Compulsory Pooling Promotes Conservation of Michigan's Oil and Gas Natural Resources

By James R. Neal

Recently, the Michigan Department of Environmental Quality (MDEQ) administrative procedure known as "compulsory pooling" or "forced pooling," has generated landowner concerns and legislative scrutiny.[1] Perhaps in part because of the menacing name, compulsory pooling invokes the specter of a Lansing-based bureaucrat compelling rural landowners to accept oil or gas development which they oppose for economic, environmental or aesthetic reasons. Landowners increasingly complain that they should not be compelled in any manner to participate in or accede to oil and gas drilling or production.

Some landowners characterize compulsory pooling as the oil company's retribution against a landowner for refusal to lease, while some oil companies complain that landowners force the initiation of compulsory pooling proceedings in an effort to extract better lease terms, or in an effort to stop drilling altogether. These reactions are unwarranted. Notwithstanding the name, compulsory pooling does not compel a landowner to undertake or accept any activities on his or her own lands, and the procedure is an important and effective conservation measure essential to Michigan's public policy in favor of conservation in the development of the state's oil and gas natural resources.

Compulsory pooling has served Michigan well for over 60 years as an integral part of our conservation efforts. It does not represent a recent bureaucratic invention designed to usurp an individual's use and enjoyment of one's own property.

The purpose of this article is to examine the traditional legal theories which generated the need for compulsory pooling to form drilling units; review the role compulsory pooling plays in Michigan's conservation laws; and highlight the safeguards built into the compulsory pooling process.

OWNERSHIP PRINCIPLES

Michigan's commercial oil and gas production began in 1925 with the discovery of the Saginaw Oil Field. Since then, Michigan has consistently placed high among the states in the annual volumes of oil and gas produced. While never approaching the frenzy of activity experienced by the big producing states, such as Texas (where the National Guard was activated in 1931 to maintain order), Michigan's early oil and gas development was frequently marked by a race among competitors to quickly capture as much oil as possible (in the early years, gas had little or no value).

Such competition inevitably led to the drilling of many more wells than were necessary to efficiently recover Michigan's reserves of oil and gas. As the accompanying photographs illustrate, other states' "forests" of drilling rigs also occurred in Michigan, with many detrimental consequences that Michigan's Legislature was forced to address.

Michigan is an "ownership-in-place" state. As such, it lines up with the majority of oil- and gas-producing states in holding that "the nature of the interest of the landowner in oil and gas contained in his land is the same as his interest in solid minerals."[2] One of the consequences of the ownership-in-place theory is that the owner of the surface has the right to explore, drill for, produce and sell oil and gas recovered from his or her property.

In Michigan, oil and gas, while in the ground, are regarded as part of the real estate.[3] One of the attributes of ownership is the right to develop a property's oil and gas resources, and reduce the resource to possession at the surface. This is an element of ownership that our courts have recognized may be protected against unlawful infringement by those who do not have an ownership interest in the property.[4]

