Hydraulic Fracturing Land Lease Negotiations

Energy Company and Landowner Rights

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John Holden has more than 36 years' experience representing clients in the natural resources area. Mr. Holden has advised clients with respect to all aspects of exploration, production, transportation, processing, sale and marketing of oil and gas, and other natural resources. This includes the formation of and use of various entities, both public and private, and the financing of the acquisition and development of hydrocarbons and related assets.

Mr. Holden advises clients with respect to the preparation and negotiation of merger and acquisition agreements, joint exploration agreements, lease acquisition agreements, seismic option agreements, leases, operating agreements, farmouts, oil and gas sales contracts, transportation agreements, processing agreements, pipeline construction and operating agreements, and other related documents. In addition, he advises and prepares surface use agreements to provide for the protection and development of both surface and mineral owners with respect to their respective interests.

Mr. Holden also has significant experience in energy lending and debt and equity financing. He has represented borrowers and financial and financing institutions with respect to the negotiation, preparation, and documentation of financing transactions. His experience includes transactions involving hydrocarbon and other mineral reserves, drilling rigs, service companies, landfill gas recovery projects, wind projects and other forms of natural resources, and fixed site power generation projects. He has worked with financial institutions in the foreclosure on and the subsequent sale of various energy assets. Mr. Holden has also negotiated and documented equity participation in the foregoing.

In addition, Mr. Holden has considerable experience representing clients on projects in Latin America. He directed the privatization of over $750 million worth of assets of YPF, the national oil company of Argentina. That process required the analysis of the applicable laws, rules, decrees and regulations of that country and the creation of appropriate entities to accomplish the country's objectives. Mr. Holden has participated in transactions in other foreign venues and has represented foreign entities doing business in the United States.

Mr. Holden is Board Certified in Oil, Gas and Mineral Law by the Texas Board of Legal Specialization.

Memberships

Mr. Holden is a member of the American Bar Association and the State Bars of Texas and the District of Columbia, as well as the Dallas Bar Association. He is a member of the Corporation and Business Law Section, Past Chairman of the Energy Law Section, and past Chairman of the International Law Section and the Mergers and Acquisitions Section of the Dallas Bar Association. Mr. Holden also is a member of the State Bar's Corporate, Banking and Business Section, the Oil, Gas and Mineral Law Section. He is a member of the Business Law, Environment and Energy Resources Law, and International Law sections of the American Bar Association. Mr. Holden is also a

member of the Association of International Petroleum Negotiators and many other regional and national energy associations. He is an Adjunct Professor of International Law at Baylor University Law School and an Associate Board Member of the Cox School of Business of the Southern Methodist University.

Awards

Mr. Holden is listed in *The Best Lawyers in America* under Energy Law. He was also named a "Texas Super Lawyer" in the 2007-2010 issues of *Texas Monthly* magazine.

Admitted

- Texas
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Education

Mr. Holden received his A.B. from Ohio University in 1965 and his J.D. from the George Washington School of Law in 1968. In 1976, he completed his L.L.M. in oil and gas and taxation from Southern Methodist University School of Law.

Publications & speaking engagements

Mr. Holden is a frequent speaker on oil and gas and international topics to business and legal audiences.

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I. Objective

The objective of this presentation is to provide an overview of the main issues and documents related to the challenges confronting mineral owners in the negotiation of contracts with energy companies. In addition the paper will provide a selective update of recent oil and gas case law relevant to those areas. While the focus will be contracts and disputes which arise between mineral owners and mineral developers, the objective of the paper is to provide an overview for any attorney dealing with questions in this area. The most important thing for attorneys to keep in mind is the objectives of their client with regard to the real property interests involved in light of the rights of the respective parties. On the one hand clients are interested in generating revenue from all sources, including leasing for oil, gas and mineral development, but this objective should not distract them from or adversely affect the other revenue producing activity being conducted on the property or burden the property in such a way that present and future uses are unnecessarily limited. The negotiation of any agreement should insure that if the mineral development does not unreasonably interfere with the manner in which revenues from the primary activity are presently being generated and will be generated in the future. Mineral development can be further complicated by the potential conflict in the competing objectives of multiple owners.

II. Strategy

One should always keep in mind the needs and objectives of the primary function of the assets in question. The focus of any strategy should be the preservation and enhancement of the asset as well as the impact each use and potential use will have on the asset as a whole.

