Effect of the Commission Order*

Section 102.017 establishes the requirements for the substance of Commission orders effectuating pooling. First, there must always be a hearing after adequate notice.[151] The order must be on terms that are fair and reasonable and that allow each mineral interest owner the opportunity to produce or receive his fair share. Every forced pooling order must: "(1) describe the land included in the unit, identifying the reservoir to which it applies; (2) designate the location of the well; and (3) appoint an operator for the unit."[152]

149. *See* TEX. NAT. RES. CODE ANN. § 102.012(1) (Vernon 1978). *But see id.* § 102.012(3) ("any owner of an unleased tract other than a royalty owner" can force pool).

150. Subsection 102.012(3) expressly excludes royalty owners from the class of person able to seek forced pooling.

151. *See id.* § 102.016.

152. *Id.* § 102.017.

A general rule of Texas law is that the pooling of lands effects a cross-conveyance of at least the right to production among the owners of minerals under the various tracts in the unit, so that each owns an undivided interest in the unitized acreage in the proportion their contribution bears to the entire unit.[153] The MIPA approaches the ownership issue with the presumption that production will be allocated on a surface acreage basis.[154] Notwithstanding this presumption, if the Commission finds that allocation on the basis of surface acreage does not allocate to each tract its fair share, the Commission may change the allocation formula to insure that each tract receives its fair share.[155] However, as to any nonconsenting owner, such fair share can never be less than he would receive under a surface acreage allocation.[156]

A common problem that occurs when oil and gas interests are pooled is that one or more owners either do not want or cannot afford to pay their share of drilling and completion costs in advance. In this event, the MIPA provides that the parties who advance the money will be reimbursed solely out of production for all "actual and reasonable" drilling, completion and operating costs.[157] The Commission, moreover, is authorized to allow the parties who have already borne these costs to recover a charge for the risk they have assumed so long as the charge does not exceed 100% of the drilling and completion costs.[158]

The determination of "actual and reasonable drilling, completion, and operating costs," however, may be a question to which the parties cannot mutually agree. In the event there is a dispute, the Commission is required to hold a hearing to determine the proper costs and their allocation among working interest owners.[159] The determination of reasonable costs may be by a completely separate hearing, or it may be made a part of the original MIPA application as long as the notice issued for the first hearing indicates

153. *See, e.g.*, Minchen v. Fields, 162 Tex. 73, 77, 345 S.W.2d 282, 285 (1961); Brown v. Smith, 141 Tex. 425, 428, 174 S.W.2d 43, 47 (1943); Nugent v. Freeman, 306 S.W.2d 167, 174 (Tex. Civ. App.—Eastland 1957, writ ref'd n.r.e.).

154. *See* TEX. NAT. RES. CODE ANN. § 102.051(a) (Vernon 1978).

155. *Id.* § 102.051(b).

156. *Id.* § 102.051(b).

157. *Id.* § 102.052(a).

158. *Id.* § 102.052(a); *see also* Windsor Gas Corp. v. Railroad Comm'n, 529 S.W.2d 834, 836-37 (Tex. Cv. App.—Austin 1975, no writ).

159. TEX. NAT. RES. CODE ANN. § 102.052(b) (Vernon 1978).

the issue of costs will be raised and determined.

In view of the numerous different lease provisions that may be involved in a particular forced pooling proceeding, the Texas Legislature prudently provided that the effect of production from, operations on, or shutting-in of a unit well on a lease that is only partially included in a pooled unit, is to be controlled by the provisions in each separate lease.[160] The original contract between the parties is not disturbed by state action under the MIPA. Therefore, whether lands lying outside a pooled unit are maintained beyond the lease's primary term by unit drilling or production is governed by the terms of the individual lease agreements.

G. *Dissolution of a Pooled Unit*

Once the Commission has established a pooled unit, the unit may not be modified or dissolved unless all mineral owners affected thereby consent to such change.[161] The unit may, however, be enlarged pursuant to the terms of the MIPA.[162] A pooled unit is automatically dissolved if any one of three conditions occur. The unit will be dissolved one year after it is created if no production is obtained or no operations are conducted on the unit.[163] Likewise, the unit will be dissolved six months after the completion of a dry hole or six months after cessation of production from the unit.[164] In the event a lease that is pooled under the MIPA subsequently terminates under its own terms, the interests covered by the lease remain in the pooled unit as unleased mineral interests.[165]

H. *Judicial Review*

The issue of judicial review presents a perplexing problem since the recodification of subsection 2(g) of article 6008c into sections 102.111 and 102.112 of the Natural Resources Code includes significant, and obviously intentional, changes in the substance of the original statute. Subsection 2(g) read as follows:

> Any person or party at interest aggrieved by an order of the Com-

160. *Id.* § 102.053(b).
161. *Id.* § 102.081.
162. *Id.* § 102.081.
163. *Id.* § 102.082(1).
164. *Id.* § 102.082(2)-(3).
165. *Id.* § 102.083.