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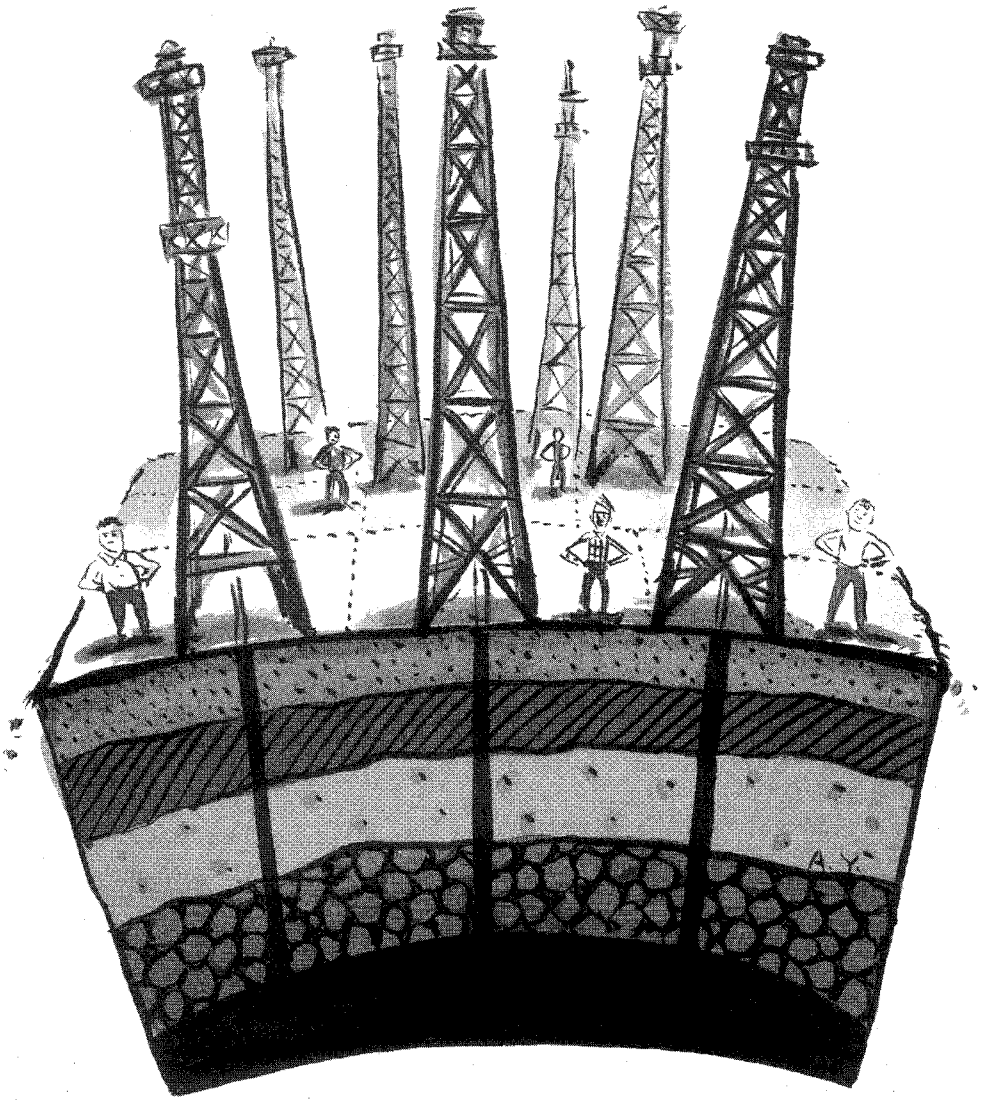
These traditional real estate principles work well when applied to static "hard" minerals, such as copper, iron ore and (briefly) coal, which have long been mined in Michigan. However, problems arise with their application to underground accumulations of oil and gas, which are anything

but static. The sometimes extraordinarily high subsurface pressures result in hydrocarbons, especially natural gas, migrating great distances within a reservoir.

The supervisor of wells has found that in certain gas reservoirs, an entire square mile can be efficiently and effectively drained by just one well.[5] Migrating oil and gas refuse to abide by our arbitrary surface ownership boundary lines. Hydrocarbons worth hundreds of thousands of dollars can migrate from one tract of land to another in just a few years' time.[6] The migratory nature of hydrocarbons lead to Michigan's recognition of the "Rule of Capture":

> *"The owner of a tract of land acquires title to the oil and gas which he produces from wells drilling thereon, though it may be proved that part of such oil or gas migrated from adjoining lands. Under this rule, absent some state regulation of drilling practices, a landowner * * * is not liable to adjacent landowners whose lands are drained as a result of such operations * * *. The remedy of the injured landowner under such circumstances has generally been said to be that of self-help—'go and do likewise'."* William and Meyers, supra, *Section 204.4, pp 55-57.*[7]

The Rule of Capture was harsh medicine for the dilatory owner. An owner slow to drill might end up drilling into an empty reservoir—the hydrocarbons having long ago drained to a neighbor's well. Such personal losses aside, the Rule of Capture induced a race to drill wells, with disastrous consequences on the overall efficiency of the recovery of hydrocarbons from the reservoir.



