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IN THE DISTRICT COURT OF TRAVIS COUNTY, TEXAS
53RD JUDICIAL DISTRICT

ELSIE OPIELA AND ADRIAN OPIELA, JR.,
Plaintiffs,

vs.

RAILROAD COMMISSION OF TEXAS,
Defendant.

On Appeal from an Order by the Railroad Commission of Texas

PLAINTIFFS' REPLY TO DEFENDANT'S AND INTERVENOR'S RESPONSES

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INTRODUCTION AND SUMMARY

Over the last two decades, the oil and gas industry and its drilling methods have changed dramatically. These changes have affected the rights of landowners whose properties are affected by the industry's operations. The Railroad Commission's ("Commission") regulations, however, have not kept up. Instead of regulating the advent of horizontal drilling with rules compliant with the Administrative Procedure Act ("APA"), the Commission has instead implemented a hodgepodge of informal state-wide policies that it routinely changes. Because these policies were never subjected to the APA's requirements, landowners and the public have been deprived of their opportunity to participate in the shaping of state policy. The APA exists to protect the public from what the Commission has done in this case: regulate without public scrutiny and make up rules as it goes. Because the Commission's horizontal drilling rules were not properly promulgated under the APA, this Court must reverse the Commission's Final Order granting Magnolia a drilling permit.

The Final Order is erroneous for several additional reasons. First, it violates the plain language of Commission Rules 26 and 40, both of which *are* APA compliant. Second, the Commission committed error in refusing to

even consider whether Magnolia has authority to drill the Audioslave well under the terms of its lease with the Opielas. And finally, the Opielas' lease does not grant Magnolia authority to drill the Audioslave well.

ARGUMENT

I. The Commission's moving goal posts are (invalid) rules under the APA.

Instead of adopting formal rules pursuant to the Administrative Procedure Act, Tex. Gov't Code § 2001.001 et seq. ("APA"), the Commission has adopted informal policies that have changed over time. Because of the Commission's informal rulemaking, the rules for allocation and Production Sharing Agreement ("PSA") wells cannot be found anywhere in the Texas Administrative Code. As the leading treatise on the issue has summarized: "As of the start of 2020, no statute or regulation addressed either PSA or allocation well permits." Smith & Weaver, *Texas Law of Oil & Gas* § 9.9(B). Instead, the rules for such wells are "hidden in the arcana of Railroad Commission forms, rejected staff Proposals for Decision, individual well permits and disclaimers, and legislative committee proposals." *Id.*

The Commission's change of policies to allow issuance of PSA and allocation well permits constitutes the single greatest change in Commission

policies (at least for mineral and royalty owners) since its adoption of rules for pro-rationing of production. The Commission's adoption of these new state-wide policies, without adhering to the rigors of the APA, is contrary to state law and, if allowed, would frustrate the very purpose of the APA.

A. The APA is intended to protect the public from this sort of informal rulemaking.

Administrative agencies wield great power. Some have argued that that administrative agencies like the Commission violate the separation of powers in that they "combine[] the basic powers of each branch—the executive branch's power to prosecute, the judicial branch's power to adjudicate, and the legislative branch's power to make law." Pete Schenkkan, *Texas Administrative Law: Trials, Triumphs, & New Challenges*, 7 Tex. Tech. Admin. L. J. 288, 293 (2004).

The delegation of broad legislative power to state agencies is a matter of convenience and pragmatism. *See R.R. Comm'n of Tex. v. Lone Star Gas Co.*, 844 S.W.2d 679, 689 (Tex. 1992) ("It is utterly impossible for the Legislature to meet the demands of every detail in the enactment of laws relating to the production of oil and gas."). And in the modern era of governing through agencies, "most legislative policy is now made by administrative agencies,

not by legislatures." Schenkkan, *supra*, 7 Tex. Tech. Admin. L. J. at 293. Because state agencies have such sweeping legislative and adjudicative powers, procedural safeguards are essential to ensure orderly administration. That is where the APA comes in. *See Tex. Ass'n of Bus. v. Tex. Air Control Bd.*, 852 S.W.2d 440, 452 n.26 (Tex. 1993) (affirming a delegation of adjudicative authority because of the APA's "full panoply of procedural safeguards.").

