

## **Statutory Unitization in Ohio: A Brief Primer**

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### **I. Introduction**

R.C. 1509.28 sets forth the statutory unitization process in Ohio. It was part of a wholesale conservation package enacted by the General Assembly in 1965 in response to the problems evident during the Morrow County, Ohio oil boom. The underlying issue at that time – the conservation challenges highlighted by an unrestricted application of the rule of capture, which encourages the drilling of as many oil and gas wells as possible, and as close to the property line as possible, leading to over-drilling and physical and economic waste.<sup>1</sup> To address those issues, the General Assembly established minimum spacing and density requirements as part of its conservation package.<sup>2</sup> But those requirements have limitations, including the potential to injure the correlative rights of those owners who possess less than the minimum amount of acreage needed to develop their interests under the new regulatory program.<sup>3</sup> To further promote the conservation of the state’s oil and gas resources, therefore, Ohio – like the majority of producing states in the country – also adopted statutory pooling and unitization procedures as a means for owners to combine acreage and interests in order to meet their statutorily-imposed obligations and efficiently develop the resource base. And while it can assist owners whose lands are otherwise too small to meet Ohio’s minimum spacing requirements, statutory unitization is meant to do more – It enables producers to optimize development of a common source of supply while utilizing the most economically-efficient and effective drilling techniques available, thereby advancing the important public policy objectives of preventing waste, protecting correlative rights and conserving the state’s scarce natural resources.<sup>4</sup> In the end, statutory unitization under R.C. 1509.28 is one way by which owners of a common source of supply get to share in the benefits of production that could otherwise be lost.

The following discussion takes a brief look at statutory unitization generally, Ohio’s statute more particularly, and the practice before Ohio’s Division of Oil and Gas Resources Management to date.

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<sup>1</sup> See, e.g., Bruce M. Kramer and Patrick H. Martin, *THE LAW OF POOLING AND UNITIZATION*, § 2.02 (LexisNexis Matthew Bender 2016) (hereinafter “Kramer and Martin”).

<sup>2</sup> See, e.g., R.C. 1509.24 and R.C. 1509.25, as enacted in H.B. 234 (1965).

<sup>3</sup> The term “correlative rights” refers to the right that each person entitled to produce from a common source of supply has to a fair and reasonable opportunity to produce his or her fair share of oil or gas. Kramer and Martin at § 5.01[4]. Note that it does not guarantee that each owner will recover a proportionate share of the resource, only that each shall be afforded the opportunity to do so. *Id.*

<sup>4</sup> See *Redman v. Ohio Dep’t of Indus. Relations*, 75 Ohio St.3d 399, 409 (1996) (“[T]he principles underlying Chapter 1509 are safety, protection of correlative rights, and the prevention of physical and economic waste.”) (internal citations omitted). See also Kramer and Martin, § 6.02; Decision of Ohio Oil and Gas Commission, Gary L. Teeter Revocable Trust, Appeal No. 895 at 12 (hereinafter “Teeter Decision”) (“So, the pooling and unitization provisions of Ohio law are actually protective of the interests of mineral owners, who choose not to voluntarily participate in the development of a well.”) (emphasis in original).

## II. Statutory Unitization Generally

Unitization is the consolidation (sometimes referred to as the “integration”) of mineral or working interests covering all or part of a common source of supply.<sup>5</sup> Designed to promote efficient development, prevent waste, and protect correlative rights, unitization – like pooling – can trace its origins, in large part, to the rule of capture and the consequences that followed.<sup>6</sup>

### A. Rule of Capture

The rule of capture, simply stated, gives a landowner the right to produce oil and gas from wells located on his property without liability to his neighbor even though the oil and gas so produced may have been drained from beneath the neighbor’s property.<sup>7</sup> The Supreme Court of Ohio was one of the first courts in the country to adopt the rule, stating:

Petroleum oil is a mineral, and while in the earth it is part of the realty, and should it move from place to place by percolation or otherwise, it forms part of that tract of land in which it tarries for the time being, and if it moves to the next adjoining tract, it becomes part and parcel of that tract; and it forms part of some tract, until it reaches a well and is raised to the surface, and then for the first time it becomes the subject of distinct ownership separate from the realty, and becomes personal property, the property of the person into whose well it came.<sup>8</sup>

But that’s not a terribly satisfactory result for the neighbor – after all, it’s her property that is being drained. The common law’s answer: *the rule of capture*, i.e., to drill an offset well on the adjoining property to protect against drainage.<sup>9</sup> The rule’s incentives, and consequences, are obvious:

If the owner of one tract may drill as many wells as he pleases at any point he desires on his tract, his neighbor, of course, has the same right. ... Naturally, the owner uses this right either to gain an

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<sup>5</sup> Kramer and Martin, § 6.02.

<sup>6</sup> Pooling typically refers to the consolidation of mineral or working interests to meet the minimum spacing and density requirements needed to obtain a drilling permit for a single well. See, e.g., Kramer and Martin at §1.02. Despite the technical differences, the terms pooling and unitization are frequently used interchangeably in the industry. See also Kramer and Martin at § 2.02 (“While not all of the vast state regulatory programs can trace their history to the ramifications of the rule of capture, the laws relating to the prevention of waste and the compulsory pooling and unitization of oil and gas reservoirs would not have developed as rapidly and as completely had not the rule of capture gained such a strong foothold in the oil and gas jurisprudence.”).

<sup>7</sup> Kuntz, A TREATISE ON THE LAW OF OIL AND GAS at § 4.2 (2016) (hereinafter, “Kuntz”).

<sup>8</sup> *Kelley v. Ohio Oil Co.*, 57 Ohio St. 317, 318 (1897).