> mission effecting pooling under this Act may appeal such order within 30 days to the District Court of the county in which the land or any part thereof covered by such order is located, and not elsewhere, notwithstanding the provisions of Section 8 of Article 6049c, Vernon's Civil Statutes of Texas.[166]

By contrast, sections 102.111 and 102.112 provide:

> A person affected by an order of the commission adopted under the authority of this chapter is entitled to judicial review of that order in a manner other than by trial de novo.[167]
>
> Appeal shall be to the district court of the county in which the land or any part of the land covered by the order is located and not elsewhere, notwithstanding the provisions of sections 85.241 through 85.243 of this code.[168]

Section 2(g) of the Article was not amended or changed by the 1971 amendment to the MIPA so that language remained unchanged until the 1977 codification. The statutory language that existed prior to 1977, moreover, was interpreted by two significant court decisions.

In 1968, the Texas Supreme Court held that the use of the word "effecting" in subsection 2(g) meant that only in those cases in which the Commission acted to create a unit (as opposed to denying an applicant's request for a pooling order) was there a right to appeal in the county where the land is located.[169] Therefore, if the Commission denied pooling, appeal was to the District Court in Travis County.[170] In 1975, the El Paso Court of Civil Appeals ruled on an appeal from a Commission order effecting pooling brought by an offset operator and one of the pooled parties.[171] The court held an offset operator was not a "person aggrieved" under the subsection 2(g) and, therefore, had no right to appeal.[172] The court, moreover, found that the pooled party had failed to appeal within the 30-day statutory time limit, holding that the 30-day limitation

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166. 1965 Tex. Gen. Laws, ch. 11, § 2(g), at 26.
167. TEX. NAT. RES. CODE ANN. § 102.111 (Vernon 1978).
168. *Id.* § 102.112.
169. *See* Railroad Comm'n v. Miller, 434 S.W.2d 670, 671 (Tex. 1968).
170. *See id.* at 671.
171. *See* Superior Ol Co. v. Railroad Comm'n, 519 S.W.2d 479 (Tex. Cv. App.—El Paso 1975, writ ref'd n.r.e.).
172. *See id.* at 481.

was jurisdictional.[173]

Recodification has made two obvious alterations to the terms of the subsection 2(g) as interpreted by the courts. First, the Code has dropped the "effecting" language, and now provides that any order of the Commission may be appealed to the district court of the county where the land lies, "and not elsewhere."[174] The second change is that the jurisdictional 30 day limit has been dropped; however, the Administration Procedure Act has a 30-day limitation.[175] The Code clearly provides that appeal is always to the county where the land is located.[176] By contrast, subsection 2(g), and the cases interpreting it, only allowed appeal to the county where the land is located if the Commission granted a pooling order and if the appeal was brought within 30 days.[177] The Act creating the Natural Resources Code, however, expressly states that no substantive changes are to be made by the enactment of the Code.[178]

A comprehensive discussion of the effects of the recodification of article 6008c is beyond the scope of this article. The intent of the legislature has been expressly declared: the Code is not to effect any substantive changes in the law as it existed under Article 6008c. If the legislature intended that the judicial review provisions of the MIPA be amended to conform with the language of the Natural Resources Code, this lawmaking body should make that intent clear by amending sections 102.111 and 102.112.

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173. *See id.* at 484.

174. TEX. NAT. RES. CODE ANN. § 102.112 (Vernon 1978).

175. *Compare id.* § 102.111 *with* Superior Ol Co. v. Railroad Comm'n, 519 S.W.2d 479, 484 (Tex. Cv. App.—El Paso 1975, writ ref'd n.r.e.) *and* 1965 Tex. Gen. Laws, ch. 11, § 2(g), at 26. The Adminstrative Procedure and Texas Register Act, TEX. REV. CV. STAT. ANN. art. 6252—13a (Vernon Supp. 1982) is an overridng statute regulatnig adminstrative procedure in general. Under this act, a person who has exhausted all administrative remedies is entitled to judicial review if he initiates his action within 30 days after the administrative decision becomes final. *Id.* art. 6252—13a, § 19(b).

176. *See* TEX. NAT. RES. CODE ANN. § 102.012 (VERNON 1978).

177. *See* 1965 Tex. Gen. Laws, ch. 11, § 2(g), at 26.

178. *See* 1977 Tex. Gen. Laws, ch. 871, art. II, § 15, at 2697.