Thus, when a state agency adopts state-wide policies of general applicability, it is exercising a legislative function and the APA's specific requirements protect the public from arbitrary agency action. "Before the APA, if the agency wanted to make a rule, the agency could do so without input from anyone, with no explanation at all, and keep the rules in its files where only the insiders even knew of its existence." Schenkkan, *supra*, 7 Tex. Tech. Admin. L. J. at 308. Now, however, because of the APA, "an agency must publish a notice that meets detailed statutory standards; must provide a meaningful opportunity for interested persons to comment on the proposed rule, its bases, and alternatives; and it must explain, in its published order adopting the rule, its reasoned justification for the

rulemaking choices it made, including why it rejected the comments it rejected." *Id.*; *see also* Tex. Gov't Code §§ 2001.023–33.

Compliance with the APA is important: "Administrative law serves the same role that a written constitution serves—it structures government decision-making to promote efficiency, fairness, and wise policy, to protect individual rights, and to foster other shared values." *Id.*

B. The Commission changed state-wide policy without adhering to the APA.

As explained in Plaintiffs' Initial Brief, a "rule," for purposes of the APA, is (1) "an agency statement of general applicability" that either "implements, interprets, or prescribes law or policy" or describes a state agency's "procedure or practice requirements." Tex. Gov't Code § 2001.003(6). Here, the Commission has dramatically altered state policy with respect to multi-tract drilling in violation of the APA.

Before the Commission started issuing PSA well permits, the only way to obtain a drilling permit for a drilling unit that encompassed multiple tracts was by forming a pooled unit and complying with Commission Rule 40. To do so, an applicant was required to file a "Certificate of Pooling Authority." 16 Tex. Admin. Code § 3.40(a). But at some point, the

Commission started issuing permits for multi-tract wells without a Certificate of Pooling Authority. The Commission instead required a showing that all interest owners had signed a Production Sharing Agreement ("PSA"). AR3 Dec. 10, Mag. Ex. P at 2. This, in and of itself, was a change in policy. Since then, the Commission has continued to change its state-wide policies.

In 2008, the 100% PSA requirement was "relaxed to approval of permits where 65% of the interests involved had executed the PSA." *Id.*[1] Had the Commission followed the APA, it would have had to provide, among other things, its reasoned justification for the 65% threshold. But because the Commission did not follow the APA, it has never explained why 65% is a sufficient critical mass to override the wishes and contractual rights of the remaining 35%.

In this case, Magnolia purports to rely on agreements with 65.62% of the total royalty ownership under the Opielas' lease. Magnolia Resp. at 12.

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[1] *See also* Tex. R.R. Comm'n, Formal Comm'n Actions, Hearings Div., Status #665639 (Sept. 9, 2008), available at https://web.archive.org/web/20161222204413/https://www.rrc.texas.gov/media/9027/090908.pdf ("Commissioners Jones and Carrillo voted to approve, directing staff that wells that are permitted based on a production sharing agreement should be approved when the usual criteria are met and the operator certifies that at least 65% of the working and royalty interest owners in each component tract have signed the production sharing agreement.").

Thus, the 65% threshold is central to this dispute, and that threshold is not in any rule adopted pursuant to the APA. In its Response, Magnolia argues that "something like a 65% agreement threshold" is not a rule for APA purposes because it is just "a common-sense *rule* of thumb to ensure that the majority is not held hostage by minority holdouts." Magnolia Resp. at 24 (emphasis added). However, the Commission's state-wide policy of overriding the will of 35% of royalty and mineral owners is indisputably a statement of general applicability that "implements, interprets or prescribes law or policy." Tex. Gov't. Code § 2001.003(6)(A) (definition of "Rule.").

After it adopted the informal 65% threshold for PSA wells, the Commission continued to amend its policies regarding such wells. The Commission initially refused to grant permits that did not meet the 65% threshold. *See* AR2, Item 32 at 42. Several years later, however, the Commission began issuing permits without any production sharing agreements—calling them allocation wells. AR3, Dec. 10 Mag. Ex. P at 2. Under current practice, the Commission now distinguishes between pooled unit wells, PSA wells, and allocation wells. But only pooled unit wells are addressed in the Commission's APA-compliant rules. The words "allocation well" and "PSA well" appear nowhere in Commission rules.

In its response, Magnolia asserts that PSA and allocation wells are "widely-used options for horizontal drilling." Magnolia Resp. at 9. However, their prevalence is likely a result of the Commission's failure to adhere to the APA. As Professors Smith and Weaver explain, the prevalence of PSA and allocation wells developed in part because the system remained shielded from public scrutiny:

> The informal, PSA/allocation well permitting system was becoming a standard part of the Railroad Commission's decision-making, even though no fieldwide rule or statewide rule authorized such. This situation may have developed so quietly because royalty interest owners did not receive notice of the permit applications for PSA or allocation wells, so the permitting process was largely hidden from their view.