<sup>9</sup> *Kelley v. Ohio Oil Co.*, 57 Ohio St. at syll. 3 (“The drilling of wells by each owner of adjoining lands, along and near the division line, so that each may obtain the amount of oil contained in his lands, is known as ‘protecting lines,’ and such protection affords a certain and ample remedy to prevent one operator from obtaining more than his share of oil.”). See also Patrick H. Martin, *State Conservation Regulation and Overview of Standard Spacing and Pooling*, Horizontal Oil & Gas Development, Paper No. 2, Page No. 2-1 (Rocky Mt. Min. L. Fdn. 2012) (“The defense to the rule of capture is: the rule of capture.”) (hereinafter, “Martin”).

advantage or to protect his lease from drainage by drilling offset wells. **In any event, we find an unrestricted race, the prize being the oil and gas under both tracts. The result is great physical waste of oil and gas, as well as the economic waste that flows from the drilling of unnecessary wells.**<sup>10</sup>

In response to the conservation challenges underscored by this common law principle (i.e., the physical and economic waste resulting from over- and inefficient drilling), oil and gas producing states adopted a number of regulatory mechanisms. Among them is and was the process for obtaining an order for the unit operation of a pool or part of a pool from the relevant regulatory agency – what we refer to as statutory unitization.<sup>11</sup>

### *B. Voluntary Agreement Alone is Insufficient*

In general, the unit size needed to drill a horizontal well in the Utica/Point Pleasant shale in Ohio having a productive lateral one mile in length is roughly 160 acres. In our experience, most units in Ohio used in horizontal development are significantly larger, ranging on average from 300 acres to 1,100 acres and often accommodate the drilling of multiple laterals from a single surface location. This has significant surface use and surface impact advantages, in addition to the evident conservation and economic benefits. The formation of these units – in which all of the necessary interests are joined – can be accomplished by voluntarily agreement or by state action (in the event they are not already unified in a single tract or producer).

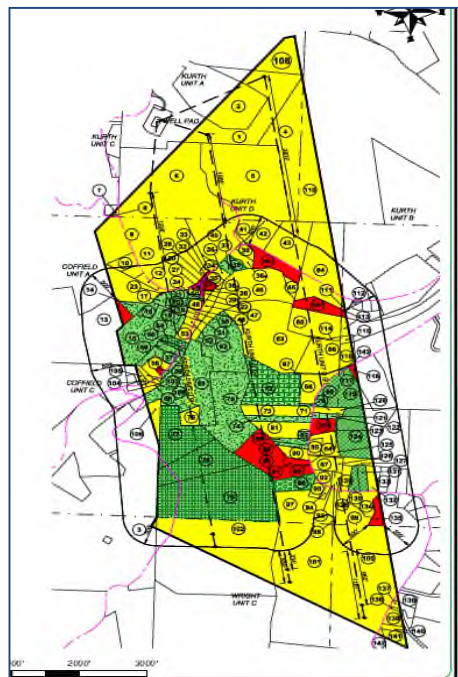
Experience has shown, however, that reaching voluntary arrangements often presents a significant challenge to orderly and efficient development. There are often tens, if not more, of separate tracts that need to be incorporated into the unit in some fashion (by lease, pooling

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<sup>10</sup> Raymond M. Myers, *The Necessity of Unitization*, 33 Miss. L.J. 1 (1961) (hereinafter “Myers”) (emphasis added). See also, e.g., Bruce M. Kramer, *Compulsory Pooling and Unitization: State Options in Dealing with Uncooperative Owners*, 7 J. Energy L. & Policy 255, 257 N.8 (1986) (hereinafter “Uncooperative Owners”); Staff Research Report No. 63, *Oil and Gas Law in Ohio*, Ohio Legislative Service Commission at 40 (1965) (hereinafter, “Staff Report”) (“To protect himself [from an adjoining landowner’s operations], his neighbor will then usually drill an offset well on his property so that he can keep the oil under his land from draining across his property line. ... The frenzy with which these neighbors produce, **disregarding conservation practices** is like two children, each with a straw in a soft drink, racing to see who can get the most.”) (emphasis added). This was captured by the phrase “I drink your milkshake” in the film, *There Will Be Blood* (Paramount 2008).

<sup>11</sup> See, e.g., Kramer and Martin at § 2.02 (observing that warnings about the challenges presented by the rule of capture “eventually led to the creation of various regulatory tools to minimize the wasteful development of oil and gas. Among those regulatory tools were the concepts of voluntary and forced pooling and unitization.”) (“Although it took some twenty years from the time that A.L. Doherty first sounded the alarm, with few exceptions, the producing states responded with the enactment of compulsory pooling and unitization statutes. They attempted to resolve the problems of overdrilling, inefficient production techniques, loss of natural reservoir pressure, and unfair allocation of production by some of the owners of a common pool of oil or gas, through the exercise of their police power.”). Note that there are a number of other regulatory mechanisms that have been adopted as well, including the use of well spacing rules intended to control well location and density. See, e.g., Kramer and Martin at § 3.02[4][b]. We are seeing today how these rules can lead to waste and impact correlative rights of owners in a unit (for example, where an owner holds less than the minimum amount of acreage needed to develop their mineral interests under the state’s regulatory program). See Kuntz at § 77.2 (“A spacing regulation which provides that a well cannot be drilled closer than a prescribed distance from a boundary line will have the effect of denying the right to drill a well on a tract of land which is too small to meet the distance requirements.”).