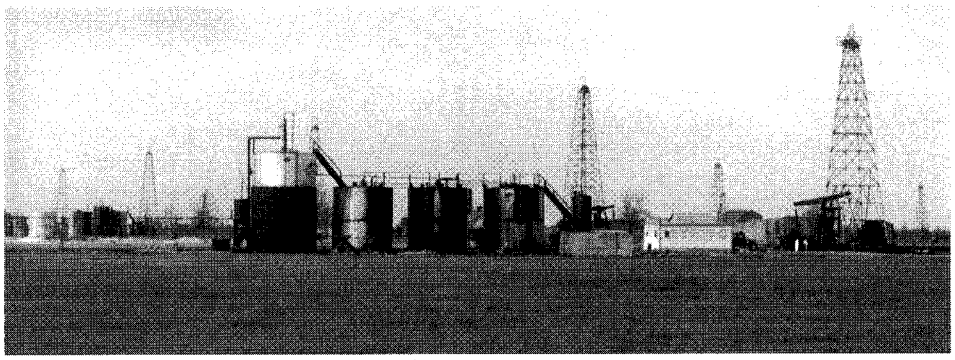
Generally, hydrocarbons are recovered through a well bore as a result of the naturally occurring pressure in the reservoir providing energy to carry oil to the surface. Excessive drilling into a reservoir had the effect of rapidly depleting or completely exhausting the reservoir energy, resulting in "dead oil" left in the reservoir. Dead oil is frequently lost forever, or its retrieval requires expensive supplemental recovery activities. The wasteful consequences of drilling more wells than necessary into a reservoir is now generally recognized, and viewed as a practice to be avoided whenever possible. For example, one commentator estimated that over $100 million was spent annually in Texas from 1947-1952 in connection with unnecessary wells.[8]

MICHIGAN'S OIL AND GAS ACT

The first Michigan law designed to regulate oil and gas drilling to avoid the drilling of unnecessary wells was passed in 1929.[9] One of that law's conservation initiatives was to mandate that wells shall not be drilled within 200 feet of the outer boundaries of any property. Later, Michigan adopted its so-called "Oil and Gas Act" with the adoption of 1939 PA 61.

Our Oil and Gas Act established a comprehensive conservation regimen designed to conserve oil and gas, including limits on daily production (prorationing), minimum distances between wells (spacing), and the establishment of drilling units (a minimum geographic area designated for each well). The Declaration of State Policy adopted in 1939 PA 61 emphasized the public need for such conservation measures. It did not cite the need to redress individual losses resulting from wasteful practices:

> *"It has long been the declared policy of this state to foster conservation of natural resources to the end that our citizens may continue to enjoy the fruits and profits thereof. Failure to adopt such a policy in the pioneer days of the state permitted the unwarranted slaughter and removal of magnificent timber abounding in the state * * *. The interests of the people demand that exploration and waste of oil and gas be prevented so that the history of the loss of timber may not be repeated. It is accordingly the declared policy of the state to protect the interests of its citizens and landowners from unwarranted waste of gas and oil and foster the development of the industry along the most favorable*



Drilling on 10-acre drilling units, Bloomingdale Field, Van Buren County, Michigan, after 1939 PA 61 enacted. Minimum drilling units in Michigan are now 40 acres, and most wells are drilled on 80-acre units.

*conditions and with a view to the ultimate recovery of the maximum production of these natural products. * * *."*[10]

To implement Michigan's policy, 1939 PA 61 defined waste, and prohibited the commission thereof. Waste consisted of:

"[T]he locating, spacing, drilling, equipping, operating, or producing of a well or wells in a manner to reduce or tend to reduce the total quantity of oil or gas ultimately recoverable from any pool."