Smith & Weaver, *supra* § 9.9(B).

In fact, it is fair to assume that had the Commission subjected its horizontal well policies to public comment, as required by the APA, the policies would have received substantial resistance. As explained in Plaintiffs' Initial Brief, proposed legislation that would have authorized the Commission to issue allocation well permits faced substantial opposition from the public and other state agencies, and the Legislature declined to adopt the proposal. Br. at 30; AR2, Item 32 at 103–06 (Tex. H.B. 1552, 84th Leg., R.S. (2015)).

In its response, Magnolia highlights that the Commission has a long history of making rules without initiating formal rulemakings. Resp. at 20–24. Magnolia identifies several such rules. For example, Magnolia asserts that the Commission has created: a new method for classifying gas wells; a method for curing Rule 37 violations; an expiration date for permits for injection wells; and an approval process for unitization when 85% of the working interest and 65% of the royalty interests in the unitized field reach an agreement. *Id.* Magnolia argues, without citing any authority, that these informal rules do not "require the bells and whistles of APA rulemaking." *Id.* at 23. Magnolia's use of the idiom "bells and whistles" is telling. *Merriam-Webster* defines "bells and whistles" as "items or features that are useful or decorative but not essential."[2] As explained above, the APA is an essential check on administrative agencies' power. It is a core component of our system of governance, not a decorative feature.

The Commission's practice of informally adopting statewide rules is clearly contrary to the APA—and the Commission should reconsider its practices. Importantly, however, none of the informal rules that Magnolia

[2] *Bells and Whistles*, Merriam-Webster, https://www.merriam-webster.com/dictionary/bells%20and%20whistles.

identifies have been subjected to judicial review. Neither Magnolia nor the Commission cites a single case that says this sort of informal rulemaking is permissible under the APA. *Cf. Tex. State Bd. of Pharm. v. Witcher*, 447 S.W.3d 520, 537 (Tex. App.—Austin 2014, pet. denied) (recognizing that agencies may "utilize ad hoc rulemaking *only in narrow circumstances*") (emphasis in original).

In short, the Commission has created an *ad hoc* regulatory regime for PSA and allocation wells that is nowhere to be found in its formally adopted rules. The Commission frequently changes it policies, and to understand them one must look in the "hidden arcana" of Commission forms. This process is incompatible with the APA's "full panoply of procedural safeguards."

As a decision based on an invalid *ad hoc* rule, the Commission's Final Order should be reversed. *Witcher*, 447 S.W.3d at 526 ("an agency decision based on an invalid rule must be reversed and remanded to the agency if the substantial rights of the appellant have been prejudiced thereby.").

II. The Commission's Final Order violates Rules 26 and 40.

Deference to an agency's interpretation of its regulations is not without limits. *TGS-NOPEC Geophysical Co. v. Combs*, 340 S.W.3d 432, 438 (Tex. 2011).

"[N]o deference is due where an agency's interpretation fails to follow the clear unambiguous language of its own regulations." *Id.*

A. Rule 26 prohibits commingling from separate leases.

The plain language of Rule 26 states: "All oil and any other liquid hydrocarbons as and when produced shall be adequately measured . . . before the same leave *the lease* from which they are produced." 16 Tex. Admin. Code § 3.26(a)(2) (emphasis added). As a prominent professor of oil and gas law has summarized, this rule "requires operators to separately measure production from a particular tract before it leaves the tract and is commingled with production from other tracts." Bret Wells, *Allocation Wells, Unauthorized Pooling, and the Lessor's Remedies*, 68 Baylor L. Rev. 1, 13–14 (2016).

Magnolia and the Commission, however, argue that this Rule does not apply to hydrocarbons that are commingled in a wellbore before being brought to the surface. *See* Magnolia Resp. at 28–31; Commission Resp. at 33–34. Magnolia and the Commission assert three arguments, none of which has merit.

First, Magnolia argues that the title of Rule 26 limits its application to commingling that occurs at the surface. Magnolia Resp. at 28. Rule 26 is

entitled: "Separating Devices, Tanks and Surface Commingling of Oil." Courts interpret administrative rules "like statutes, under traditional principles of statutory interpretation." *TGS-NOPEC Geophysical Co.*, 340 S.W.3d at 438. It is well established that when the plain meaning of a statute controls, "the title of the section carries no weight, as a heading 'does not limit or expand the meaning of a statute.'" *Abutahoun v. Dow Chem. Co.*, 463 S.W.3d 42, 47 n.4 (Tex. 2015) (quoting Tex. Gov't Code § 311.024).