When offered a lease, the first decision confronting a lessor is whether to lease. Most determine for economic reasons or control over the land to lease. In some state, other than Texas, there is forced pooling, so one can be forced to allow the development of their oil and gas under their property whether they desire the development of the minerals under their tract or not. Once a determination has been made to lease, the next questions involve the resolution of the economic terms and the degree of control over the exploration and development of the property. See Schedule A for a list of the typical lease terms with comments with respect to each. One of the issues confronting any prospective lessor is the size of units or pools which will be permitted under the terms of the lease. Generally, state and federal regulatory agencies, in Texas, it is the Railroad Commission which determines the number of acres which can be drained by a well. In order to produce a well at full capacity, a lessee must have the number of acres leased which have been determined will be drained by that well. Frequently lessees, the oil and gas companies, need to block together acreage from a number of owners in order to create a pool or unit which will drain the required amount of acreage or suffer an administrative determination that they cannot produce the well at full capacity. The size and location of the tract determines the leverage of each party. Today's horizontal wells drain larger areas, hence larger units are provided. The sharing of production from a pool or unit is generally determined by what percentage of the pool or unit the subject lease comprises. In almost all cases, the determination of who owns what percentage of the pool or unit is based on a surface acreage basis. The negotiating strength of each party will generally increase with the size of the tract owned or leased. In evaluating whether to

permit pooling, one must consider the likelihood that the entire productive zone will be located under the subject acreage. Like the stock market, the choice is between putting all your money in one stock or spreading it out among a number of stocks. With the development of the unconventional shale formations, the specific tract is felt to be less important since it is presumed that the productive hydrocarbons will be evenly distributed throughout all tracts in an area. Of course, there are geological variations which affect productivity from area to area. The impact of owning or controlling less than one hundred percent of the subject mineral interests under a specific tract is also a factor in a party's negotiating leverage. Finally the impact on the surface must be considered. Can the minerals be developed from a tract other than that of the mineral owner or will the mineral owner's tract bear all the burden of the well located on that tract but enjoy only a percentage of the production from that well because it is contained in a unit or pool?

A second decision confronting the mineral owner is what size pool or unit should be provided for in the lease? How large a pool should a landowner permit? As a general rule, lessors, mineral owners, want the pool or unit to be small so more wells will be required to develop the tract. Generally the opposite is true of the lessee oil company which wants the units to be larger so that more acreage will be held with fewer wells, reducing the size of the required investment. This permits the oil company to inventory more acreage. By inventorying more acreage, the oil company will have the opportunity of coming back later and drilling more wells (infill) at a later date. Many feel that including an interest in a large pool or unit is not in the best interest of the lessor because the interest of the lessor would be diluted by the other lessor, mineral owners and because it reduces the pressure on the lessee to fully develop the pool or unit in the short term. With the price fluctuations we have experienced in recent years, it is not always easy to know when it is best to have a well produce, in the present or sometime in the future. Many feel that oil companies have more information with which to make such a decision. Others, of course, want all the money they can get, as soon as possible and do not trust oil companies with that decision. Other factors are at play, such as the age of the present mineral owner and potential changes in ownership. These represent the two major schools of thought held by mineral owners and mineral developers. In the end, both parties should seek the full development of the subject mineral interests.

In today's unconventional shale resource plays one must also consider the number of wells that will be drilled inside a unit in order to fully develop all the minerals within the unit. If one is comfortable being in a pool or unit with other mineral owners, they will still want to make sure that the unit containing any of their minerals is fully developed. The primary issue should not be whether to permit pooling or unitization, but ensuring that the minerals in a pool are fully developed and that the development is on a desired schedule. That is to say one might be better off with an interest in a larger pool with a number of wells in it than having a small pool or unit with only one well developing the minerals from their property. The complete development of the tract is the issue as well as the timing of that development. Today, there are additional factors to consider. Technology continues to improve the potential for the development of mineral tracts. One innovation is simultaneous fracing of neighboring wellbores and horizontal paths. Wells are intentionally placed close to each other to cause the fractures created by fracking one well to assist fracking neighboring wells,

thus causing increased drainage from all fractured wells. One must be careful to not insist on a method of development which would not permit the use of the best practices of the day.

The next major consideration is determining what sort of restrictions and what degree of specificity should be employed in a lease. Is the lessor mineral owner negotiating with a lessee oil company that will work with them to accomplish the lessor's objectives either now or later? How specific must the language in your lease be? There is always the possibility that the subject lease will be assigned to an unknown and inflexible party with whom lessor cannot work or who will not honor the "understandings" which were reached with the previous lessee. These are things which one must consider in protecting the primary objectives and use of the subject property. As a general rule, it is always best to have everything specific and in writing.