"Surface waste... including all of the following: the unnecessary or excessive surface use or destruction without beneficial use, however caused, of gas, oil or other product... (c) the drilling of unnecessary wells."[11]

Elsewhere, 1939 PA 61 specifically defined unnecessary wells as being wasteful, and cited the public hazards presented by unnecessary wells:

"The drilling of unnecessary wells is hereby declared waste because unnecessary wells create fire and other hazards conducive to waste, and unnecessarily increase the production cost of oil and gas to the operator, and therefore also unnecessarily increase the cost of the products to the ultimate consumer."[12]

Having defined unnecessary wells as wasteful, 1939 PA 61 prohibited wasteful activities:

"It shall be unlawful for any person to commit waste in the exploration for or in the development, production, or handling or use of oil or gas...."[13]

In 1994, Michigan's Oil and Gas Act was codified as Part 615 of the Natural Resources and Environmental Protection Act, 1994 PA 451.[14] The traditional shorthand reference to "Act 61" has now given way to "Part 615."

DRILLING UNITS

One of Part 615's strong measures to prevent the drilling of unnecessary wells was by conferring on the supervisor of wells the authority to establish "drilling units":

"To prevent the drilling of unnecessary wells, the supervisor may establish a drilling unit for each pool. A drilling unit, as described in this subsection, is the maximum area that may be efficiently and economically drained by one well. A drilling unit constitutes a developed area if a well is located on the drilling unit that is capable of producing the economically recoverable oil or gas under the unit."[15]

Michigan's definition of a drilling unit has several important components. First, the supervisor of wells must consider the peculiar geologic attributes of "each pool" when determining the size of the drilling unit for a particular field.[16] Thus, Michigan has many different-sized drilling units, custom-designed, based on geological and engineering evidence, to apply to particular pools. Secondly, because Part 615 mandates that a drilling unit must be "the maximum area that may be efficiently and economically drained by one well,"[17] in establishing the size of drilling units, the supervisor of wells must necessarily apply technical expertise to determine the maximum area that a well will drain.

No longer will an individual landowner have the prerogative to drill on his or her individual tract of land which is smaller than the drilling unit established for the pool. Instead, wells will be drilled on drilling units designed to economically and efficiently drain the hydrocarbons from the pool, rather than solely designed to recover the oil or gas from a single tract.

Lastly, as long as the drilling unit contains a producible well, the entire drilling unit "constitutes a developed area"[18] rather than just the tract upon which the well was drilled. The owner of the drill site tract will not receive all of the benefits of the well, but must share the benefits with the owners of all tracts within the drilling unit. And, because each tract is "developed" by the drilling unit well, development on the drilling unit ceases after one well has been drilled. In its important ruling in *Manufacturer's National Bank v DNR*, our Supreme Court commented on the function of drilling units:

"To prevent unnecessary wells, and, therefore, prevent waste, the supervisor may establish drilling units. The establishment of a drilling unit prevents unnecessary wells because the size of the unit depends on the area that can be drained by one well, and only one well is allowed in a drilling unit...."[19]

The common-law Rule of Capture, and the right of each individual to develop his or her own tract of land have been modified by Part 615. No longer can a single landowner "go forth and do likewise" in response to a neighbor's well. Rather, neighboring tracts of land must be consolidated into square or rectangular drilling units. The *laissez faire* ability of each individual owner to determine whether, and on what conditions, development of the common resource will occur on his or her tract has been banished in Michigan since 1939. In its place, wells are drilled on drilling units. Every owner forfeits the right to drill a well on his or her own individual tract of land, but every owner within the drilling unit will share in production from the well.