Second, Magnolia and the Commission assert that the term "lease" in Rule 26 does not refer to the actual lease from which the oil is produced, but instead refers to Commission's lease identification number. They argue that when an operator drills a PSA or allocation well, the multiple tracts within the drilling unit are combined into a single "lease" for Commission purposes. However, neither Magnolia nor the Commission identifies a Commission rule that allows operators to combine separate tracts into a single "lease" for regulatory purposes (except for pooled units under Rule 40). In fact, existing regulations require that each oil producing property be given a separate lease number. 16 Tex. Admin. Code § 3.4(a).[3]

[3] The Commission has apparently created—without following the APA—an exception to Rule 3.4(a) for properties that are included in a PSA or allocation well.

Third, Magnolia and the Commission argue that for purposes of Rule 26, hydrocarbons are not "produced" until they reach the wellhead. However, that argument ignores the context in which the term "produced" is used. The Rule states that hydrocarbons must be measured before they leave "*the lease from which* they are produced." 16 Tex. Admin. Code § 3.26(a)(2) (emphasis added). In other words, the hydrocarbons must be measured before they leave the property from which they originate.

Texas' existing regulatory framework, like Rule 26, exposes one of the biggest problems with allocation and PSA wells: because allocation and PSA wells commingle production from multiple tracts, the lessee must pay royalties based on *estimated* production from each tract. Before the Commission started issuing permits for allocation and PSA wells, Rule 26 required lessees to measure production before it left the leased premises. Thus, lessors were assured that their royalties were based on actual production from their land.

When a lease is properly pooled, this problem is avoided because in a pooled unit, royalties are calculated by agreement. For example, a "standard industry pooling clause" provides that royalties are allocated among the tracts in the unit based on the proportion of acreage from each tract in the

pooled unit. *Wagner & Brown, Ltd. v. Shepard*, 282 S.W.3d 419, 423 (Tex. 2008). For allocation and PSA wells (to the extent not all owners have signed a PSA), royalties are calculated neither by actual production nor by agreement; they are calculated based on estimated shares of commingled production. This matters because, as one commentator has noted: "obtaining actual measurements of production from each tract committed to an allocation well is a large burden, if not an impossible one." Clifton A. Squibb, *The Age of Allocation: the End of Pooling as We Know It?*, 45 Tex. Tech L. Rev. 929, 953 (2013).

Rule 26 exists, among other reasons, to ensure accurate calculation and payment of royalties. Indeed, the limited exceptions to Rule 26, which do allow commingling, provide multiple safeguards to protect royalty owners. For example, when a party applies for a Rule 26 exception, the applicant must provide "a method of allocating production to ensure the protection of correlative rights" and must give notice to all royalty and working interest owners. 16 Tex. Admin. Code § 3.26(d)(1). If an interest owner objects, the Commission must hold a hearing and can permit commingling only if the applicant demonstrates that (1) the proposed commingling will prevent waste, promote conservation, or protect correlative rights and (2) the

applicant's method of allocation accurately attributes "to each interest its fair share of aggregated production." *Id.* § 3.26(d)(2) & (e).

For allocation and PSA wells, the Commission has not adopted any of the safeguards found in Rule 26(d) and (e). The Commission does not require notice to royalty owners, and it does not require an applicant to show that it will accurately allocate production among the tracts. Instead, the Commission refuses to even consider the issue, and its forms for allocation and PSA well permits include a disclaimer stating that: "Issuance of the permit is not an endorsement or approval of the applicant's stated method of allocating production proceeds among component leases or units." AR2, Item 32 at 26.

Because the Commission's Final Order allows Magnolia to commingle production from the Opielas' land before it is properly measured, the Final Order violates Rule 26.

B. Rule 40 requires contractual pooling authority and a Certificate of Pooling Authority.

Rule 40 is the only Commission rule that allows an applicant to combine acreage from multiple tracts into a single drilling or proration unit. That rule requires the applicant to file a Certificate of Pooling Authority. 16

Tex. Admin. Code § 3.40(a). Here, Magnolia and the Commission argue that Rule 40 does not apply because the well was permitted as a PSA well, not a pooled unit well. However, Magnolia did include the Opielas' land in a pooled unit, and as discussed below, it lacked the authority to do so.