agreement, or operating agreement, for example). Many of these tracts have fractionalized mineral interests with multiple owners, sometimes numbering in the hundreds due to intergenerational conveyances over the years.<sup>12</sup> And, to exacerbate the issue still further, there are often significant uncertainties regarding that multiplicity of ownership.<sup>13</sup> As a consequence, identifying and locating all of the potential owners and obtaining unanimous agreement on the multitude of issues that arise when considering large-scale development can be tremendously difficult, costly in terms of both time and money, and easily prevented by the strategic behavior of minority interest owners.<sup>14</sup> Not surprisingly, therefore, the Supreme Court of Ohio’s recent decision in *Corban v. Chesapeake Exploration, LLC*, has led to a renewed focus on these issues.<sup>15</sup>



Nor are the problems of reaching a voluntary agreement just theoretical. In *Dobson v. Ark. Oil and Gas Comm.*, for example, the undisputed facts showed that unit operations were necessary to prevent the waste of millions of barrels of oil and billions of cubic feet of natural gas in the McKamie-Patton field.<sup>16</sup> Efforts to reach a voluntary agreement on field-wide unitization were largely – but not entirely – successful, with a proposed unit plan being executed by 97% of the operators and 75% of the royalty interest owners, with the latter number growing to 96% by the time the case was tried. Nonetheless, the Arkansas Supreme Court overturned the regulatory agency’s unit order, even though

<sup>12</sup> See Owen L. Anderson and Ernest E. Smith, *The Use of Law to Promote Domestic Exploration and Production*, 50 Oil & Gas Law & Taxation Ch. 2 at 2-7 (1999) (“**The division of mineral fee interests and royalties into smaller and smaller fractional interests creates legal, practical and economic disincentives to mineral development.** Fractionalization does this in at least three ways. Every increase in the number of owners who must sign a document makes it correspondingly more difficult to obtain unanimous or near-unanimous agreement. Moreover, as its interests become fractionated, identifying, locating and dealing with owners becomes more time-consuming and more expensive. Indeed, because of dormancy, locating owners often becomes impossible.”) (hereinafter “Anderson and Smith”).

<sup>13</sup> See Anderson and Smith at 2-7 (“These problems are compounded by title uncertainties, for there is a frequent correlation between the number of owners and the number and difficulty of title problems.”).

<sup>14</sup> See Martin at 2-9 (“While unitization in many cases is in the best interests of all of the parties, voluntary unitization of all the owners has been difficult to attain.”); Myers at 7 (“Unitization may be accomplished voluntarily by the execution on the part of interested operations and royalty owners ... This is a prolonged and difficult matter, particularly where it is necessary to secure the signature of a large number of operators and royalty owners scattered over the United States ...”); Anderson and Smith at 2-76 (“Although the benefits of unitized operations have been long recognized, voluntary unitization agreements are difficult to negotiate. Because unitization negotiations involve multiple parties, strategic behavior by even a small number can prevent a deal.”). For a discussion of the challenges in negotiating unitization agreements, see Robert E. Hardwicke, *Unitization Statutes: Voluntary Action or Compulsion*, 24 Rocky Mntn. L. Rev. 29, 37 (1951).

<sup>15</sup> 2016-Ohio-5796 (2016) (holding that the 1989 version of Ohio’s Dormant Mineral Act was not self-executing and that surface owners wishing to reunite severed mineral interests with the surface estate must follow the 2006 version of that act, which allows severed mineral interest owners an opportunity to cure non-use after receiving statutory notice of an impending abandonment).

<sup>16</sup> 235 S.W.2d 33 (Ark. 1950).

“the evidence show[ed] pretty conclusively that over a period of years this method of developing the pool [would] avert a substantial waste of mineral resources and [] ultimately provide a greater return to operators and royalty owners alike.” The reason: A lack of statutory authority.<sup>17</sup> Arkansas adopted a statutory unitization provision the very next year.<sup>18</sup>

### III. Ohio: R.C. 1509.28

Every major producing state, other than Texas, has enacted a statutory unitization provision.<sup>19</sup> While the early statutes were sometimes limited to a particular purpose (such as secondary recovery operations), today they are used to more generally advance a state’s public policy interests in preventing waste, promoting conservation, and protecting a property owner’s correlative rights.<sup>20</sup> Oklahoma was the first state to adopt a statutory unitization law, enacted in 1945 and amended substantially in 1951. “Since then, states have adopted or amended compulsory unitization statutes that range from the short and terse to the lengthy and prolix.”<sup>21</sup> Ohio followed suit in 1965, adopting a unitization statute – moderate in length – as part of a substantial oil and gas conservation package in the wake of the Morrow County, Ohio oil boom.<sup>22</sup>

Until recently, however, Ohio’s unitization statute was rarely used. The first application for which there appears to be records was filed by Meridian Oil Inc. in April, 1994. The goal was to combine 51 separate tracts located in Perry Township, Allen County, Ohio, for purposes of conducting a water flood pilot project to improve oil production from the Trenton formation. The Division granted that application in July, 1994. Then, for the better part of two decades, the use of R.C. 1509.28 remained dormant until Chesapeake Exploration, L.L.C., filed its application for the Rufener Unit in November, 2011, requesting a unit order to develop the Utica / Point Pleasant shale underlying 146 separate tracts of land in Portage and Stark Counties, Ohio, covering more than 950 acres. Since then, there have been roughly 120 applications filed pursuant to R.C. 1509.28, with more than 30 orders having been issued.

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<sup>17</sup> Id. at 35-36.

<sup>18</sup> Bruce M. Kramer, *Unitization: A Partial Solution to the Issues Raised by Horizontal Well Development in Shale Plays*, 68 Ark. L. Rev. 295, 313 (2015) (hereinafter, “Unitization: A Partial Solution”).