V. Rule 69: Out-Of-State Sale Of Gas Produced From Public Lands

A. *Enactment of the Statute*

During the energy crisis of 1975, the then existing Federal Power Commission imposed artifical price restraints on all natural gas sold in interstate markets. As a result, a wide price differential developed between gas sold interstate under regulated prices and gas sold intrastate at current market prices. Not surprisingly, this price differential produced a public outcry by Texans who were paying much more for use of natural gas produced in their state than were interstate consumers of the same commodity. In response, the Texas Legislature enacted chapter 52, subchapter H of the Natural Resources Code.[179] Generally, the act prohibits natural or casinghead gas produced from state lands, pursuant to mineral leases executed after April 6, 1975, from being "sold or contracted for sale to any person, corporation or other entity for ultimate use outside the State of Texas" unless the Commission finds there is no present intrastrate need for the gas,[180] or grants an exception to prevent physical waste or unreasonable economic hardship.[181]

To ensure compliance with the terms of the statute, the act makes it illegal for any person authorized to execute state leases to do so unless the lease contains this interstate sale prohibition,[182] and prevents any state lease from being received and filed (as required by law) unless it includes the necessary restriction on out-of-state sales.[183] The act further provides that all oil, gas and mineral leases executed or filed in violation of the statute are null and void.[184] Accordingly, the various state boards for lease have in-

179. Tex. Nat. Res. Code Ann. §§ 52.291-52.296 (Vernon 1978) (originally codified as Tex. Rev. Civ. Stat. art. 5382f).

180. *Id.* § 52.293.

181. *Id.* § 52.296.

182. *Id.* § 52.292.

183. *Id.* § 52.294.

184. *Id.* § 52.295. It should be noted the act ignores the problem most commonly presented to lessees—that in which the lease on state land is executed, received and assigned in total compliance with the statute, but gas wells are later drilled and sale of the gas is subsequently made "for ultimate use" outside Texas. The act is silent as to what possible penalties the lessee may face, how they may be imposed, and when they may be assessed. The Attorney General of Texas has suggested this lease provision is to be enforced in the

serted additional provisions into their standard oil and gas leasing forms for state-owned minerals, requiring compliance with the statute before any gas produced from such leases may be sold for ultimate use outside the state.[185]

B. *Railroad Commission Interpretation and Application of the Statute to Date*

Pursuant to the act, the Commission has promulgated statewide rule 69, which tracks almost verbatim the applicable portion of the legislation.[186] As mentioned above, the statute allows two different means by which a lessee may obtain permission from the Commission to sell gas from state lands in the interstate market. The most common method is to seek an exception under section 52.296 and rule 69(b) by showing that enforcement of rule 69 would cause physical waste of the hydrocarbons or unreasonably deny the lessee an opportunity to economically produce the gas underlying its lease.[187]

At the time of the initial hearings on rule 69(b) applications, there was a surplus of natural gas to be found in Texas. Consequently, upon a satisfactory showing that no intrastate market existed for gas expected to be produced from applicant's lease, the Commission would grant an exception without restrictions as to the duration of the exception, the horizons covered or possible future changes in the productivity of the lease or the availability of intrastate markets.[188] In more recent times, however, the Commis-

same manner as any other material provision in the lease. *See* TEX. ATT'Y GEN. OP. No. H-1197 (1978). Noting that the usual legal remedy of money damages may not be suitable in this situation, however, the Attorney General apparently advocates lease forfeiture as the penalty. *See id.*

185. The language of these additional provisions generally tracks the statutory prohibition of section 52.293.

186. *See* TEX. ADMIN. CODE ANN. tit. 16, § 3.64 (McGraw-Hill 1980).

187. *See* TEX. NAT. RES. CODE ANN. § 52.296 (Vernon 1978); TEX. ADMIN. CODE ANN. tit. 16, § 3.64(2) (McGraw-Hill 1980).

188. *See* Docket No. 7C-68,160, Special Order Approving the Application of Dyco Petroleum Corporation for Exception to Statewide Rule 69 for Certain Leases in the Farmer (San Andres) Field, Crocket County, Texas (March 13, 1978); Docket No. 8-68,089, Special Order Approving the Application of Saxon Oil Company for Exception to Statewide Rule 69 for Certain Leases in the Keystone (San Andres) Field, Winkler County, Texas (Feb. 13, 1978); Docket No. 8-68,106, Special Order Approving the Application of Joseph I. O'Neill, Jr. for Exception to Statewide Rule 69 for Certain Leases in the Block 12 (Yates) Field, Andrews County, Texas (Feb. 13, 1978); Docket No. 8-68,074, Special Order Approving the

sion, recognizing the surplus of natural gas in Texas may be disappearing, has developed a policy of generally restricting exceptions that are granted to the producing reservoir in which the well or wells are completed. Furthermore, when an exception is granted an interruptibility clause is included in the Commission order making future sales to interstate markets subject to cancellation should an intrastate market develop for the gas.[189]

The most common circumstances in which exceptions have been granted include the following:

(1) the producing rates and recoverable reserves are relatively low;
(2) the interstate market is the only market nearby;
(3) the intrastate pipelines will not purchase the gas because they are too far away and the reserves of the well do not justify the cost of transportation;
(4) waste would result because the lessee would have to flare casinghead gas or shut-in a gas well with recoverable reserves since no intrastate market is available;
(5) there will be no economic return to the lessee if the well is shut-in or the casinghead gas flared.[190]