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VOLUNTARY AND COMPULSORY POOLING OF TRACTS

In oil and gas parlance, the consolidation of small tracts into drilling units is

called "pooling." Part 615 endorses two mechanisms for the consolidation of tracts into drilling units: voluntary pooling and compulsory pooling. In the *Manufacturer's Natural Bank v DNR* case, the Michigan Supreme Court explained how drilling units and the pooling of tracts work in concert:

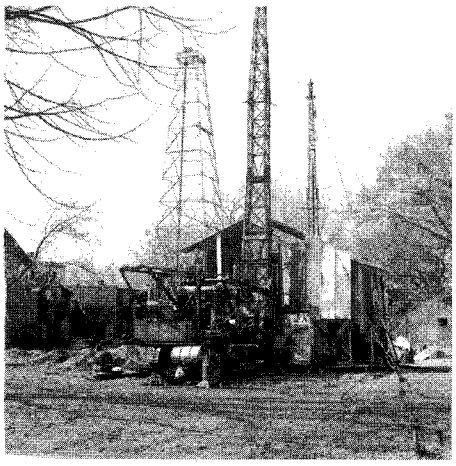
> *"When there is but one owner of all the land in the area the supervisor has designated as a drilling unit, the owner alone may simply apply for a permit to drill. If, however, different persons own the lands within the unit, problems arise. If an individual owner's land is smaller than the size of the drilling unit established for the oil or gas pool, the owner will be prohibited from drilling, unless unique circumstances would allow a well to be drilled on that land without waste. Therefore, so that the owners of land within a drilling unit can join together to apply for a drilling permit, there is the concept of pooling.*
>
> *The term 'pooling' has been defined as a term 'properly used to denominate the bringing together of small tracts sufficient for the granting of a well permit.'* Williams and Meyers, *8 Oil and Gas Law, p 554... On the subject of pooling, MCL 319.13; MSA 13.139(13) [now MCL 324.61513(4)] provides:*
>
> *'The pooling of properties or parts thereof shall be permitted, and, if not agreed upon, the supervisor... may require such pooling.'"*[20]

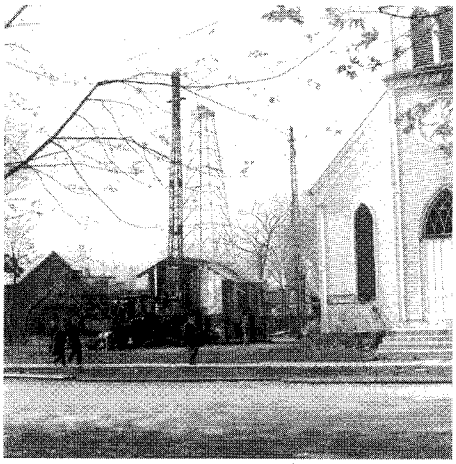
Voluntary pooling is the preferred method of consolidating tracts into drilling units:

> *"[Part 615] clearly provides that the Supervisor of Wells may only pool lands or allocate production if the parties have not agreed to do so."*[21]

Voluntary pooling occurs when all of the owners within a drilling unit agree among themselves to consolidate their tracts into a single drilling unit for purposes of drilling a well. Voluntary pooling most frequently takes the form of all landowners within a drilling unit individually negotiating oil and gas leases as lessors, with a single oil company, as lessee. Much less frequently, an owner of a tract will join together with other owners, or the lessees of other owners, to pool their tracts to form a drilling unit.

The Supreme Court in the *Manufacturer's* case held that voluntary pooling is contractual in nature. Most oil and gas leases contain a pooling clause where the lessor delegates to the lessee "... the power to pool [the lessor's] lands with the land of others in the unit."[22] The pooling clause of the oil and gas lease sets limits on the scope of the delegation. An important limitation is to establish the maximum acreage that may be pooled. Such maximums have usually been 160 acres for oil wells and 640 acres for gas wells, but special shallow gas pooling clauses permitting much larger units have recently come into use.[23]





"Town lot drilling" in the village of Bloomingdale, Van Buren County, 1938.