<sup>19</sup> See Kramer and Martin at § 6.02 (“Texas, although lacking in a compulsory unitization statute, has accomplished many of the statutory goals by using innovative administrative orders relating to poolwide development. For a thorough history of the Railroad Commission’s surreptitious compulsory unitization program, and the political reasons for the lack of a compulsory unitization statute, see J. Weaver, *Unitization of Oil and Gas Fields in Texas: A Study of Legislative, Administrative and Judicial Policies* (1986).”).

<sup>20</sup> Martin at 2-9 (“In some states, compulsory unitization can be used for specific purposes only, such as recycling operations or secondary recovery operations; **but the majority of states authorize compulsory unitization in order to prevent waste, increase the ultimate amount of hydrocarbons recovered, avoid the drilling of unnecessary wells, and/or protect correlative rights.**”) (emphasis added). See also Teeter Decision (rejecting claim that Ohio’s statute applied only to secondary recovery operations).

<sup>21</sup> Kramer and Martin at § 18.01.

<sup>22</sup> See R.C. Chapter 1509 (1965) generally and R.C. 1509.28 (1965) more specifically. See also, e.g., Ohio Legislative Service Commission, Report of Committee to Study Oil and Gas Laws in Ohio at 5 (1964) (“The most effective and efficient way to operate an oil pool is as a unit. This allows the wells to be placed strictly according to reservoir characteristics and allows secondary recovery techniques to be put in operation. ... Seldom will one owner control all of the land area which overlies a pool, and selfish interests may keep multiple owners from joining with each other for their mutual benefit and for conservation. **In order to meet this situation a number of oil producing states have adopted unitization procedures similar to these which we recommend so that a minority cannot keep the majority from proper development and producing practices.**”) (emphasis added).

### A. Application

Statutory unitization in Ohio is normally initiated with the filing of an application by the owners of sixty-five percent (65%) or more of the proposed unit area.<sup>23</sup> Note that the term *owner* has a particular meaning under Ohio law – referring to “the person who has the right to drill on a tract or drilling unit, to drill into and produce from a pool, and to appropriate the oil or gas produced therefrom either for the person or for others.”<sup>24</sup> No particular form of application is required by statute. Nonetheless, the Division has posted guidelines on its website mandating that an application include, among other things, four copies of the following:

- a cover letter requesting unitization;
- an affidavit attesting that the application is being submitted by owners of at least 65% of the land area overlying the unit area;
- a summary of the request for unitization that includes: (i) a statement describing why unitization is necessary; (ii) a description of the plan for unit development; (iii) an identification of the geologic formations to be developed; (iv) an estimate of the value of the recovery for each well proposed for the unit area; (v) an estimate of the cost to drill and operate each well in the unit area; and (vi) a designated contact for communication purposes;
- separate lists of all mineral owners, working interest owners, and unleased mineral owners in the unit;
- maps and aerial photographs of the unit identifying, among other things, the unit boundary, the well pad and lateral locations, and the ownership of the separate tracts in the unit by type (leased to the applicant, unleased, leased to other working interest owners, etc.);
- logs and cross-sections identifying the unit’s producing formations;
- an affidavit detailing the attempts, if any, to lease unleased properties in the unit; and
- a copy of a joint operating agreement for other working interest owners in the unit, if applicable.<sup>25</sup>

SIDEBAR: While not required by the Guidelines, most applicants also submit written testimony for the witnesses they intend to call at the unitization hearing before the Division. This can allow for a much quicker hearing if the matter is uncontested – simply have the witnesses adopt the pre-filed testimony as their own after being sworn in at the hearing and limit the direct testimony

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<sup>23</sup> R.C. 1509.28 also authorizes the chief to initiate proceedings.

<sup>24</sup> R.C. 1509.01(K).

<sup>25</sup> See [Unitization Application Guidelines](#) (rev. May 9, 2014) (attached) (review for specific requirements). The legal status of the guidelines has not yet been determined. For those reading a digital copy of this article, there are hyperlinks to several of the items referred to herein.

to key issues. It also provides the Division with an opportunity to better understand the issues requiring unitization before the scheduled hearing, permitting more targeted questioning at the hearing. And it may provide a future mechanism for hearings on uncontested applications to be based entirely on the written submissions or to be heard by telephone.<sup>26</sup>

SIDEBAR: As discussed in greater detail below, Ohio's unitization statute gives the Division substantial flexibility when fashioning a unit order. Where appropriate, use the application to better describe the need for a unit order under the particular circumstances at hand and to suggest one or more mechanisms for addressing those circumstances.

SIDEBAR: When planning, applicants should take into account the length of time it may take to get a unit order. The Division requires that applications be submitted at least 120 days prior to the desired hearing date, and then it may take several months for an order to be issued following the hearing.

### *B. Notice*

The statute is silent regarding what notice, if any, is required before a unit order may be issued under R.C. 1509.28. It is the Division's practice to send notice by certified mail to every owner of an interest identified in the application as being subject to the requested unit order at least 30 days prior to the hearing. The Division also requires the applicant to publish notice of the hearing in a newspaper of general circulation in the county or counties in which the proposed unit is going to be located.<sup>27</sup> If there is no such newspaper available, current Division practice allows for publication in a daily circulated paper of a neighboring county.

SIDEBAR: While beyond the scope of this paper, the applicant should consider what role procedural due process may play in the context of providing notice.

SIDEBAR: As noted above, the Division currently requires applications to be submitted at least 120 days prior to the desired hearing date posted on the Division's website. That length of time raises the possibility of intervening property conveyances and the issue of what additional investigation must be made, if any, regarding potential new owners.<sup>28</sup>

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<sup>26</sup> Note that the Division has on occasion requested pre-filed testimony as a condition for setting a hearing date even if not included with an application.

<sup>27</sup> Guidelines at 4.

