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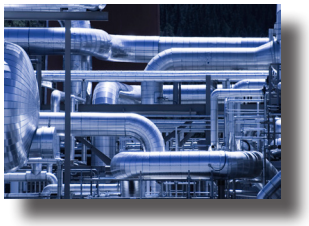

Proration Units and Lease Expirations

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In October, two Texas Courts of Appeals handed down decisions about how to determine which acreage expires when a lease hits the end of the primary term (or continuous drilling program). As expected, the conclusion turns on the language in the lease.

In the *Chesapeake Exploration et al. v Energen Resources Corporation* (Tex.Civ.App.—El Paso, October 1, 2014) case, the lease covered 640 acres and contained a pooling provision. Eighty of the leased acres were put into a 640 acre unit (Unit A); the remaining 560 acres were put into a different 640 acre unit (Unit B). The continuous drilling provision expired in 1979 and, at that time, both units were producing. Unit A continues to produce today, although Unit B ceased to produce in 1988. Energen received an assignment of the original lease, while Chesapeake took a new lease from the lessors on the basis that, upon the cessation of production from Unit B, the 560 acres reverted to the lessors. Energen drilled a well on the 560 acre tract; Chesapeake obtained a permit to drill on the same 560 acre tract. A dispute ensued.

The lease provided that, when continuous development ends, the lease terminates as to all acreage except for each proration unit upon which exists, either on the land or on lands pooled therewith, a well capable of producing.

In essence, Chesapeake argued that the termination provision is a "rolling" one, such that if production ever ceases from a unit, all of the acreage in that unit expires. Energen argued that the clause operated once and once only, so that if a unit did not terminate at the end of the continuous drilling program, the clause could have no further effect and expiration or termination could depend only upon other lease terms. Because the pooling clause said that production on any part of the pooled acreage acted as production from the lease and the habendum clause provided that the lease should continue as long as there was production from the lease or lands pooled with the lease, the producing well in Unit A continued the entire 640 acre lease.

The El Paso court rejected the rolling termination approach saying that no language implied a rolling termination ("[T]he retained acreage clause does not expressly provide for rolling termination of proration units as they cease to exist.") and that the lease language confirms that production anywhere on the 640 acres, or from lands pooled with it, is sufficient to maintain the lease: "In the absence of anything in the lease to indicate a contrary intent, production on one tract will operate to perpetuate the lease as to all tracts described therein and covered thereby." Citing the pooling clause, the court said "this clause ensures that production anywhere on a pooled unit maintains the lease in effect as to all lands covered by the lease, both within and outside the unit, unless the lease expressly provides otherwise."

The court's opinion held that the lease did not require actual production, but merely a well capable of production, "indicat[ing] they did not intend the retained acreage clause to be triggered any time actual production stops."

The *Chesapeake* case, then, stands for the proposition that, if the language of the lease does not so specify, the Pugh clause, which terminates the lease as to all acreage outside of existing units, will be applied only at the time the lease would have ended, i.e. either at the end of the primary term or at the end of the continuous drilling clause. Further, if production ceases after such point in time, the termination

clause will not apply. Because the Pugh clause had no further applicability after the end of the continuous drilling clause, lease termination was determined by the remaining provisions in the lease; because 80 acres of the lease were in a unit having an off lease well, and the habendum clause said the lease continues as long as there is production from the lease or lands pooled with the lease, the lease continued.

In the *Endeavor Energy Resources et al. v. Discovery Operating, Inc. et al.* (Tex.Civ.App.—Eastland, October 23, 2014) case, the lease contained the following automatic termination clause:

> 18. At the end of the Primary Term or upon the cessation of the continuous development of the Leased premises … this lease shall automatically terminate as to all lands and depths covered herein, save and except those lands and depths located within a governmental proration unit assigned to a well producing oil or gas in paying quantities …, with each such governmental proration unit to contain the number of acres required to comply with the applicable rules and regulations of the Railroad Commission of Texas for obtaining the maximum producing allowable for the particular well.

Endeavor, as Operator, drilled two producing wells. The applicable field rules established 80 acre proration units, but allowed an 80 acre tolerance so that it could receive an allowable credit for not more than 160 acres. When Endeavor filed its certified proration plat it assigned 81 acres to each of four wells. Yet, it assigned none of the two disputed quarter sections to the wells, although it could have.

Discovery took leases on the two disputed quarter sections believing they had expired under Section 18 of the Endeavor lease. Discovery drilled two producing wells in each of the disputed quarter sections. When challenged, Discovery argued that the Endeavor lease was a determinable fee subject to a special limitation in Section 18. Because that special limitation allowed Endeavor to preserve the acreage "assigned" to a well and the only way to "assign" a proration unit to a well "is for an operator to file a certified proration plat with the" Railroad Commission, Endeavor was bound by its 81 acre designation.

Endeavor responded that, because the last portion of Section 18 says the unit contains the acreage required for the maximum producing allowable, the size of the proration units was automatically established under the special field rules at 160 acres. Rejecting Endeavor's argument, the court concluded that "the parties intended the last clause in Section 18 to define the amount of acres that Endeavor was to include in the governmental proration units that it assigned in its certified proration plats filed with the RRC." It concluded:

> We conclude that Section 18 unambiguously required Endeavor to file, before the automatic termination date, a certified proration plat with the RRC that assigned acreage to a governmental proration unit in order to avoid having its mineral interests in that acreage revert back to the lessors. Because Endeavor did not file certified proration plats with the RRC that assigned the acreage in the disputed quarter section by the automatic termination dates, the quantity of acreage that terminated under the lease includes the acreage in the disputed quarter sections.

A similar case is currently pending before the Amarillo Court of Appeals (*XOG Operating, LLC v. Chesapeake* (No. 07-13-00439-CV)). Like *Endeavor*, this dispute concerns a retained acreage clause and whether acreage must be in a proration unit in a filing with the RRC to hold acreage under a termination clause. *Endeavor* was concerned with a retained acreage clause in an oil and gas lease, but this case will turn on a similar clause in a Term Assignment to determine if the assigned leases will revert back to XOG or stay with Chesapeake.

For more information on the matters discussed in this *Locke Lord QuickStudy*, please contact the authors:

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