Moreover, as Magnolia's counsel argued below, PSA wells and pooled unit wells are functionally indistinguishable:

> Now, I think if you scratch below the surface on that, that argument doesn't make any sense. It puts form over function. What does a pooled unit do? A pooled unit says here's how we're going to allocate production from this big area now that we've combined these tracts. Everybody is gonna share on a surface acreage basis. So one of the key aspects of pooling is, Here's how we're going to share production from this bigger area than any one tract. That is a production sharing agreement. That's one of the components of it. And so a pooled unit should count towards the 65 percent sign-up threshold.

AR1, Dec. 10 at 40.

Magnolia's predecessor originally permitted the well as an allocation well, over the Opielas' objections. After the well was drilled, but before it was completed, Magnolia took over as operator and filed a new application to permit the well as a PSA well, representing that it had PSAs from at least

65% of the royalty and mineral owners in each tract crossed by the well. AR2, Item 32 at 26. Magnolia (or its predecessor) also filed a Designation of Pooled Unit for the well. AR3 Dec. 10, Compl. Ex. 22. But it did not then seek a permit to drill the well as a pooled unit well. Nevertheless, Magnolia relies on ratifications of the pooled unit by some royalty owners as support for the 65% threshold. So, we have a well that is neither fish nor fowl. If Magnolia indeed intends the well to be a pooled-unit well—as shown by the designation of pooled unit—it should have obtained a pooled-unit permit and complied with Rule 40. All this confusion about what type of well this is illustrates the problems the Commission has created by failing to adopt formal rules governing the permitting of these types of wells.

Finally, as discussed below, a PSA well is in fact a type of pooled unit well. Because Magnolia failed to file a Certificate of Pooling Authority, the Final Order violates the plain language of Rule 40.

III. Magnolia has not satisfied the 65% threshold requirement for PSA wells.

As discussed above, the Commission has not issued any formal rules regarding PSA wells. Importantly, it has not even formally defined the term "production sharing agreement." The Commission has never stated what

constitutes a valid, acceptable PSA that can contribute to the 65% threshold and it has no process to verify that what was submitted is actually a valid PSA. Again, the failure to adopt any discernable standards has led to this case.

Magnolia argues that consents to pool (signed by NPRI owners who have no authority to grant pooling) satisfy the 65% threshold for a PSA well because "there is no particular form of agreement required to be a production sharing agreement." Resp. at 40. Because there are no regulations or caselaw discussing PSAs, Magnolia cites to no authority.

However, Magnolia' reliance on consents to pool exposes that PSA wells are just a type of pooled unit well. According to Magnolia, it does not need to comply with Rule 40 because the Audioslave Well is not a pooled unit well. But at the same time, Magnolia has filed a pooled unit designation and relies on consents to pool to satisfy the 65% threshold. Magnolia cannot have it both ways. If PSA wells and pooled unit wells are so different that they deserve separate regulatory treatment, as Magnolia contends, then a consent to a pooled unit cannot be the basis for a PSA.

IV. The Commission's Order is based on the faulty assumption that the Commission cannot consider Magnolia's legal authority to drill the well under its lease.

Under *Magnolia Petroleum Co. v. Railroad Commission*, 170 S.W.2d 189 (Tex. 1943), the Commission has the power and duty to evaluate permits for reasonableness. In *Magnolia*, the Texas Supreme Court addressed the effect of a title dispute on the Commission's ability to grant drilling permits. *Id*. at 190-91. While the Court explained that legal title could only be settled by the courts, the Court also declared that "the Railroad Commission should not do the useless thing of granting a permit to one who does not claim the property in good faith." *Id.* The Court instructed that "[t]he Commission should deny the permit if it does not reasonably appear to it that the applicant has a good-faith claim in the property." *Id.* (emphasis added). In other words, while the Commission does not have the authority to make binding determinations of property rights, the Commission does have the authority—and the duty—to examine and evaluate property rights in the performance of its regulatory responsibilities. *See FPL Farming Ltd. v. Envtl. Processing Sys., L.L.C.*, 351 S.W.3d 306, 313 (Tex. 2011) ("Consistent with our suggestion in *Magnolia Petroleum* that the Railroad Commission has the

authority and obligation to look to the parties' legal status in determining whether a permit should be issued . . . .").