The lessee exercises the delegated pooling power by recording with the register of deeds a document known as a Declaration of Pooling. The declaration provides public notice of the legal description of the drilling unit and identifies the oil and gas leases dedicated to the unit. Supervisor of Wells Rule 303 recognizes that full drilling units may be formed by voluntary pooling.[24]

The statutory authority for, and limitations upon, the Supervisor of Wells' compulsory pooling power are contained in Section 61513 of Part 615:

> *"[T]he supervisor may require pooling of properties or parts of properties... All others requiring pooling described in this subsection shall be upon terms and conditions that are just and reasonable, and will afford to the owner of each tract in the pooling plan the opportunity to recover or receive his or her just and equitable share of the oil or gas...."*[25]

The statute does not use the words "compulsory" or "forced" pooling, but rather simply states that if voluntary pooling cannot be attained, then "the supervisor may require pooling of properties or parts of properties." Compulsory pooling under Part 615 is not an offensive or coercive proceeding, by or against any owner. On the contrary, the supervisor's order must "afford to the owner of each tract... his or her just and equitable share of the oil or gas...." Compulsory pooling is necessary whenever an owner desires to develop his or her mineral rights, but cannot do so because the owner's tract is smaller than the established drilling unit. Compulsory pooling must be available because drilling units prohibit the drilling of wells on small tracts. It would be fundamentally unfair, and perhaps an unconstitutional taking of property, if Michigan were to prohibit an owner from developing his or her property because a full drilling unit could not be voluntarily pooled.[26]

A compulsory pooling proceeding is initiated by the filing of a petition with the supervisor of wells. For obvious reasons, the owner desiring to drill the well is the owner who files a petition seeking compulsory pooling. The petition asks the supervisor to exercise his or her jurisdiction to require the just and reasonable pooling of a drilling unit. It does not ask the supervisor to force an unleased landowner to execute an oil and gas lease, contribute to the risk and expense of drilling a well, or take any other action.

ASSURANCES THAT COMPULSORY POOLING IS JUST AND REASONABLE

All participants in a compulsory pooling proceeding are offered the procedural and substantive due process protections set forth in the Administrative Procedures Act.[27] A compulsory pooling order can be issued by the supervisor only after all owners who have not voluntarily agreed

have been given notice of and offered the opportunity for a public hearing.[28] In addition, the rules adopted by the supervisor under Part 615, and past orders of the supervisor of wells, assure that the property rights of all owners are considered and respected. Such safeguards include the following:

- The compulsory pooling order does not authorize the drilling of a well on an unleased owner's surface tract.[29] The supervisor also disallows pipelines and other facilities on unleased surface tracts;
- The unleased mineral owner is entitled to his or her proportionate share of production from the drilling unit.[30] Thus, an unleased 20-acre tract within an 80-acre drilling unit is entitled to one-fourth of production from any well drilled on the unit;
- An unleased tract is responsible for the tract's proportionate share of the cost of drilling, completing, equipping and operating the well. However, the owner of the unleased tract does not assume any personal responsibility for the costs unless the owner affirmatively elects, in writing, to assume responsibility for costs[31] (see following item);
- With respect to production and costs, the unleased owner can elect one of two options:
  - Assume personal responsibility for payment of costs and pay 100 percent of his or her proportionate share of costs, in advance, and receive both a one-eighth royalty on his or her proportionate share of production, and the entire remaining seven-eighths of his or her proportionate share of production, subject to timely payment of the costs; or
  - Assume no personal responsibility for payment of costs, pay nothing toward costs, and immediately receive a one-eighth royalty on his or her proportionate share of production, and after his or her share of costs and additional compensation for the risk of the project are recovered by the owner who drills, from the unleased owner's share of production, then receive the remaining seven-eighths of his or her proportionate share of production, subject to payment of operating costs out of the seven-eighths share of production.[32]

(Under the second option, the unleased owner is never personally responsible for payment of any cost; immediately receives a one-eighth royalty on his or her share of production; and receives the remaining seven-eighths share after the owner who drills recovers costs and additional compensation [discussed in next item]. If the well is dry, the unleased owner never pays, out of pocket, any cost, and is not personally responsible for any costs. All costs are recovered out of production, if any);

- The unleased owner's one-eighth royalty interest is free of all costs, including post-production costs;[33]

Compulsory pooling accommodates the varied wishes of all landowners whose property overlies a common pool.