There and many issues of this nature which are raised in a lease relationship. For instance, should specific locations for a drillsite, roads and pipelines be designated? Will there be a time of day or season when work should be done or prohibited? What degree of control should be retained or delegated?

III. Division Orders

Assuming that a lease has been agreed upon and the oil company has successfully drilled a well, the next event to occur will be the presentation of a division order. The lessee oil company will have prepared a title opinion confirming the mineral ownership of the subject tract. Based on that opinion, they send a division order to all the mineral owners in the unit or lease held by a well to confirm their ownership percentage. While there are many different forms of division orders, attached as Schedule B is a form of division order created by the state of Texas and found in the Texas Natural Resources Code Annotated at 91.402 (Vernon 2011). This is all the information required for the interest to be put in a "pay" or paying status. As one can see from the form, there are few requirements. The main issues relate to payment, indemnification and suspension of funds. The cases dealing with division orders are:

A. **Chicago Corp. v. Wall**

In *Chicago Corp.* v. *Wall*, 293 S.W.2d 844, 844 - 847 (Tex.1956), the Texas Supreme Court was called upon to address a situation involving a mistake by the Payor and acquiescence in that mistake by the Payee by signing the Division Order. Here, the Walls, the Payee, owned three tracts of land. They sold the tracts to Smith and reserved a nonparticipating royalty interest. Smith entered into an oil and gas lease with Chicago Corporation. The Chicago Corporation pooled the tracts, but did not credit the Walls with their interest in a ten acre and a thirty acre tract. The Walls sued the Chicago Corporation for the unpaid funds. The Chicago Corporation defended on the basis of the executed division order, saying they had paid others. The Texas Supreme Court held that after the Walls executed the transfer orders they were no longer entitled to money they had directed Chicago Corporation to pay to others, and the Walls could not recover from Chicago Corporation. To hold otherwise would be to cause Chicago Corporation to suffer an injury as the result of a double payment. Based upon detrimental reliance on the representations contained in the

Division Orders issued by Chicago Corporation and agreed to and executed by the Walls, the Texas Supreme Court refused any recovery by the Walls.

B. **Exxon Corp. *v.* Middleton**

Another significant case in the development of Division Order law is *Exxon Corp. v. Middleton*, 613 S.W.2d 240,249 -251 (Tex.1981). *Middleton* was a "market value at the well" royalty case. Exxon and Sun had long term intrastate gas sales contracts at a low price as compared to the intrastate gas market price which had been increasing. Based on *Texas Oil &Gas Cor.* v. *Vela,* 429 S.W.2d 866 (Tex.1968), the Court held that Exxon owed the Middletons royalty based on the then "market value" of the intrastate gas and not the royalty calculated as a percentage of the payments under the long term gas sales contracts. The amount of the royalty differential due plus interest amounted to $1.5 million. Here, the Texas Supreme Court reversed the Court of Appeals opinion holding that the division orders were irrevocable. The Court held that after its decision in Chicago Corporation v. Wall, *supra,* Texas law was that payments made and accepted under an agreement such as a division order or a transfer order were effective until the agreement was revoked R. HEMINGWAY, THE LAW OF OIL & GAS s 7.5 (1971). The Supreme Court went on to say,

> we agree with defendant, that, until withdrawn or modified, they constitute the precise and definite basis for payments, and payments made in accordance with them are final and binding...Binding as they are, however, in respect of payments made and accepted under them, these division or transfer orders did not [permanently change the terms of the lease]

In essence, the division orders prepared and sent by Sun changed the royalty provision of the oil and gas leases for a time, but did not permanently amend the oil and gas leases. Division orders are binding only for the time and to the extent that they have been or are being acted upon.

C. **Gavenda v. Strata Energy,**

A somewhat related case, *Gavenda v. Strata Energy, Inc.,* 705 S. W.2d 690, 690 (Tex.1986) involved the misinterpretation of a reserved term royalty interest. The Gavenda family conveyed a tract of land and reserved a NPRI for fifteen (15) years and only fifteen years. The Texas Supreme Court found that the Gavenda family had, in fact, reserved one half of the proceeds from any production and not one half of the royalty provided. Since division orders had been executed, Strata argued that the division orders were binding until revoked. Both the trial court and the appellate court agreed with Strata. The Gavendas contended that the Middleton rule that division orders are binding until revoked does not apply when there is unjust enrichment. The Texas Supreme Court stated that division and transfer orders bind underpaid royalty owners until revoked. Detrimental reliance explains why purchasers and operators are usually protected by the rule that division orders are binding until revoked. The court cited Chicago Corp. v. Wall for the holding that to do otherwise would be exposing purchasers and operators to double liability. Generally, underpaid royalty owners, can recover from

the overpaid royalty Owners. *Allen v. Creighton,* 131 S.W.2d 47, 50 (Tex. Civ. App.-Beaumont 1939, writ ref d). The doctrinal underpinning for the "binding until revoked" rule is detrimental reliance.