As explained in Plaintiffs' Initial Brief, the Austin Court of Appeals has held that the Commission can (and should) examine whether the applicant for a well permit has a good-faith basis to assert pooling authority. *Cheesman v. Amerada Petroleum Corp.*, 227 S.W.2d 829, 831 (Tex. Civ. App.—Austin 1950, no writ). There the Court acknowledged that the Commission could not "adjudicate the validity" of the pooling agreement, but it could take that into account when determining whether the applicant had made a "reasonably satisfactory showing of good faith" of pooling authority. *Id.* at 832. The Commission reviewed the pooling agreement at issue and, considering the applicable law, determined that a guardian lacked authority to execute leases beyond the age of the ward's majority. *Id.* at 831–32 (citing pertinent statutory provisions).

In its response, Magnolia argues that *Cheesman* limits the "Commission's jurisdiction to threshold questions of lease validity." Magnolia Resp. at 47. However, nothing in the court's analysis suggests that it is limited to "threshold questions." Rather, the court's analysis shows that when determining whether an applicant has shown a good-faith claim in the

property, the Commission must examine property and contractual rights when evaluating applications for good faith.

Here, the Commission committed legal error in refusing to even consider whether Magnolia has shown a good faith-claim to the property rights it asserts under the parties' lease. That error alone warrants reversal.

V. Magnolia lacks authority to drill the Audioslave well because the well impermissibly pools the Opielas' property.

The Lease at issue in this case expressly prohibits pooling the Opielas' property or any portion of it with any other tract for production from a well classified as an oil well: "Nothing contained herein shall authorize Lessee *in any manner whatever* to pool said land or any part of the same for oil, and for the production of oil from said land under this lease." AR3, Dec. 10 Compl. Ex. 4 (emphasis added).

Despite this clear language, Magnolia has included Opielas' property in a pooled unit. AR3, Dec. 10 Compl. Ex. 22 (designation of pooled unit). The decision in *Luecke* is on point. In *Luecke*, the operator filed a pooled unit designation and drilled horizontal wells located partly on the Lueckes' property. *Browning Oil Co. v. Luecke*, 38 S.W.3d 625, 638 (Tex. App.—Austin 2000, pet. denied). But the Lueckes' lease did not authorize the formation of

the pooled unit, and the Lueckes refused to agree to the unit. *Id.* The court held that Browning's completion of a horizontal wells located partly on the Lueckes' land violated the terms of the Lueckes' lease. *See id.* at 632 ("We affirm the trial court's determination that Lessees breached the pooling provisions of the leases."). The court rejected the operator's argument that it had not violated the leases, reasoning that "a lessee has no power to pool absent express authority." *Id.* at 634. The Court did not mince words; it stated that when a lease does not allow an operator to combine multiple tracts, "rather than ignore the written lease, the prudent operator must seek to negotiate a solution mutually beneficial to both the lessee and the lessor *or else forego drilling*." *Id.* at 647 (emphasis added).

Under the plain holding in *Luecke*, Magnolia could not include the Opielas' property in a pooled unit. Although the Commission does not have jurisdiction to adjudicate the parties' rights under the lease, the Commission had a duty to consider applicable law when determining whether Magnolia has made a good-faith claim to drill the well. *See FPL Farming Ltd.*, 351 S.W.3d at 313 ("Consistent with our suggestion in *Magnolia Petroleum* that the Railroad Commission has the authority and obligation to look to the parties' legal status in determining whether a permit should be issued . . ..").

Under the plain language of the Lease and holding in *Luecke*, Magnolia could not make a good-faith showing.

Magnolia argues that the holding in *Luecke* does not apply here because allocation wells and PSA wells are not the same thing as pooling. Magnolia's argument lacks merit for two reasons.

First, Magnolia's argument ignores that Magnolia did in fact include the Opielas' property in a pooled unit. The Commission also argues that, despite the designation of unit purporting to pool the Opielas' property, "the Audioslave Well is not on a pooled unit." Commission Resp. at 34. Neither Magnolia nor the Commission explain how an operator may opt to include a property in a pooled unit and pay royalties on a pooled unit basis but choose to not comply with the regulatory requirements for a pooled unit well. 16 Tex. Admin. Code § 3.40.