- The supervisor authorizes the owner who drills to recover from the unleased owner additional compensation for the risk of the well. If an unleased owner elects the option of assuming no personal responsibility for payment of costs, then all of the risk of a dry hole is on the owner who drills. For the compulsory pooling order to be fair and reasonable to the owner who drills, such owner is authorized to recover cost plus additional compensation for the risk that it has solely assumed. The unleased owner is protected because determinations of the amount of additional compensation must be based on evidence of the level of risk involved.[34] The greater the level of risk, the greater the additional compensation;
- The supervisor may decrease the size of the drilling unit. In *Traverse Oil v NCR Chairman*,[35] the Court of Appeals affirmed the supervisor's contraction of an 80-acre drilling unit to a 40-acre unit on the basis that only a 40-acre unit was fair and reasonable. The contraction had the effect of doubling the non-participating owner's interest from 6.3/80 (7.875 percent) to 6.3/40 (15.75 percent);
- In almost all compulsory pooling proceedings, the supervisor interprets the evidence to conclude that a surface acreage allocation of production is appropriate, on the basis that the reservoir appears to uniformly underlie the entire drilling unit, and each tract makes an equal *pro rata* contribution to the unit. In rare cases, the supervisor allocates production on an "underlain acreage" basis, when the evidence establishes that each of the tracts making up the drilling unit do not contribute equal *pro rata* portions of the reservoir to the drilling unit.[36] This is necessary for the required pooling plan to be fair and reasonable;
- The supervisor must approve the costs to drill, complete and equip the well, as projected by the owner who desires to drill. The supervisor allocates a proportionate share of costs against the unleased owner's share of production only to the extent that the costs are found to be appropriate;[37] and
- The owner desiring to drill must have made a good faith, *bona fide* effort to voluntarily pool before asking the supervisor to compulsory pool. Such effort is generally required to include the offering of lease terms at least equal to other lease terms generally offered in the area. However, with respect to lease terms and conditions, the supervisor does not act as a "mediator or arbitrator" between oil companies and landowners.[38]

CONCLUSION

Michigan's declared policy is to foster the development of its oil and gas natural resources "with a view to the ultimate recovery of the maximum production of these natural products."[39] Those who want to capture the oil and gas beneath their land are entitled to do so, but their efforts are subject to Michigan's declared policy and regulatory implementation of that policy. In Michigan, we have done the following:

- Established drilling units;
- Rigorously limited the number of wells that may be drilled; and
- Required minimum distances between wells.

The role of compulsory pooling in this regulatory scheme has been to preserve drilling units. The practice successfully balances the rights of those desiring to develop their oil and gas interests against the wishes of other owners who either oppose development altogether, or who oppose development on economic terms other than their own.

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Compulsory pooling, in concept and application, is not designed to help or harm any owner, or to penalize anyone. Part 615 mandates that it must be "just and reasonable," and offer each owner "the opportunity to recover or receive his or her just and equitable share of the oil or gas...." Compulsory pooling accommodates the varied wishes of all landowners whose property overlies a common pool.

The number of separate owners inside 40-, 80-, and 640-acre drilling units will continue to increase as rural land continues to be divided into ever smaller tracts. It will thus become increasingly likely that one or more owners, for whatever reason, will refuse to execute an oil and gas lease, or otherwise support development, making voluntary pooling ever more difficult to achieve. These circumstances require that compulsory pooling remain an effective regulatory procedure available to the supervisor of wells to maintain the public benefits of one well per drilling unit. ■