In *Exxon v. Middleton*, Division orders were binding until revoked, even though there had been no detrimental reliance because they had not profited from their error and the court found no unjust enrichment. The court observed that Exxon and Sun could not have relied on the division orders' representations in making the long-term gas contracts, because the contracts were executed before division orders were executed. In Gavenda, the court held that the division and transfer orders did not bind the Gavendas citing *Stanolind Oil & Gas Co. v. Terrell 183 S.W. 2d 743 (Tex. Civ. APP.- Galveston 1944)* where erroneous division orders were executed but the benefits were retained by the operator. In *Terrell*, the division orders were found to be not binding because the operator deducted the gross production tax from the royalty, although the lease provided that there would be no deductions, thus profiting from its own error.

Here, Strata underpaid the Gavenda family by 7/16th. It profited, unlike the operators in *Exxon v. Middleton,* at the royalty owner's expense. Strata was liable to the Gavendas for whatever portion of their royalties it retained. The division order would not be binding until revoked if unjust enrichment could be demonstrated. In general, the underpaid royalty owner's remedy lies in an action against the overpaid royally owners or other interest owners.

D. **Cabot Corp. v. Brown**

It appears that the Texas Supreme Court would relax the "binding until revoked" rule for unjust enrichment, but not for ordinary, run of the mill, enrichment. This was the holding of Cabot Corp. v. Brown, 754 S.W.2d 104, 107-108 (Tex 1987). Cabot's production was initially subject to FPC (federal interstate) jurisdiction but Cabot got it released and sold a large portion of the production into the intrastate market at a higher price, but continued to pay royalty based on the lower interstate price. The Court held Brown was limited to the lower interstate price allowed by federal regulation until the division orders were revoked due to the Middleton case. In essence, Brown's division order remained binding upon her until revoked. The division order was deemed revoked by the filing of the lawsuit.

E. **Time Limits on Payment of Proceeds**

The original statute addressing the period of time within which the proceeds of production were to be paid was enacted in 1983. Prior to that time payments for production could be withheld from royalty owners with little risk until sued. The statutory determination of when payments should be made has been carried forward and is now found in Section 91.402 (Vernon 2011) of the Texas Natural Resources Code Annotated.

§ 91.402 Time for Payment of Proceeds

(1) 60 days after the end of the calendar month in which subsequent oil production is sold; or
(2) 90 days after the end of the calendar month in which subsequent gas production is sold.

Further, the Lessee operator has 120 days after the end of the

month of first sale of production from the well to pay proceeds. …

If the Payor fails to make payment within the safe harbor provisions of §91.402 (a) interest will be due on the unpaid amount unless there is a title dispute or other statutory excuse.

§91.403. Payment of interest on Late Payments

§91.402 (b) provides statutory excuses for late payment without interest. Payments may be withheld without interest if:

(1) there is a dispute concerning title;

(2) there is a reasonable doubt that payee:

(A) has sold or authorized the sale

(B) has clear title to;

(3) there are unsatisfied title requirements

What would be an example of a "title question"? In *Browning Oil Co., Inc v. Luecke* 38 S.W.3d 625, (Tex.App. [3rd] 2000) the court denied. Browning's argument that section 91.402 of the natural Resources Code prohibits prejudgment interest.

The court stated that the purpose of the statute is to protect royalty owners from intentional payment delays while permitting delays that result from legitimate title disputes Concord *oil Co. v. Pennzoil Exploration & Prod. Co*. *(966 S.W.2d 451 (Tex.1998).* The court went further and stated that the legislature puts limits on what could be included in the required division order.

§91.402 (c)

In Coastal Oil & *Gas Corporation v. Roberts* 28 S.W.3rd 759 (Tex. App.[13th] 2000), the Corpus Christi Court of Appeals held that the Texas Natural Resources Code provides that a payor is entitled to receive a signed division order-from a payee as a condition for the :payment of proceeds from the sale of oil and gas…However, "[i]f an owner in a producing property will not sign a division order because it contains provisions in addition to those provisions provided for in this .section, payor shall not withhold payment solely because of such refusal."