A more difficult problem arises when a lessee is faced with competing offers from both inter- and intrastate purchasers. On at least three occasions the Commission has granted an exception to rule 69 in such situations.[191] Although it will not be sufficient for an applicant to merely show the intrastate price does not equal the

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Application of Wood, McShane and Thams for Exception to Statewide Rule 69 for the Crews & Mast Wells Nos. 1 & 2, the Crews & Mast "A" Wells Nos. 1 & 2, the Crews & Mast Unit Well No. 1, and the Crews & Mast-Arco Unit Well No. 1 in the Block A-34 (yates) Field, Andrews County, Texas (Jan. 30, 1978).

189. The interruptibility clause provides that the contract may be interrupted if an intrastate purchaser wants the gas and the producer cannot show that the sale to the intrastate purchaser would cause waste or be uneconomical. *See* Docket No. 7C-77,226, Final Order (Nov. 2, 1981); Docket No. 7C-76,902, Final Order (Sept. 8, 1981); Docket No. 7C-76,558, Final Order (July 13, 1981).

190. *See* Docket No. 7C-68,160, Special Order Approving the Application of Dyco Petroleum Corporation for Exception to Statewide Rule 69 for Certain Leases in the Farmer (San Andres) Field, Crockett County, Texas (March 3, 1978); Docket No. 7C-68,159, Special Order Approving the Application of Robert M. Wynne for Exception to Statewide Rule 69 for Certain Leases in the Farmer (San Andres) Field, Crockett County, Texas (March 13, 1978).

191. *See* Docket No. 8-76,034, Final Order (April 20, 1981); Docket No. 8-71, 601, Final Order (Nov. 30, 1979); Docket No. 8-71,588, Final Order (Nov. 19, 1979).

interstate price,[192] the Commission will apparently be persuaded by an economic analysis that the intrastate offer is not "economically reasonable."[193]

The only other means a lessee of state owned lands has of securing approval for the interstate sale of his gas is to proceed under section 52.293 and rule 69(a). The statute requires the Commission to find there is no present need in the state for the gas and outlines six broad categories of users to be considered in making this determination.[194] To date, the Commission has ruled only once on an exception under rule 69(a). Based on a finding that no substantial evidence was presented, the application was denied.[195] While there did appear to be substantial evidence that no present need for the gas existed in Texas, no appeal was taken from the Commission's order. Based on the position of the Commission in this single application, it appears the rule 69(a) exception is not a viable one for a lessee seeking permission to sell his gas out of state.

C. *Constitutional Questions Raised by the Statute*

Since the statute's enactment, there has been considerable discussion among practitioners as to whether chapter 52, subchapter H, and corresponding statewide rule 69, must fail for constitutional infirmities. Generally, the constitutional criticisms leveled at the statute center around its vagueness and the impermissible burden it places on interstate commerce. A careful consideration of the statute indicates it should fall under a constitutional challenge on

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192. Interstate offers will generally be the maximum allowed under the National Gas Policy Act of 1978, 15 U.S.C. §§ 3301-3432 (Supp. IV 1980). The intrastate offer may be as much as 15% less.

193. In two instances, the applicant was able to show that the intrastate offer, if accepted, would result in a long term loss, whereas acceptance of the interstate offer would yield a positive rate of return. *See* Docket No. 8-71,601, Final Order (Nov. 30, 1979); Docket No. 8-71,588, Final Order (Nov. 19, 1979). In another case, both the intrastate and the interstate offers would result in a positive rate of return. *See* Docket No. 8-76,034, Final Order (April 20, 1981). Nonetheless, the Commission approved the exception, finding that the intrastate offer was still not a reasonable economic return. *See id.*

194. *See* TEX. NAT. RES. CODE ANN. § 52.293 (Vernon 1978); TEX. ADMIN. CODE ANN. tit. 16, § 3.64(1) (McGraw-hill 1981).

195. *See* Docket No. 2-68,794, Special Order Denying the Application of Energy Development Corporation, N.J., for an Exception to Statewide Rule 69 in the San Antonio Bay, S. Field Area, Calhoun County, Texas (Nov. 20, 1978). Commissioner Jon Newton dissented from the Commission's denial of the exception. *See id.*

either ground.

1. The Statute is so Vague and Overbroad it Violates Both Federal and State Requirements of Due Process.

The specific language of the statute appears to be so vague that the conscientious lessee would be incapable of determining exactly what conduct is required of him. The "no need" exception prohibits the sale or contract for sale of gas "to any person *for ultimate use* outside the state . . . ."[196] "Ultimate use" however, is not defined by the statute. While this language clearly prohibits a lessee from selling directly to the interstate market, the prohibition may reasonably be read to have broader application as well. The provision could be construed to impose a duty on the lessee to ensure that gas from a particular lease will not be "ultimately used" by consumers outside Texas, no matter how many times the gas may be sold or exchanged after leaving the leased premises. Alternatively, the provision may extend a lessee's duty beyond the initial transfer from the leased premises, yet end that duty somewhere short of infinite responsibility.