Second, the fact that Magnolia has seamlessly gone from calling the Audioslave well a pooled unit well, allocation well, or PSA well, depending on context, reveals that the three things are the same. In its response, Magnolia claims that Texas law has a narrow definition of pooling, and that pooling occurs only when certain "attributes" are present. Magnolia Resp. at 36. But Magnolia's narrow definition of "pooling" is inconsistent with the

term's common meaning. For decades, the term "pooling" has been consistently defined as the combination of multiple tracts into a single drilling unit:

- "The term 'pool' or 'pooling,' as here used, and as commonly used by members of the petroleum industry, means the integration of areas and interests in order to form a drilling unit or to permit the location of a well so that it may be drilled in compliance with a spacing regulation." Robert E. Hardwicke, *Oil-well Spacing Regulations & Protection of Property Rights in Texas*, 31 Tex. L. Rev. 99, 100 (1952).
- "Pooling occurs when tracts from two or more leases are combined for purposes of drilling a single well." Smith & Weaver, *Texas Law of Oil & Gas* § 4.8.
- "Pooling – the bringing together of small tracts of land or fractional mineral interests over a producing reservoir for the purpose of drilling an oil or gas well. Pooling is usually associated with collection a large enough tract to meet well-spacing regulations." *Pooling*, Black's Law Dictionary (11th ed. 2019).
- "Consistent with the historic purpose and in recognition for why pooling clauses were invented, commentators early-on articulated the definition of pooling as the combining of tracts to form a drill site in a well spacing pattern, and this accepted definition has been carried forward in leading treatises." Wells, *supra*, 68 Baylor L. Rev. at 17.
- "Technically, '[p]ooling means the bringing together of small tracts sufficient for the granting of a well permit under the applicable spacing rules." *Circle Dot Ranch, Inc. v. Sidwell Oil & Gas, Inc.*, 891 S.W.2d 342, 347 (Tex. App.—Amarillo 1995, writ denied).
- "Often if a tract is of insufficient size to satisfy the state's spacing or density requirements, lessees will 'pool' acreage from different leased tracts. Pooling allows a lessee to join land from two or more leases into a single unit." *Luecke*, 38 S.W.3d at 634.

In this case, Magnolia included multiple tracts, including the Opielas', into a single drilling unit. Magnolia has therefore "pooled" those tracts. Because the plain language of the Opielas' lease prohibits pooling, Magnolia cannot show a good-faith claim to operate the well.

Magnolia also argues that *Luecke* is distinguishable because the operator there *permitted* its wells as pooled unit wells. But the lease violation in *Luecke* was not the permitting of the wells, but the filing of the pooled unit designation without authority from the lessor, just as in this case. It does not matter that Magnolia's permit was first for an allocation well and then for a PSA well. Magnolia had no authority to pool the Opielas' lease, and it had no authority under the lease to drill a well crossing lease lines without pooling.

Magnolia and the Commission's Proposal for Decision rely heavily on Professor Ernest Smith's writings about allocation wells. For a contrary view, see Brett Wells, *Allocation Wells, Unauthorized Pooling, and the Lessor's Remedies*, 68 Baylor L. Rev. 1 (2016). In Professor Smith's law review article cited by Magnolia, he relies on *Luecke* for his conclusion that a lessee does not need pooling authority to drill a horizontal well that crosses lease lines. This is a misreading of *Luecke.* If the court in *Luecke* had held that Browning

had no obligation to form a pooled unit in order to drill its wells, it would not have held that Browning had breached its lease. There, the Court clearly held that the multi-tract wells constituted unlawful pooling. *Luecke*, 38 S.W.3d at 640–42. Using Professor Smith's logic, Browning would not have violated the Lueckes' lease if it had not filed a pooled unit designation. That is not *Luecke's* holding.

Professor Smith and Magnolia argue that *Luecke* supports their argument that operators can drill wells across lease lines without pooling authority, and that royalties should be paid on the estimated portion of well production from each tract crossed by the wellbore. While the court suggested that an allocation of royalties was one method of measuring the Lueckes' damages for breach of the lease, it did not hold that drilling the well was not a breach of the lease or that allocation should be the Lueckes' only remedy. In fact, on remand, the court instructed that the Lueckes may have other remedies available to them. *Id.* at 647 n.30. On the issue of whether the lease allowed the operator to drill the well, the court did not mince words: "We hold that the trial court did not err in ruling that Lessees failed to comply with the pooling provisions in the leases." *Id.* at 642.