In both §91.402 (c) (2) and (d), any division order authorized by this statute must state that the terms of the division order do not amend, modify or alter the terms of the oil and gas lease or other document providing for the payment of proceeds of production. This requirement is restated and amplified in subparagraph (h) of § 91.402. Subsection (h) which provides:

"(h) The execution of a division order between a royalty owner and lessee or between a royalty owner and a party other than lessee shall not change or relieve the lessee's specific, expressed or implied obligations under an oil and gas lease, including any obligation to market production as a reasonably prudent lessee. Any provision of a division order between payee and its

lessee which is in contradiction with any provision of an oil and gas lease is invalid to the extent of the contradiction."

Any division order must be limited by the terms of the oil and gas lease. Terms different from the oil and gas lease and included in the division order are invalid. If they are invalid, the Payor cannot argue that the terms in the division order are binding until revoked, *Heritage Resources, Inc. v. Nationsbank,* 895 S.W.2d 833, 838-839 (Tex.App.-El Paso,1995); rev'd 939 S.W.2d 118 (Tex.1996); *Yzaguirre* v. *KCS Resources, Inc.,* 47 S.W.3d 532, 545 (Tex.App.-Dallas 2000, aff'd 53 S.W.3d 368 (Tex.2001). This subsection, arguably, excludes the offensive use of the division order to alter or excuse the Payor from complying with the terms of the oil and gas lease, at least for the payments made and accepted. If the division order contradicts or varies the oil and gas lease, the Payee will not be prevented from asserting a claim for payment with a four year "look back" statute of limitations, unlike the situation in *Middleton*.

IV. Who owns the minerals and how are they transferred?

The mineral estate is part of the bundle of rights comprising the fee estate. If they are never severed or separated from the surface, they remain as part of the fee or surface estate. If there is a transfer of the surface, unless the minerals are specifically retained or reserved, they pass to the grantee along with the conveyance of the fee. The minerals can be severed or divided from the surface either partially or entirely. When the minerals are transferred by themselves, the transfer is by mineral deed in the state of Texas. As noted, an assignment of the surface will pass mineral title also in the absence of a specific reservation.

V. Executive Rights

Frequently negotiations for the sale of the surface, where all or a portion of the minerals remain with the surface prior to the sale, involve a compromise between the party desiring to retain all or a portion of the minerals and the party primarily interested in the surface. If the surface owner does not receive the minerals or a waiver of surface rights from all mineral owners, the surface owner's ability to develop the surface or use in a specific manner could be affected or eliminated. There are two compromises, the first involves executive rights, the right to grant a lease and the second, is a non-participating royalty interest. In the case of a non-participating royalty interest, the holder of such an interest does not have the power to lease, but does participate in any royalty resulting from leasing. In both cases the right to lease is given to a party other than the party receiving royalties. The mechanics of executive rights are discussed in Day& Co. v. Texland Petroleum, Inc., 32 Tex. Sup. Ct. J. 549, 550 (Tex 1989) opinion withdrawn and new opinion issued, 786 S.W. 2d 667. If the right to lease the minerals, the executive right, is given to the surface owner and not retained by the mineral owner, frequently the minerals are never developed. The surface owner's incentive is to develop the surface and not the minerals. There is a view that mineral development restricts the ability of the surface owner to develop the surface due to well location and road and pipeline easements. For this reason, the mineral owner should keep the executive rights with respect to any minerals transferred with the surface. That way, the mineral owner can retain control over the mineral development of the tract.

VI. Pipeline Permits, Easements and Seismic Permits

When confronted with a request to grant a pipeline easement or permit, a mineral and surface owner needs to give careful consideration as to the process. Any agreement entered into to permit the laying of a pipeline must be careful to require a beginning date and an ending date for the construction of the pipeline and restoration of the surface. In addition, the permit should allow no more than one line which is limited to a specific purpose. The agreement should have a term which will end when the pipeline is not used for a period (frequently 12 continual months). If the purpose is to bring production from a specific well, it should terminate when the well is no longer producing. There should be a damage provision in addition to the payment of the right-of-way fee for the land to provide for surface damages over and above normal installation damages. Consideration should be given to how the trench will be dug and dirt is replaced in the trench. "Double ditching" requires separation of deeper dirt from shallower dirt to insure the best soil is restored to the surface. Surface restoration should be required to occur within a specific period after the pipeline has been installed. The right to cross the line and other surface uses should be reserved to the grantor. There should be a specific indemnification provision and provision for insurance against any loss suffered by the party granting the permit. Typical pipeline easement language can be found attached as Schedule C. Note the language provided is primarily pipeline protective and does not contain the above suggested surface owner protections. Road easements are typically similar to those used to provide access to and across surfaces and involved maintenance and other typical provisions.