Similarly, the statute seems to prohibit only the "*sale or contract of sale*" of gas for ultimate use outside the state.[197] In light of the entire statutory purpose to prevent out-of-state use of gas from state lands, however, a lessee might reasonably be charged with violating the statute even if such producer did not sell or contract for sale the gas produced pursuant to state lease, but rather transported the gas for "ultimate use" either to the lessee's own plants or those of affiliates which happened to be located in other states.

The United States Supreme Court has long held "a statute which either forbids or requires the doing of an act in terms so vague that men of common intelligence must necessarily guess at its meaning and differ as to its application violates the first essential of due process of law."[198] Although this standard was first enunciated as the proper test for vagueness in statutes imposing criminal liability, the same standard has also been adopted as the proper test for civil liability.[199]

196. TEX. NAT. RES. CODE ANN. § 52.293 (Vernon 1978) (emphasis added).
197. *See id.* § 52.293.
198. Connally v. General Constr. Co., 269 U.S. 385, 391 (1926).
199. *See* A.B. Small Co. v. American Sugar Ref. Co., 267 U.S. 233, 239 (1925).

In *Grayned v. City of Rockford*,[200] the Court summarized the dangers inherent in vague laws:

> Vague laws offend several important values. First, because we assume that man is free to steer between lawful and unlawful conduct, we insist that laws give the person of ordinary intelligence a reasonable opportunity to know what is prohibited, so that he may act accordingly. Vague laws may trap the innocent by not providing fair warning . . . . Uncertain meanings inevitably lead citizens to "steer far wider of the unlawful zone" . . . than if the boundaries of the forbidden areas were clearly marked.[201]

The Texas Supreme Court has likewise applied a "fair notice" standard to statutes challenged for vagueness.[202] In Texas, a statute is fatally vague and an unconstitutional violation of due process when it exposes a potential actor to some risk or detriment without fair warning.[203] Greater leeway in applying a fair notice test is traditionally allowed in regulation statutes governing business activities,[204] and statutes will not automatically be invalidated as vague simply because difficulty is encountered in determining whether marginal offenses fall within their language.[205] A statute, however, must still convey "sufficiently definite warning as to the proscribed conduct when measured by common understanding and practices."[206]

The vagueness of section 52.293 falls precisely within the dangers outlined. From the broad terms of the statute, a lessee cannot clearly know what conduct is proscribed. The only safe course of conduct for a lessee is to either consume the gas himself within the state, or sell the gas directly to a Texas consumer and thereafter

200. 408 U.S. 104 (1972).

201. *Id.* at 108-09.

202. *See* Lone Star Gas Co. v. Kelly, 140 Tex. 15, 19, 165 S.W.2d 446, 448 (1942); *see also* Sanders v. State Dep't of Pub. Welfare, 472 S.W.2d 179, 182 (Tex. Civ. App.—Corpus Christi 1971, writ dism'd).

203. Texas Liquor Control Bd. v. Attic Club, Inc. 457 S.W.2d 41, 45 (Tex. 1970); *see* Murphy v. Rowland, 609 S.W.2d 292, 297 (Tex. Civ. App.—Corpus Christi 1980, writ ref'd n.r.e.); Sanchez v. Texas Dep't of Human Resources, 581 S.W.2d 260, 266-67 (Tex. Civ. App.—Corpus Christi 1979, no writ).

204. *See* Papachristou v. City of Jacksonville, 405 U.S. 156, 162 (1972); Pennington v. Singleton, 606 S.W.2d 682, 689 (Tex. 1980).

205. *See* United States v. National Dairy Products Corp., 372 U.S. 29, 32, *reh. denied*, 372 U.S. 961 (1963).

206. United States v. Petrillo, 332 U.S. 1, 8 (1947).

monitor its actual use. Similary, there is no "sufficiently definite warning" ascertainable in the terms of section 52.293 to adequately warn a lessee of state owned lands what conduct is definitely required of him. Under any variation of the "fair notice" test the Texas statute should fall for vagueness.

2. The Statute Imposes an Impermissible Burden on Commerce.

The statutory prohibition against sales or contracts of sales to any person for ultimate use outside the state, unless the Commission makes certain findings, establishes an in-state preference for the distribution of natural resources owned by the state. The statute is clearly a protectionist one and raises the question of whether such an in-state preference is permissible in light of the Commerce Clause[207] as it has been interpreted and developed since the earliest days of this republic.