<sup>28</sup> See Martin at 2-16 to 2-17 ("In determining the reasonableness of effort to give notice, there are competing interests at work for both the agencies and the courts. ... Each tract of land may have a separate owner (or several as in co-owned family property) and that owner may have created royalty interests or acquired the land subject to other royalty interests. Fractional mineral interests may have been created at one time or another. ... The time and expense of checking title to all of this can be great. ... If notice is not properly given to someone who might be affected, what is the consequence of this? ... It is unfair to the parties who have taken part in the proceedings and made decisions in reliance on an agency order to have to start all over for one party who has not had notice.").

### C. Hearing

The conservation purposes behind Ohio's unitization statute are self-evident from the elements needed to sustain a unit order and the mandate if they are met. By statute, the chief *shall* issue a unit order if he finds (i) that unit operations are reasonably necessary to increase substantially the ultimate recovery of oil and gas from the unit area; and (ii) that the value of the estimated additional recovery exceeds the estimated additional costs incident to conducting the unit operations.<sup>29</sup>

Three witnesses are typically called at the hearing to satisfy those elements. A landman frequently testifies as to the unit's formation – its size and location, where the surface facilities are anticipated, ownership of interests in the unit, and the challenges necessitating the application for a unit order. A geologist often testifies regarding the formation that is being unitized and the surrounding subsurface – its thickness and productive characteristics, the relevance of the logs and cross-sections contained in the application, known faulting and other geologic or geophysical information regarding the area, its characterization as a pool or a part of a pool, and the appropriateness of any proposed allocation formula for production and expenses. Last, an engineer usually testifies as to the anticipated unit production with and without an order and the economics of the proposal.

The hearing is quasi-judicial in nature and relatively informal. Held before several Division personnel, the rules of evidence do not strictly apply. After a brief introduction by the Division, the applicant will take the direct testimony of its witnesses. Following each witness, the Division will ask any questions it may have. When the presentation of the applicant's evidence is finished, other interest owners in the unit who wish to participate are afforded an opportunity to make statements and present their evidence. To date, the Division has limited the questioning of witnesses to their counsel and the Division staff, however. Check the [Guidelines](#) for technical requirements well in advance of the hearing – there are certain constraints regarding the use of exhibits and other documents, for example. Following any statements or presentations by other interest owners in the unit, the Division may take a brief recess to consider whether it has any additional questions or needs any additional information. The Division then asks any additional questions that it may have for the applicant or other participating parties, or concludes the hearing. At that time, the applicant is frequently given the opportunity to offer closing remarks and rebuttal evidence if it deems it necessary or advisable.

**SIDEBAR:** The hearings are held monthly and a schedule is posted by the Division on its [website](#). Before appearing at a hearing for the first time, consider attending one if it's convenient or asking the Division for a transcript of a typical hearing. Know also that the Division uses its website to post applications, supplements, and orders, and as one means of notifying interested parties and the public regarding hearing cancellations and continuances. It pays, therefore, to check back periodically to confirm scheduling and update yourself on other hearing information.

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<sup>29</sup> R.C. 1509.28(A). Contrast, e.g., R.C. 1509.27 (which sets forth the elements needed to obtain a mandatory pooling order in Ohio; "If a tract or tracts are of insufficient size or shape to meet the requirements for drilling a proposed well thereon ... and the owner has been unable to form a drilling unit under agreement ..., on a just and equitable basis, the owner may make application to the division of oil and gas resources management for a mandatory pooling order.").



#### *D. Order*

The Division has broad authority to prescribe the terms of a unit order promoting conservation of the state's oil and gas resources and protecting the correlative rights of interest owners within the unit. R.C. 1509.28 requires generally that any unit order issued by the Division be on terms that are just and reasonable and prescribe a unit plan that includes the following (among other provisions):<sup>30</sup>

- an allocation of production from the unit area to the separately owned tracts;
- a provision regarding how unit expenses, including capital costs, shall be charged to the separately owned tracts;
- a provision for carrying or otherwise financing any person unable to meet their financial obligations with respect to the unit, including a reasonable interest charge;
- a provision regarding the supervision and conduct of the unit operations; and
- any other provisions appropriate for conducting unit operations and protecting correlative rights.<sup>31</sup>

While the allocation formula can take into account a variety of different factors, in Ohio it has been fairly straightforward: the Division allocates production and expenses to the separate tracts on a surface acreage basis.<sup>32</sup> Instead, the primary challenge to date has involved the participation of non-consenting owners, and in particular, non-consenting mineral owners.

SIDEBAR: Note that the unit order typically contains a provision prohibiting the surface use of unleased tracts absent a separate written agreement from the owner of the surface estate. Plan accordingly.

#### 1. Alternatives for Non-Consenting Owners

As noted above, there are a variety of obstacles to unit development through voluntary agreement, including incentives for owners to behave strategically for economic reasons. To accomplish the state's goals of conservation, waste prevention, and protection of correlative rights, therefore, regulatory agencies need to avoid encouraging non-consenting owners to hold out in order to obtain an arrangement equal to or better than they could get in the market. Otherwise,

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<sup>30</sup> Note that the Division's terms must be just and reasonable with respect to all of the interests included in the unit, and not solely with respect to those being compelled into the unit by statute. See Teeter Decision at 20 ("The terms and conditions of a unitization order must not only be just and reasonable to an unleased owner, like Mr. Teeter, but must be just and reasonable to **all** parties subject to the order, including Rex.") (emphasis in original).

<sup>31</sup> See R.C. 1509.28(A)(1)-(9).