When approached for a seismic permit, there are several things to consider. One should seriously consider whether it is advisable to enter into a permit prior to entering into an oil and gas lease (not option) of the underlying minerals. The seismic evaluation could result in the condemnation of the land for a rather nominal sum prior to receiving a lease bonus (generally much larger sum). It is generally not advisable to enter into a seismic permit prior to entering into a lease. Any seismic permit should contain a specific term and provide for a pre-agreed amount of damages. There should be control over the method used as well as the method of data collection. Will dynamite or "vibroseis" be used? What size trucks and support vehicles will be sued?. How will fences and gates be handled? There will need to be an indemnification provision and an insurance provision. If possible, the mineral owner should negotiate to receive a copy of the processed data with respect to the subject property.

VII. The dominance of the Mineral Estate and the Accommodation Doctrine and Regulation

The mineral estate has been defined to be the dominant estate in Texas as described in Meyer v. Cox 252 S.W.2d 207 (Tex.Civ.App.1952). It is the dominant estate because if it were otherwise, the surface owner in a severed mineral situation would not allow the development of the minerals. The severed mineral situation arises where all or a portion of the minerals are not owned by the surface owner. As such, the surface owner does not economically benefit from the activity conducted on its surface and generally resists all surface development. As the

dominant estate, the mineral estate has the right to use as much of the surface as is reasonably necessary to exploit the minerals under the tract of land comprising that estate.

In light of the fact that the estate is the dominant estate, the mineral lessee, the oil company, would also be dominant and would be able to reasonably use the surface for mineral development. This is so even if it is inconsistent with the surface owner's uses. The rights of the mineral owner are significant, but not absolute. It has been held that the rights of the mineral owner must be exercised with due regard for the rights of the surface owner.

The mineral owner's obligation to the surface owner was further defined in Getty Oil Company v. Jones, 470 S.W.2d 618 (Tex 1971). There, the Texas Supreme Court established the "Accommodation Doctrine" finding that where a pre-existing surface use existed, with no alternative to that use for the surface owner and alternative methods by which the mineral owner could develop the minerals under the subject tract, the mineral owner must accommodate the surface owner and use that alternative method to develop the minerals.

The development of minerals is also impacted by regulatory bodies such as the Railroad Commission of Texas. For instance, Rule 37 of the Railroad Commission of Texas defines how close the mineral development of one tract can be to a neighboring tract. While Texas recognizes the "Rule of Capture", the right of a mineral owner to capture all oil and gas flowing under its tract, it must do so from a location which is no closer than a defined distance from that neighboring tracts.

Another rule which can impact mineral and surface development is Railroad Commission Rule 76 regarding the creation of a "Qualified Subdivision". This Rule essentially provides a method by which surface owners can cause a determination with respect to how and where the surface use will occur for the mineral development of their tract. The Rule establishes a method by which the number and location of tracts used for mineral development will be located. Essentially there is a determination as to where wells can be drilled so that the surface can be developed in an orderly and protected way. The mineral owner is allowed only that number of surface locations necessary to adequately develop the minerals under the subject tract. The final determination is made at a hearing before the Railroad Commission of Texas. This Rule is restricted to areas in counties with large urban populations. There are also municipal ordinances in addition to zoning which provide limitations on locations, noise and light.

As mineral development has increasingly moved into urban areas, municipalities have increasingly attempted to expand their perceived role as a protector of their citizens and regulate that development. They have attempted to restrict drilling activities, pipeline construction and operations as well as other oilfield activities through their permitting process and the use of their police powers. In Klepak v. Humble Oil, 177 SW 2d 215 (Tex. Civ. App. Galveston, 1944); the authority of a municipality to adopt; regulations governing drilling within city limits was affirmed. In more recent years, municipalities have been so strapped for cash that they have recognized the desirability of mineral development as a source of revenue for both the municipality and its citizens, and some have relaxed their attempts to stop all mineral development. There is also a "green" movement which attempts to use regulations to inhibit or stop

all hydrocarbon development. Frequently the anti-drilling or anti-fracking movements are stem from the fact that minerals have been separated from the surface and the surface owner has no incentive to allow mineral development.