The Supreme Court has consistently recognized that a state has no authority to prohibit or restrict the exportation of its natural resources to the detriment of interstate commerce.[208] As the Court first noted in *West v. Kansas Natural Gas Co.*,[209] if a state should have the power to confine its natural resources to the use of its inhabitants, exercise of that power could, and almost surely would, lead to a national crisis.[210] If one state has such power, all states have it as well; "embargo may be retaliated by embargo, and commerce will be halted at state lines."[211] The very core of the Commerce Clause is to prevent this economic fragmentation and creation of preferential trade areas destructive of free trade among the several states.[212] Yet, the intent and effect of chapter 52, subchapter H is to create the precise situation the Commerce Clause was meant to prevent.

In *Pennsylvania v. West Virginia*,[213] the Court struck down as

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207. U.S. CONST. art. I, § 8, cl. 3.

208. *See, e.g.*, Hughes v. Oklahoma, 441 U.S. 322, 325-26 (1979); Pennsylvania v. West Va., 262 U.S. 553, 596-97 (1923); West v. Kansas Natural Gas Co., 221 U.S. 229, 255-56 (1911).

209. 221 U.S. 229 (1911).

210. *See id.* at 255. In the Court's words, "Pennsylvania might keep its coal, the Northwest its timber, the mining states their minerals." *Id.* at 255.

211. *Id.* at 255.

212. *See* Boston Stock Exch. v. State Tax Comm'n, 429 U.S. 318, 329 (1977).

213. 262 U.S. 553 (1923).

unconstitutional a West Virginia statute which placed similar burdens on producers as that created by the Texas statute.[214] The West Virginia law required state pipeline companies to satisfy the needs of all West Virginia consumers before transporting the gas across state lines. The Court found the purpose of the statute was to give local customers, both present and future, a preferred status and to permit only surplus gas to be pipelined to other states. Such a restriction, the court held, constituted an impermissible interference with interstate commerce:

> Natural gas is a lawful article of commerce, and its transmission from one state to another for sale and consumption in the latter is interstate commerce. A state law, whether of the state where the gas is produced or that where it is to be sold, which by its necessary operation prevents, obstructs or burdens such transmission is a regulation of interstate commerce—a prohibited interference.[215]

The Court followed its previous decision in *West*, rejecting arguments by the state that the statute was a reasonable exercise of its police power to conserve the state's natural resources and protect the health, safety and welfare of its citizens.[216]

In more recent years, consistent with its renewed belief in the importance of federalism in the administration of a dual political system, the Court has refined its analysis of the Commerce Clause doctrine. Rather than finding any state statute which imposes a burden upon interstate commerce to be illegal per se, the Court applies a three-part balancing test in order to weigh a state's interest in the subject legislation against the burden imposed and the nation's interest in the free flow of trade.[217] As the Court observed in *Pike v. Bruce Church, Inc.*,[218] when a "statute regulates evenhandedly to effectuate a legitimate local public interest, and its effects on interstate commerce are only incidental, it will be upheld

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214. *See id.* at 600.

215. *Id.* at 596-97; *see also* FPC v. Louisiana Power & Light Co., 406 U.S. 621, 632-33 (1972); FPC v. Corporation Comm'n, 362 F. Supp. 522, 533 (W.D. Okla. 1973), *aff'd mem.*, 415 U.S. 961 (1974); City of Altus v. Carr, 255 F. Supp. 828, 839-40 (W.D. Tex.), *aff'd per curiam*, 385 U.S. 35 (1966).

216. *See* Pennsylvania v. West Va., 262 U.S. 553, 598-600 (1923).

217. *See, e.g.*, Hughes v. Oklahoma, 441 U.S. 322, 336 (1979); Raymond Motor Transp., Inc. v. Rice, 434 U.S. 429, 441-42 (1978); Pike v. Bruce Church, Inc., 397 U.S. 137, 142 (1970).

218. 397 U.S. 137 (1970).

unless the burden imposed on such commerce is clearly excessive in relation to the putative local benefits."[219]

When applying this balancing test to the Texas statute, there seems to be little doubt that chapter 52, subchapter H is unconstitutional. First, the act on its face is hardly an evenhanded one. It grants a preferred status to Texas natural gas purchasers and consumers and mandates that only the state's surplus may be sold to and used by customers in other states.[220] By its terms, the statute constitutes an obvious discrimination against interstate marketers and consumers of natural gas produced in Texas from state lands. The statute makes it unlawful for a producer under a state lease to sell gas interstate without prior Commission approval, yet no such imposition is placed on sales to intrastate purchasers. In the balancing test, "facial discrimination by itself may be a fatal defect,"[221] regardless of the state's purpose. At the very least, facial discrimination requires the "strictest scrutiny of any purported legitimate local purposes and the absence of nondiscriminatory alternatives."[222]

Whether the act serves any legitimate local purpose which may be factored into the balancing test is questionable as well. The vagueness of the "ultimate use" prohibition weighs heavily against the legitimacy of any state interest. If the "ultimate use" restriction only limits the initial sale by lessees and the intrastate purchaser is free to resell immediately the same gas into the interstate market, the act does not protect any legitimate interest at all. Instead, it merely permits profits to accrue to intrastate purchasers who may buy cheaply on the intrastate market and then resell to interstate purchasers at a higher price, thereby denying these same profits to lessees and royalty interest owners who may very well be state residents themselves. If, on the other hand, the "ultimate use" restriction extends beyond the point of initial sale into the intrastate market and prohibits use out-of-state if any in-state needs exists, the local purpose becomes one of mere protectionism and hoarding.[223] Even if a legitimate local purpose may be dis-

219. *Id.* at 142.