<sup>32</sup> That allocation methodology tends to be supported by the direct testimony of the geologist regarding the relatively uniform thickness and productive characteristics of the formation across the unit area.

the incentive is for the non-consenting owner to adopt a wait-and-see attitude and thereby prevent or substantially delay development. And that negative effect multiplies once it becomes more widely believed that non-consenting owners in a unit can do better than the market would otherwise provide (encouraging even more strategic behavior by even more owners). “Unfortunately, several state approaches to the compulsory pooling and unitization process do not make it less palatable but seemingly reward holdouts by offering more than the marketplace would if a holdout forces the operator to go through the administrative process.”<sup>33</sup>

a. *Generally*

There are generally three ways in which states address the non-consenting owner issue in the context of statutory unitization. Some states allow the non-consenting owner to be “carried” as to his or her proportionate share of the unit expenses without penalty – often characterized as a “free ride.” The non-consenting owner pays nothing up front. If the operation is successful, the non-consenting owner is liable for its share of the unit expenses out of unit production only. If the operation fails for some reason (e.g., the related well is a dry hole), the non-consenting owner owes nothing. In effect, the applicant is forced to give the non-consenting owner an interest-free loan that can be – and often is – defaulted upon in the absence of substantial production. One prominent author describes it as follows:

Assume that a stock broker or professional gambler approached you with the following offer: the broker/gambler will advance you \$3000 or \$3,000,000 if you agree to invest it at her request. She agrees to bear the entire risk of loss should the stock decline or craps be rolled at the gaming table. If the return on the investment is less than \$3000 or \$3,000,000 you owe her nothing. If, however, the return on the investment exceeds either of those sums, all profit is turned over to you while she keeps only the initial investment advanced to you. This is an offer one could truly not refuse. While no rational gambler or stock broker would ever make this offer, an analogous situation arises in the oil and gas industry when operators seeking to develop their mineral holdings are unable to have unleased mineral owners or other working interest owners voluntarily agree to pool or unitize their interests [and regulatory agencies impose a free-rider solution].<sup>34</sup>

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<sup>33</sup> Uncooperative Owners at 260.

<sup>34</sup> See Uncooperative Owners at 255 and more generally at 261-76 (discussing these alternatives in greater detail). See also Martin at 2-31 to 2-32. This situation exists in the context of cotenancy as well. In the majority of states, one cotenant can develop jointly-owned property without the unanimous consent of the other owners, but she must account to the others for their share of the profits or rents. Most operators are often hesitant to engage in that development due the potential economics, even while being permitted by law to do so. See, e.g., Anderson and Smith at 2-13 (“Leasing is directly affected by fractionalization. From a lessee’s standpoint, **some minimum fraction of interests must be bound by a lease before drilling and development will be undertaken.** ... “[As] Professor John S. Lowe has pointed out, ‘business people do not rely on the majority rule of the rights of concurrent owners [because] ... it confers legal rights that may make little economic sense.’”) (emphasis added).

Other states apply a risk-penalty approach. That is, non-consenting owners may be given the opportunity to participate in operations by paying for them like any other party to the joint endeavor *or* be treated as a carried-interest subject to a risk penalty. If the non-consenting owner chooses to be carried (and the consenting owners pay the additional share of costs), *and if* the consenting owners are successful in their joint operations, they can recoup from production their share of costs attributable to the non-consenting owner, plus some additional percentage (frequently set at 300-500% in the marketplace – and possibly much higher). Again, the non-consenting owner owes nothing if the operations are not successful. The risk penalty concept serves not only to encourage non-consenting owners to ultimately participate or risk being out of pay for some period of time (i.e., until payout is reached), but it also rewards the consenting owners for undertaking the risks associated with the operation.<sup>35</sup> The challenge for the regulatory agency is in setting the appropriate level of that risk penalty to meet the state’s goals of promoting conservation, preventing waste, and encouraging the protection of correlative rights. If the percentage is set too low, substantially below the level that would be set in the marketplace, for example, it won’t discourage non-consenting owners from engaging in the strategic behavior that otherwise prevented the parties from reaching a voluntary arrangement, and it may discourage the consenting parties from undertaking the development due to the attendant risks and related economics.<sup>36</sup>

And still other states provide non-consenting owners with an election of various options. By statute, for example, non-consenting owners may be given the option of either (i) surrendering their interests to the participating owners for some reasonable compensation, (ii) participating on a non-carried basis, or (iii) electing to be carried with a penalty set by state statute or the regulatory agency.<sup>37</sup> Or they might be given an option to transfer their interests to the participating owners on either a permanent or temporary basis, as in Arkansas. “The permanent transfer, which is merely a total assignment of the working interest in exchange for a cash consideration, eliminates the owner from further development of the field. The second option turns into a risk penalty option because the assignment of the working interest is for a limited time, subject to recoupment.”<sup>38</sup> And other states – such as South Dakota – direct the relevant regulatory body to provide alternatives on a just and reasonable basis, leaving the state agency considerable latitude

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<sup>35</sup> See, e.g., *Uncooperative Owners* at 264 (“All risk penalty statutes seek to achieve the objective of compensating the risk-taker and preventing the free ride by the non-consenting owner.”). The risks associated with joint operations are varied and can be substantial, recalling the aphorism *Success has many fathers, but failure is an orphan*: “Drilling a well is a risky undertaking. The well may produce in great quantities and adjacent owners of interests will be eager to share. The well may result in a dry hole, and all expenditures on drilling will have produced absolutely no revenue, only losses, and few neighbors will be found who are willing to pick up a share of the costs.” *Martin* at 2-30. And of course, the results may fall somewhere in between – producing some revenue but never paying out. See also *Teeter Decision* at 22 (“Mr. Teeter suggests that the interest charges are excessive as no geologic risks have currently been identified in association with the targeted formation. ... However, the evidence further established that geologic risks may still exist. Moreover, geologic risks are not the only risks faced by the driller of a well. ... As noted previously, oil & gas development is an uncertain business. **Geology, of course, adds to this uncertainty. But, economic and operational risks are inherent elements of oil & gas development.**”) (emphasis added). See also *Uncooperative Owners* at 266 (describing the various types of risks).