VIII. Recent Texas Oil and Gas Cases

A. Effect of Lease Termination on Pooling

Wagner & Brown v. Sheppard, 282 S.W.3d 419 (Tex. 2008).

The dispute in Wagner & Brown v. Sheppard involved the basic question of whether a lessor's interest remains pooled even after a lease in that unit has terminated. Sheppard, a lessor, argued the answer was no. She claimed that when her lease terminated (due to the fatal breach of a provision requiring the timely payment of royalties) the lessee's fee simple determinable estate ended and her possibility of reverter became possessory. With the termination of her lease, Sheppard argued she became a cotenant in the wells which were drilled on her lease tract and that her tract was no longer subject to the pooling unit to which the lessee had committed her interest while the lease was in effect. She consequently rejected the lessee's payments because of the dilution resulting from unit-based royalty verses receiving the entire royalty from her tract, and claimed that since the producing wells were on her property, cotenancy accounting rules applied. As such, the lessee should be required to account to her as an unleased cotenant on a net profits basis (she should share of profits from all wells on her tract less the reasonable drilling and operating costs). The court’s holding was that despite the termination of the lease, the mineral interest remained subject to the pooling unit, thus the royalties due Sheppard were diluted by the relative size of her tract in relation to the size of the entire unit.

The opinion contradicted the prevailing view among attorneys and others that the standard lease pooling clause does not permit a lessee to pool the lessor's possibility of reverter. As a consequence, conventional wisdom would be that with the termination of the lease, lessors' interests would no longer be pooled. It also begged many related issues dealing with the unleased mineral interest.

B. Lease Termination Quasi Estoppel

Cambridge Production, Inc. v. Geodyne Nominee Corp., 292 SW3d 725 (Tex. App. Amarillo 2009, pet. denied)

This case presented a complicated set of facts whereby Cambridge which was seeking to terminate section 33 oil and gas leases which had been combined with leases held by a well in Section 44 of Hemphill County in a related voluntary pooling designation. In addition, Cambridge, the owner of top leases covering the mineral interests in Section 33, was requesting damages as well.

In January of 1980, the Prater No. 1-39 well was completed in the interval between 14,364 feet and 14,929 feet, and produced from that interval throughout its productive life. In May of 1980, Geodyne's predecessor in title, Northern Natural Gas Company, filed a pooling agreement that designated the unit depths and intervals as being those encountered in the Prater No. 1-39 well. As a result of a scrivener's error, the pooling language which was filed stated that the acreage was pooled insofar and only insofar as the stratigraphic equivalent of depths between 14,364 fee and 14,372 feet below the surface are concerned. Some 19 years later, in March of 1999, Geodyne filed an

amended pooling designation for the Pater No. 1-39 well describing the correct pooled depths as being between 14,634 and 14,929 encountered in the Prater well, stating that the prior misstated depths were the result of a scrivener's error. In the case, Cambridge was appealing the Trial Court's entry of summary judgment in favor of Geodyne with respect to the lease termination claims.

The Texas Court of Appeals addressed two of the issues raised on appeal since it found that those issues were dispositive of the appeal. First, the court held that the claims of Cambridge were barred by "equitable estoppel". Equitable estoppel precludes a party from accepting the benefits of a transaction and then taking a subsequent inconsistent position to avoid corresponding obligations. The Court found that equitable estoppel applies when it would be unconscionable to allow a party to maintain a position inconsistent with one in which it acquiesced or from which it accepted a benefit. In the present case, the Section 33 mineral owners had, by virtue of the pooling designation, accepted the benefit of revenues of production from the Prater No. 1-39 well that was not located on Section 33.

Second, the Court rejected Cambridge's contention that it was a bona fide purchaser of the top leases covering Section 33. Among other considerations, the Court found that Geodyne was in the same position as its lessor in the Prater Unit, and a producing well was being operated on the Unit, at the time Cambridge obtained the top leases. The court stated that, "Had Cambridge made reasonable inquiry as to the basis upon which Geodyne was in possession of the well and was paying royalties from production to Geodyne's lessors, it would have discovered the basis upon which Geodyne claimed . . . the Section 33 leases." The Court cited prior holdings that a purchaser of land is charged with constructive notice of an occupant's claims.

C. Accommodation Doctrine.

Valence Operating Co. v. Texas Genco, LP, 255 S.W.3d 210 (Tex. App. Waco 2008, no pet.) .