220. *See* TEX. NAT. RES. CODE ANN. § 52.293 (Vernon 1978).

221. Hughes v. Oklahoma, 441 U.S. 322, 337 (1979).

222. *Id.* at 337.

223. *See* City of Philadelphia v. New Jersey, 437 U.S. 617, 627 (1978); Baldwin v. Fish & Game Comm'n, 435 U.S. 354, 385-86 (1978).

cerned for the restrictions imposed on interstate sales of Texas natural gas, such interest may well be outweighed by the greater needs of the nation in having access to the individual state's fuel reserves.[224]

The statute fails to meet any of the criteria established by the Supreme Court in its balancing test and should be set aside for unconstitutionally burdening interstate commerce. The exceptions to the statute's blanket prohibition against interstate sales, moreover, do not remedy this constitutional defect. Instead of evaluating the statute's impact upon interstate commerce if an exception is denied, the Commission is directed to determine, in essence, whether there is any intrastate need for the gas, or whether waste will occur or the producer will be denied the reasonable opportunity to produce hydrocarbons by the statute's enforcement.[225] Such considerations do not make the burdens imposed upon interstate commerce any less restrictive nor any more legitimate.

The out-of-state sale restrictions imposed by section 52.293, however, differ from other state imposed burdens traditionally held unconstitutional under the Commerce Clause. The Texas statute may be said to place restrictions on the sale of gas owned by the state itself, and not on transactions between private parties.[226] Furthermore, these restrictions are set forth at the initial point of transfer of the gas to private parties, the lease agreement with the state's lessees, rather than independently placed on sales by producers.[227] In doing so, the state may argue that it is not acting as a political unit creating barriers to free flow of trade, but as a private participant in the marketplace.

The Supreme Court, moreover, has recognized a distinction between the state as a regulator and the state as a participant in the market. In *Hughes v. Alexandria Scrap Corp.*,[228] the Court held that any burden on interstate commerce imposed by the state when acting as a private participant in the marketplace is not the type of burden prohibited by the Commerce Clause.[229] Writing for

224. *See* Hicklin v. Orbeck, 437 U.S. 518, 533-34 (1978).
225. *See* TEX. NAT. RES. CODE ANN. § 52.293 (Vernon 1978); TEX. ADMIN. CODE ANN. tit. 16, § 3.64 (McGraw-Hill 1980).
226. *See* TEX. NAT. RES. CODE ANN. §§ 52.291, 52.293 (Vernon 1978).
227. *See id.* § 52.294.
228. 426 U.S. 794 (1976).
229. *See id.* at 810, 814.

the majority, Justice Powell noted that "[n]othing in the purposes animating the Commerce Clause prohibits a state, in the absence of congressional action, from participating in the market and exercising the right to favor its own citizens."[230]

In *Alexandria Scrap*, the state had entered the marketplace as a *purchaser*, and as such could favor its citizens by choosing to only trade with them or with businesses located within the state.[231] In *Reeves, Inc. v. Stake*,[232] the Court extended the distinction between the state as a market participant and a market regulator to situations where the state acted as a *seller*.[233] In *Reeves*, the state's policy, as applied in times of shortage, of confining the sale of cement produced at state-owned plants solely to state residents was challenged as a violation of the Commerce Clause. The Court very broadly stated that whenever a state is characterized as a marketplace participant, commerce clause policies are not involved. In this situation, "[t]here is no indication of a constitutional plan to limit the ability of the states themselves to operate freely in the free market."[234]

On its face, the Texas prohibition against out-of-state sales of gas would seem to fall squarely within the sweeping language of *Reeves*. Under section 52.293, the state is acting as a "seller" of its own property and therefore is a market participant rather than a market regulator. Yet, a vital distinction must be drawn; the Texas statute places restrictions on natural resources, the free flow of which has long been deemed vital to the nation's interests.[235] By contrast, neither *Alexandria Scrap* nor *Reeves* dealt with in-state preferences over the use of natural resources.

In *Reeves*, the Court reserved the question of the applicability of a participant/regulator test in such situations, stating the argument was not raised by the facts in the case. The Court expressly

230. *Id.* at 810 (footnotes omitted).

231. *See id.* at 796-801. Maryland had offered a bounty for the scrap processing of abandoned and wrecked motor vehicles in a conservation measure to beautify the state. The state's bounty created a market for these vehicles which had not existed before the statute's enactment. Under these circumstances, the Court found it justifiable for Maryland to prefer its own citizens. *See id.* at 808-09.