<sup>36</sup> The author is aware, for example, of at least one instance in which an applicant allowed a unit order issued by the Division to lapse because it failed to contain a risk penalty that would encourage the applicant to assume the entirety of the economic and other risks of unit development.

<sup>37</sup> See, e.g., *Uncooperative Owners* at 272.

<sup>38</sup> *Id.* at 273.

when coming up with appropriate options to meet the state’s public policy goals.<sup>39</sup> “States that authorize the use of alternatives provide a more realistic replica of the actual marketplace for working interests and, therefore, more closely achieve what the market cannot because of the rule of capture.”<sup>40</sup>

Most state statutes make no distinction between non-consenting *working interest* owners (i.e., lessees) and non-consenting *mineral* owners (i.e., unleased mineral owners).<sup>41</sup> Nonetheless, as a practical matter, unleased mineral owners may be treated differently within the three approaches cited above. For example, several states treat the unleased owner’s interest as a 1/8<sup>th</sup> royalty interest and a 7/8<sup>th</sup> working interest, with the latter treated the same as other non-consenting working interests for purposes of development. Others treat the unleased owner as having only a royalty interest until payout and as an 8/8<sup>th</sup> working interest owner thereafter. And still others give the unleased owner the option (i) to lease to the applicant, (ii) to participate as any other working interest owner, or (iii) to be carried with a risk penalty and a royalty interest until payout.<sup>42</sup> In states like Ohio, where the statute makes no distinction amongst non-consenting owners but grants broad discretion to the regulatory agency, the treatment of unleased owners is limited largely by the creativity of the parties and the willingness of the regulatory agency to adapt its orders to the circumstances at hand.

#### b. *Division Practice*

The first unit order issued by the Division for shale development treated non-consenting working interest owners as carried interest owners having a reasonable interest charge of 200% for the initial well and 150% for subsequent wells. It further gave unleased mineral owners the option of executing a lease with the applicant for a bonus and a 1/8<sup>th</sup> net royalty or participating in the development as a non-consenting carried working interest owner.<sup>43</sup> That treatment has evolved over time, and today the Division largely considers the interests of non-consenting working interest owners to be carried interests subject to the market risk penalties proposed by the applicant, while unleased owners are largely treated as having a 1/8<sup>th</sup> gross royalty payable upon first production and a 7/8<sup>th</sup> net proceeds interest subject to reasonable interest charges of 200% for the initial well and 150% for subsequent operations.<sup>44</sup>

SIDEBAR: The Division’s treatment of non-consenting owners is not inflexible. It has evolved over time and is likely to continue to evolve as the Division faces different circumstances. As a consequence, if there are circumstances that suggest a particular approach would be better suited for how unit interests should be addressed, you should consider making that proposal in your application – typically in the summary document – and calling it to the attention of the Division at the hearing.

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<sup>39</sup> Id.

<sup>40</sup> Id. at 274.

<sup>41</sup> Uncooperative Owners at 276.

<sup>42</sup> See Martin at 2-32 to 2-33 generally. See also Uncooperative Owners at 276-290.

<sup>43</sup> See generally Chief’s Order No. 2012-13 (Jul. 10, 2012).

<sup>44</sup> See Teeter Decision at 21 (observing, “This type of interest charge is sometimes referred to as a ‘risk penalty.’”).

## 2. Effective Date

Any unit order issued by the Division does not become effective unless and until the unit plan prescribed by the order is approved in writing by (i) those owners required under the order to pay at least sixty-five percent (65%) of the costs of unit operations and (ii) by royalty and unleased fee owners of sixty-five percent (65%) of the acreage to be included in the unit. Those approvals must be submitted within six months of the date that the unit order is made or the order ceases to be of further force and effect and must be revoked by the Division.<sup>45</sup>

## 3. Relationship with Private Arrangements

The unit order can intersect with private arrangements in any number of ways. Does unit production satisfy the habendum clause of leases on non-drill site tracts and therefore extend those leases into the secondary term? If two or more parties to the proposed unit operations have entered into a joint operating agreement, how would the unit order impact that private arrangement, if at all? Does the unit order supersede or amend potentially conflicting terms of a private agreement? These and other similar issues are largely beyond the scope of this paper and deserve their own separate treatment. Still, there are a couple of related items to note briefly. First, the General Assembly expressly recognized that unit orders might intersect with private arrangements, stating, for example:

Oil and gas allocated [under a unit order] to a separately owned tract **shall be deemed, for all purposes, to have been actually produced from the tract, and all operations**, including, but not limited to, the commencement, drilling, operation of, or production from a well **upon any portion of the unit area shall be deemed for all purposes the conduct of such operations** and production **from any lease or contract for lands any portion of which is included in the unit area.**<sup>46</sup>

This language is strikingly similar to common lease pooling and unitization language used to extend a lease beyond its primary term in accordance with typical lease habendum and operations provisions. It seems clear, therefore, that the General Assembly intended for unit production and unit operations to satisfy that lease language, thus extending leases in the unit into their secondary term regardless of whether production or operations came from or were being conducted on the related tracts. This should be fairly non-controversial and is consistent with the way such production and operations are treated generally in the context of pooling and unitization.

Second, it seems equally as clear that the General Assembly directed the Division to issue unit orders where the statutory criteria were met *even if* those orders may be inconsistent with private contractual arrangements. R.C. 1509.28(B) states that:

**[O]perations** conducted pursuant to the order of the chief **shall constitute a fulfillment of all the express or implied obligations**

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<sup>45</sup> R.C. 1509.28(B).

