What is Forced Pooling?

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To drill a well, the oil and gas operator would like to acquire, through purchase, lease, or agreement, the right to extract the oil and gas accessed by the well. But what if there is one mineral owner in that area who does not want to allow drilling? Then the operator has the ability to apply to the Colorado Oil and Gas Conservation Commission (COGCC) to "force pool" the reluctant mineral owner – thereby allowing the mineral development to go forward. The force pooling laws are found in **C.F.R. 34-60-116** and **COGCC Rule 530**.

Forced pooling is often threatened by landmen to persuade reluctant mineral owners to lease their minerals. **But the threat of forced pooling should not be used to pressure a mineral owner to hastily sign a lease.** Forced pooling is only used as a last resort for operators who have already acquired leases to the vast majority of acreage they are planning to develop. In 2010, the COGCC received 62 forced pooling applications. Operators want to avoid the additional time and expense of going through the COGCC process to force pool a mineral owner.

In negotiating with a landman, it is helpful for a mineral owner to understand the process of forced pooling. Before an operator can pool an area, the area must be included into a drilling and spacing unit. This is done through an application with the COGCC. The COGCC defines a "drilling unit" as the largest amount of acreage that can be efficiently and economically drained by a single well. C.F.R §34-60-116(2). Thus, a landowner who only owns a percentage of the minerals under his land may be made part of a drilling unit, regardless of the size of the unit. Likewise, if a "common source of supply" (i.e. a large reservoir of oil) underlies several parcels of land, all the mineral rights underlying those parcels may become part of a single drilling unit.

To create a **drilling unit**, the COGCC defines the boundaries of the "common source of supply" and determines the approximate location of the well in that drilling unit that will efficiently drain the resource. All of the mineral owners within the proposed drilling unit are given notice (Rule 507(b)) and may require a hearing on the drilling unit by submitting a formal protest to the COGCC. (Rule 509). However, this is simply a hearing on the underlying geology of the area. A mineral owner would only be able to object to the size or shape of the drilling unit. To influence the COGCC decision, the landowner would likely have to offer expert testimony from a geologist.

Once the drilling unit has been established, an affected mineral owner, who has not leased his minerals, has four different options: He can choose to sell his minerals, lease his minerals, consent to voluntarily pool his mineral interest with the others and participate (financially) in the drilling operation, or be a "non-consenting" owner and be "force pooled".

To "**force pool**" a non-consenting mineral owner, the industry must apply to the COGCC to get a "force pooling order". An unleased mineral owner is considered "non-consenting" if the mineral owner has refused a ***reasonable offer to lease***. If the order is formally contested by the mineral owner (Rule 509), the COGCC will hold a hearing to determine if the offer to lease was reasonable. Reasonableness of the offer is determined by comparing the terms offered in the lease to terms accepted by adjacent mineral owners. Before the hearing, the non-consenting mineral owner should request copies of the operator's lease agreements with all other mineral owners in the unit. At the hearing, the non-consenting mineral owner may only present information as to why the lease terms offered were not reasonable (Rule 530(c)) or challenge the operator's compliance with the rules or statutes.

If the COGCC issues a force pooling order, there are four consequences for the non-consenting owner; 1) oil and gas operations in that drilling unit are allowed to proceed, 2) the mineral owner will get a 1/8 (12.5%) royalty payment, 3) the other 7/8 of the mineral interest payments are withheld to pay-off the costs of the well (plus penalties), and 4) if the mineral owner owns 100% of the minerals under a parcel of land, the operator will ***not*** be able to locate the well or facilities on that parcel.

A non-consenting mineral owner's working interest in the well is his proportionate share of mineral rights in the drilling unit. If the mineral owner had ten (10) acres of mineral rights in a forty-(40) acre drilling unit, his working interest in the well would be 25%. To obtain a working ownership interest, he would be required to pay 25% of the costs but then would receive 25% of the income.

Because the non-consenting owner has not paid his (25%) share of the costs, he will not receive his working interest income until those costs are paid. Instead, the non-consenting owner will only get a 1/8 royalty payment from that working interest. The other 7/8 income is withheld by the other owners until the amount collected equals the non-consenting mineral owner's proportionate costs of operating the well and off-site equipment, and <u>**double**</u> the proportionate costs of drilling the well. Once the costs are paid, then the mineral owner gets his 8/8 proportionate share of the well (in our example, the full 25% working interest share).

Here is an (oversimplified) example of how it works using *completely* fictional numbers:

- If the force-pooled mineral owner has 25% of the minerals in the drilling unit, then that owner would get 1/8 (12.5%) of that proportionate share of production proceeds as a royalty.
- The other 7/8 (87.5%) of the force-pooled mineral owner's proportionate income goes to pay the mineral owner's proportionate costs of annual operation and off-site equipment (25%), and <u>**double**</u> the proportionate costs of drilling the well (50%).
- For the sake of convenience, let's say the cost of drilling a well is three-million ($3,000,000), off-site equipment is $100,000, and the cost of annual operations are $100,000/year.
- The costs that must be recouped by the operator before the mineral owner becomes a part-owner of the well are:
    - 50% of $3,000,000 drilling costs = $1,500,000
    - 25% of $100,000 = $25,000
    - 25% of $100,000/year in operating costs= $25,000/year
- If the well generates an average of one million ($1,000,000) in revenue a year, the working interest in our example would be 25% of one million= $250,000 (minus costs).
- The royalty payment the mineral owner receives is 1/8 (12.5%) of $250,000 = $31,250/year.
- The other 7/8 (87.5%) of the mineral owner's income would go to pay the costs of the well listed above. 7/8 of $250,000 = $218,750

In this scenario, it would take over **seven years** to pay the proportionate share of the costs that must be recouped before the non-consenting mineral owner gets their 25% ownership share in the well. At that point, the well production may have substantially declined.

This scenario is, of course, based on completely fictional numbers. Recently, the costs of drilling wells in the Niobrara have been as high as $6 million. Yet, if the well is a real producer, like the *Jake* well in Weld County, it would pay-off in less than one year. Other wells never pay off.

In summary,

- Someone who owns all of the minerals on a large acreage probably will not be force pooled.
- But force pooling is a real threat to the small landowner or a landowner who does not own 100% of his minerals.
- This threat of force pooling is only carried out when the operator has acquired leases to a majority of the acreage it is planning to develop. During the early leasing phase, an operator ***will not*** force pool a mineral owner.
- Mineral owners who are forced pooled will still receive a 1/8 royalty interest—then their full proportional mineral interest once well has paid off double the drilling costs.
- If you are forced pooled, it is best to get legal representation to ensure your rights are protected.