Footnotes

1. 1998 House Bill 5316; 1998 House Bill 5317.
2. *Manufacturer's National Bank v Department of Natural Resources,* 420 Mich 128, 141 (1984); *Wronski v Sun Oil Co,* 89 Mich App 11,21 (1979); *Attorney General v Pere Marquette R Co,* 263 Mich 431.
3. *Eadus v Hunter,* 268 Mich 233 (1934).
4. *Ross v Damm,* 278 Mich 388 (1936).
5. Special Order of the Supervisor of Wells No. 1-86, effective August 8, 1986.
6. *Wronski v Sun Oil Co,* 89 Mich App 11 (1979).
7. *Id.,* at 17.
8. Hardwicke, "Oil Well Spacing Regulations and Protection of Property Rights in Texas," 31 *Texas Law Review 99,* 111 (1952).
9. 1929 PA 15. Earlier, 1927 PA 65 first created the office of the supervisor of wells. Today, the director of the MDEQ also holds the title of supervisor of wells. In practice, the assistant supervisor of wells initially wields the regulatory power, with appeals going to the director. The assistant supervisor of wells also wears several other hats: chief of the Geological Survey Division of the MDEQ; and state geologist.
10. Section 1, 1939 PA 61, now MCL 324.61502; MSA 13A.61502.
11. Section 2(1), 1939 PA 61, now MCL 324.61501(p); MSA 13A.61501(p).
12. Section 13, 1939 PA 61, now MCL 324.61513(3); MSA 13A.61513(3).
13. Section 4, 1939 PA 61, now MCL 324.61504; MSA 13A.61504.
14. MCL 324.61501 *et seq.*; MSA 13A.61501 *et seq.*
15. MCL 324.61513(2); MSA 13A.61513(2).
16. If the supervisor of wells has not established the size of a drilling unit for a certain area, then by rule, the "default" drilling unit is a 40-acre quarter quarter-section. 1996 AACS, R 324.301(1)(a).
17. MCL 324.61513(2); MSA 13A.61513(2).
18. *Id.*
19. 420 Mich 128, 133.
20. 420 Mich 128, 133-134.
21. *Manufacturer's National Bank v DNR,* 420 Mich 128, 146. (1984)
22. *Id.* at 146.
23. Shallow gas pooling clauses sometimes authorize multiple well natural gas units up to 2,560 acres in size.
24. 1996 AACS, R 324.303.
25. MCL 324.61513(3); MSA 13A.61513(3).
26. Compulsory pooling powers were first conferred on the supervisor of wells by 1939 PA 61. No published Michigan decisions address the constitutionality of these powers. However, the constitutionality of a similar statute in Oklahoma was upheld in *Palmer Oil Corp v Phillips Petroleum Co,* 204 Okla 543, 231 P2d 997 (1951), *appeal dismissed for failure to raise a substantial federal question sub nom, Palmer Oil Corp v Amerada Petroleum Corp,* 323 US 390, 1 O&GR. 876 (1952). Compulsory pooling, like zoning, is a legitimate exercise of the police power.
27. 1996 AACS R 324.1203.
28. 1996 AACS R 324.1201.
29. Petition of Patrick Petroleum, Order of the Supervisor of Wells No. (A) 19-7-91, dated September 17, 1991.
30. 1996 AACS R 324.1206(4).
31. *Id.*
32. *Id.*
33. Petition of O.I.L. Energy Co, Order of the Supervisor of Wells No. (A) 35-11-96, dated November 19, 1997.
34. Petition of Fairway Petroleum, Inc, Order of the Supervisor of Wells No. (A) 44-11-86, dated December 22, 1986.
35. 153 Mich App 679 (1986).
36. Petition of Amoco Production Company, Order of the Supervisor of Wells No. (A) 4-5-82, dated August 6, 1982 Petition of Schmude Oil, Inc, Order of the Supervisor of Wells No. (A) 27-9-91, dated March 11, 1993.
37. Petition of Wiser Oil Company, Order of the Supervisor of Wells No. (A) 13-5-83, dated May 31, 1983.
38. Petition of O.I.L. Energy Co, Order of the Supervisor of Wells No. (A) 35-11-96, dated January 15, 1997.
39. MCL 324.61502; MSA 13A.61502.