232. 447 U.S. 429 (1980).

233. *See id.* at 440.

234. *Id.* at 437.

235. *See, e.g.*, Hicklin v. Orbeck, 437 U.S. 518, 533-34 (1978); Pennsylvania v. West Va., 262 U.S. 553, 596-97 (1923); West v. Kansas Natural Gas Co., 221 U.S. 229, 255-56 (1911).

noted that "[c]ement is not a natural resource, like coal, timber, wild game or *minerals*."[236] Furthermore, the state had not sought to limit access to its limestone or other raw materials used in making cement in the state's plant, nor was it suggested that the state possessed unique access to any of the necessary raw materials.[237]

Chapter 52, subchapter H raises the very distinctions made by the Court in *Reeves*. This statute *does* involve the free flow into interstate commerce of a natural resource. It also limits access to the state's resources and the state *does* have unique access to such raw materials, since by definition it is the owner of the gas prior to leasing.

In *Hicklin v. Orbeck*,[238] decided two years prior to *Reeves* and two years after *Alexandria*, the Court was asked to set aside an Alaska statute which allowed the state to place restrictions, violative of the Privileges and Immunities Clause of the federal constitution,[239] in oil and gas leases the state executed on its lands.[240] Although the Commerce Clause was not involved, it was clear the decision of the Court rested on commerce clause doctrine.[241] The state had argued that under the *Alexandria Scrap* rule, constitutional prohibitions were not meant to apply to decisions by the states as to how they would permit the use and distribution of natural resources they actually own.

The Court, however, dismissed the argument, finding a state's interest in controlling those things it owns was not absolute. As the Court observed:

> Rather than placing a statute completely beyond the [Privileges and Immunities] Clause, a State's ownership of the property with which the statute is concerned is a factor—although often the crucial factor—to be considered in evaluating whether the statute's discrimi-

236. Reeves, Inc. v. Stake, 447 U.S. 429, 443 (1980) (emphasis added).

237. *See id.* at 444.

238. 437 U.S. 518 (1978).

239. U.S. CONST. art IV, § 2, cl. 1.

240. Under Alaska law, all oil and gas leases to which the state was a party had to contain a provision requiring the preferential employment of Alaska residents. *See* Hicklin v. Orbeck, 437 U.S. 518, 520 (1978).

241. *See id.* at 531-34. Although the Court grounded its decision on the Privileges and Immunities Clause, the Court noted that the "mutually reinforcing relationship between the Privileges and Immunities Clause . . . and the Commerce Clause" supported its holding that the Alaska law was unconstitutional. *Id.* at 531-32.

nation against non-citizens violates the Clause.[242]

The Court then applied the traditional balancing test to find the oil and gas upon which the restrictions lay were of such national importance, and the restrictions so overly broad, that Alaska's ownership of the oil and gas could not justifiably support the burdens imposed.[243]

It thus appears that if the past decisions of the Supreme Court regarding protectionist statutes are to retain their validity, there must be some restriction placed upon the broad *Alexandria Scrap/ Reeves* rule when applied to the hoarding of natural resources by individual states. However, even if the participant/regulator test is applicable in this situation, it still appears chapter 52, subchapter H must fall as unconstitutional. The restriction against out-of-state sales is not one placed on the state as a participant in the marketplace at the initial point of transfer to private parties, but rather is an impermissible "downstream" regulation of interstate commerce. The *Alexandria Scrap/Reeves* rule may allow Texas to prefer in-state producers in the *awarding* of leases on state-owned minerals, but it cannot allow the state to *regulate* these producers' *subsequent* sales. The objectionable downstream restraint is not eliminated merely by putting the restriction in the original lease to producers. The downstream regulation of the free flow of natural gas into interstate commerce is still as effective and as onerous as any burden heretofore held unconstitutional by the Supreme Court.[244] Consequently, chapter 52, subchapter H must be deemed unconstitutional under the Commerce Clause.

VI. CONCLUSION

Although dealing with only a few of the myriad regulations affecting the oil and gas industry in Texas, the foregoing sections outline those areas most commonly encountered by the general practitioner involved in a proceeding before the Railroad Commission's Oil and Gas Division. For a thorough understanding of any problem in this area, the practitioner must consult the Railroad

242. *Id.* at 529.
243. *See id.* at 533-34.
244. *See* Anson & Schenkkan, *Federalism, the Dormant Commerce Clause, and State-Owned Resources*, 59 TEXAS L. REV. 71, 93-95 (1980).

Commission's rules and regulations, as well as all applicable statutes. However, the four topics addressed in this article will hopefully serve as a helpful reference for the general practitioner when advising his clients of the rights and remedies available to them, and the regulations which may be imposed upon the oil and gas industry by the Railroad Commission of Texas.