<sup>46</sup> R.C. 1509.28(B) (emphasis added).

**of each lease or contract** covering lands in the unit area to the extent that compliance with such obligations cannot be had because of the order of the chief. [Emphasis added.]

That is, the General Assembly knowingly considered that an order issued by the Division for unit operations might contradict private contractual agreements of owners within the unit area – and declared that in such instances, the unit order would take precedence. And that makes sense: By its very nature, R.C. 1509.28, like every other unitization statute, seeks to achieve important state public policy goals over the opposition of individual owners.<sup>47</sup>

While no Ohio court has directly addressed the issue to date, the general principle that state regulatory agencies cannot be constrained by private contractual arrangements is supported by case law in other jurisdictions.<sup>48</sup> In Louisiana, for example, the state Supreme Court long ago addressed the claim that a lease could be terminated because an agency order pooled the lessor's acreage despite the deletion of the lease's pooling provision, stating:

The deleting of this provision in the printed form of lease merely denied the lessee the right to consent to pooling the leased premises with other land or mineral interests, but it did not, **because it could not, interfere with the authority of the Commissioner of Conservation** or with any federal authority, **to compel the combining or utilizing of the leased premises with other land or lands or mineral interests** for the purpose of forming a drilling unit, for the prevention of waste and to avoid the drilling of unnecessary wells.<sup>49</sup>

This illustrates the clear difference between a lessee's exercise of a lease's pooling or unitization provision and a state agency's exercise of its legislatively-delegated authority to require non-consenting owners to have their interests unitized to meet important state conservation goals. To allow a private arrangement to prevent the exercise of that police power would be to impermissibly defeat the legislative prerogative to exercise governmental authority for legitimate public purposes.

Recently, the Supreme Court of North Dakota reached the same conclusion. Lessee had acquired two leases in which the pooling and unitization clauses had been deleted and replaced with provisions prohibiting the leases from being “committed to any unit plan of development or operation without the prior express written consent of the [lessors].” Lessors claimed that the

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<sup>47</sup> See also Teeter Decision at 11 (recognizing that unit orders can be issued under R.C. 1509.28 despite the wishes of private parties) (“Ohio’s pooling and unitization statutes allow the joining of the mineral interests of landowners, who refuse to lease their properties, into a drilling unit or unitized formation. In such cases, the state may bring a landowner into a pool or unit against the landowner’s wishes.”).

<sup>48</sup> See Kramer and Martin at § 8.04.

<sup>49</sup> *Hood v. Southern Production Co.*, 19 So. 2d 336 (La. 1944) (emphasis added). See also, e.g., *Sunray D-X Oil Co. v. Cole*, 461 P.2d 305 (Okla. 1967) (state Supreme Court observing, “Although defendants could not have voluntarily pooled the leased acreage into units exceeding 40 acres, **the parties by contractual agreement could not limit the Corporate Commission** from establishing drilling and spacing units in excess of the 40 acres.”) (emphasis added).

lessee had breached those provisions by applying for compulsory pooling orders from the North Dakota Industrial Commission. North Dakota's Supreme Court rejected that claim, stating:

Penalizing as a breach of contract an interested person's use of the application procedure for forced pooling would inhibit use of a statutory procedure designed to implement the strong public policy of fostering the efficient development and use of the state's oil and gas resources. Agreements should not be construed to be injurious to the public or against the public good.<sup>50</sup>

These cases are representative of the way that pooling and unitization statutes have been interpreted by courts across the country – i.e., that private parties cannot restrict state oil and gas conservation agencies from exercising their statutory pooling or unitization powers by private agreement.<sup>51</sup>

SIDEBAR: As a practical matter, agreements between unit participants regarding joint operations are effective except to the extent they conflict with the unit order issued by the Division. The potential for those agreements and how they are to be treated are frequently noted in the application documents, and the Division regularly includes in its unit orders a provision like the following: “In the event of a conflict between this Chief's Order and Operator's Unit Agreement and Model Form Operating Agreement attached to the application, this Chief's Order shall take precedence.”

#### 4. Timing of Development

Unit orders typically require the applicant to commence drilling operations in the unit area within 12 months from the date that the order is approved (and therefore becomes effective). They also typically require production from all of the wells described in the application within three or four years of the effective date, although earlier orders provided a 5-year period. The Division frequently reserves the right to modify orders and could extend the development timeline under the appropriate circumstances.

### IV. Conclusion

Statutory unitization is an essential regulatory tool for promoting conservation, preventing waste, and protecting the correlative rights of Ohio's citizens. While rarely used before 2011, operators have turned to it more and more to meet the legal, practical, and economic difficulties of long, horizontal development in the Utica / Point Pleasant shale. The challenge going forward will be to continue the development of Ohio law and regulatory practice in a way that promotes – and does not defeat – the public policies that underlie R.C. 1509.28's enactment.

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<sup>50</sup> *Egeland v. Continental Resources, Inc.*, 2000 ND 169, ¶13 (N.D. 2000) (internal citations omitted).

<sup>51</sup> See, e.g., *Kramer and Martin* § 8.04; *Gordon v. Crown Central Petroleum Co.*, 679 S.W.2d 192 (Ark. 1984); *Rebstock v. Birthright Oil and Gas Co.*, 406 So.2d 636 (La. App. 1981); *Frost v. Gulf Oil Corp.*, 238 Miss. 775 (Miss. 1960); *Armstrong v. High Crest Oils, Inc.*, 164 Mont. 187 (Mont. 1974); *Nisbet v. Midwest Oil Corp.*, 1968 OK 115 (Okla. 1968).