Finally, Magnolia makes much of the fact that the Opielas have sued Magnolia in Karnes County for breach of the lease, and it argues that that court is the proper forum to determine whether the Lease authorizes the drilling of Magnolia's well. It is true that the issues in this case and the Karnes County case overlap to some degree. But the court in Karnes County cannot decide whether the Commission erred by granting Magnolia's permit in violation of its own rules and the APA. Only this Court can make those determinations. Tex. Gov't Code § 2001.176(b)(1) (conferring administrative appeal jurisdiction to Travis County district courts).

Because the Audioslave well combines the Opielas' property with other tracts, it is an improper pooling and violation of the lease. Accordingly, Magnolia cannot show a good-faith claim to drill the well, and the Commission committed reversible error.

VI. An Order invalidating the Audioslave Well permit would not invalidate thousands of permits.

Magnolia claims that a ruling in the Opielas' favor would be devastating for the industry, taking away a valuable tool allowing it to drill wells that could not otherwise be drilled and invalidating thousands of

allocation and PSA well permits. There are several flaws in Magnolia's Chicken-Little arguments.

First, Texas, unlike many other oil-producing states, does not authorize forced pooling. If landowner rights were truly a substantial impediment to development, the Legislature would have passed a forced-pooling statute—like most oil-producing states have.[4] However, Texas public policy favors the rights of property owners and their ability to negotiate contracts with respect to the use of their property. When the Legislature considered legalizing allocation wells in 2015, the University of Texas System "presented data showing that private bargaining between lessees and lessors almost always resulted in acceptable terms to both parties." Smith & Weaver, *Texas Law of Oil & Gas* § 9.9(B). As the court stated in *Luecke*: "rather than ignore the written lease, the prudent operator *must seek to negotiate* a solution mutually beneficial to both the lessee and the lessor *or else forego drilling*." *Luecke*, 38 S.W.3d at 647 (emphasis added). Defendants' purported policy-based arguments are inconsistent with Texas' policy favoring property rights and freedom to contract.

[4] *See* 6 Patrick H. Martin & Bruce M. Kramer, Williams & Meyers, Oil & Gas Law § 905.2 (surveying state compulsory pooling statutes).

Second, Magnolia's doomsday predictions of devastating results from this Court's ruling should not affect this Court's consideration of whether the Commission has complied with the APA or whether Magnolia has shown a good-faith claim of right to drill its well. The consequences of the ruling to other wells and other parties and cases would be decided another day.

Third, a ruling in the Opielas' favor would not somehow nullify previously granted permits. The time limits for challenging those well permits have long expired. An order in the Opielas' favor may require the Commission to comply with the APA going forward and it may require oil and gas lessees to negotiate with their lessors for *future* operations. But, for wells that have already been drilled and completed, without protest from lessors (who have signed division orders and received royalties), any potential claims by the lessors would almost certainly be barred by limitations, laches, or estoppel. *See Hooks v. Samson Lone Star, LP*, 457 S.W.3d 52, 66 (Tex. 2015) (lessor ratified pooled unit by accepting royalties from pooled unit).

Fourth, every single operator of an allocation well or PSA well has been put on notice that such wells are on a shaky legal foundation. The

Commission's permit applications contain a conspicuous disclaimer stating that:

> Commission Staff expresses no opinion as to whether a 100% ownership interest in each of the leases alone or in combination with a "production sharing agreement" confers the right to drill across lease/unit lines or whether a pooling agreement is also required.

AR2, Item 32 at 26. In light of this warning from the Commission, Magnolia cannot now argue that allocation wells are "well-established" options, no matter their prevalence.

The Court should not give any weight to Magnolia's hyperbole. A ruling in Plaintiffs' favor would be correct on the law and it would *not* "impact many thousands of allocation and PSA wells already drilled across the state." Magnolia Resp. at 1.

CONCLUSION AND PRAYER

For the reasons stated above, Plaintiffs respectfully request that the Court reverse and remand. Plaintiffs request such other and further relief to which they are entitled.

Respectfully submitted,

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Pursuant to Travis County District Court Local Rule 10.5, which requires briefs in administrative appeals to conform to the limits on length set forth in Tex. R. App. P. 9.4(i)(3), I certify that the foregoing document complies with the word count limitations set out in Tex. R. App. P. 9.4. It contains 6,210 words, excluding parts exempted by Tex. R. App. P. 9.4(i)(1) and the Travis County District Court Local Rules. In making this Certificate of Compliance, I am relying on the word count provided by the software used to prepare the document. This is a computer-generated document created in Microsoft Word, using 14-point Book Antiqua typeface for body text and 12-point Book Antiqua typeface for footnotes.

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