In this case, Texas Genco operated a limestone plant that included a 541 acre landfill in which to deposit coal ash which fueled the plant which made electricity to run its neighboring operation. Genco deposited ash waste from its electric generating coal plant into the landfill. It had mapped out cells or pods for ash disposal on the various portions of the landfill. As a cell was filled, Texas Genco closed it and opened a new cell in a different part of the landfill. Here, 91 acres of the landfill were located in the Holmes Unit where Valence owned the mineral rights. The Holmes Unit contained four gas wells that were located within, or on the edge, of the landfill used by Texas Genco. The location of the wells on the edge of the tracts permitted Texas Genco to continue using the landfill because it would simply "notch around" these wells with their new ash disposal cells.

Valence obtained a drilling permit to drill an additional well within the landfill. While the well would be on the outer edge of the tract, it would be at a location which potentially reduced the area within and thus the lifespan of the landfill. While waste was not being deposited in the cell where the proposed well would be drilled at the time, Texas Genco objected to the proposed well location and filed a lawsuit for a temporary injunction against Valence, seeking to stop Valence from drilling another well. Valence responded seeking a temporary injunction and counterclaimed that Texas Genco was wrongfully seeking an injunction. A jury found for Texas Genco and the trial court

issued a permanent injunction against Valence based on the accommodation doctrine.

Under the accommodation doctrine, where there is an existing use by the surface owner which would otherwise be precluded or impaired, and established practices in the industry provide alternatives the mineral developer whereby the minerals can be recovered, the rules of reasonable usage of the surface may require the adoption of those alternative methods by the mineral owner. If there is only one means by which to produce the minerals, then the mineral owner has the right to pursue that use regardless of the impact on the surface. If reasonable alternative drilling methods exist that protect the surface owner's existing use, then an accommodation by the mineral owner would be required.

On appeal, Valence argued that the permitted location of the well would not substantially impair Texas Genco's existing use of its landfill. Valence focused on the fact that after Texas Genco filed suit it expanded the footprint of the landfill to the east to include an area that Texas Genco offered as an alternative drilling location. Once Valence rejected the proposed alternative location, Texas Genco expanded the footprint. Valence asserted that Texas Genco's use was not substantially impaired because the proposed alternative site was just a "stones throw" from the approved location.

The Court of Appeals first concluded that Texas Genco presented sufficient evidence that the approved drilling location would substantially impair Texas Genco's use of the landfill. The location would be within the landfill's footprint, and though no ash deposits had been made in these particular cells of the landfill they were platted. Further, Texas Genco had made preparations for their use. The approved drilling location would also cut 2.2 years (about 20% off) of the estimated 11-year remaining life of the landfill.

Texas Genco maintained that the landfill footprint was modified to maximize "every available square inch" of space on the landfill's eastern side because the landfill was surrounded by wells and had no option to expand. Further, Valence was proposing additional wells within the footprint. The court concluded that the jury was free to believe this explanation over Valence's allegation that Texas Genco simply modified the footprint to improve its litigation position.

D. Pipeline Condemnation

<u>Texas Rice Land Partners, Ltd. v. Denbury Green Pipeline-Texas LLC</u> 296 S.W.3d 877 (Tex. App.—Beaumont September 24, 2009, pet. filed)

In this case the court held that an entity's filings with the Texas Railroad Commission ("TRC") can establish the entity's status as a common carrier as a matter of law. Texas Rice repeatedly refused Denbury Green access to Texas Rice's property to survey the proposed location of a carbon dioxide pipeline. Denbury Green filed suit claiming common carrier status and seeking a temporary restraining order and a permanent injunction to prevent Texas Rice from denying it access to the property. Denbury Green prevailed on summary judgment. Texas Rice argued summary judgment was improper because there was no evidence that Denbury Green would actually operate the proposed pipeline as a common carrier, rather than for its own private purposes.

The court found that a person is a common carrier . . . if it . . . owns, operates, or manages, wholly or partially, pipelines for

the transportation of carbon dioxide or hydrogen in whatever form to or for the public for hire, but only if such person files with the commission [TRC] a written acceptance of the provisions of this chapter expressly agreeing that ... it becomes a common carrier subject to the duties and obligations conferred or imposed by this chapter.

A common carrier, as defined under section 111.002(6) of the Texas Natural Resources Code has the right to exercise eminent domain.

The court noted that "when determining whether [a pipeline company] is a common carrier under § 111.002(6) of the Texas Natural Resources Code, we have been instructed by the supreme court to give great weight to the TRC's determination of that issue." The court then considered Denbury Green's summary judgment evidence, including its TRC application for a permit to operate a carbon dioxide pipeline as a common carrier; the TRC's declaration of its common carrier status; Denbury Green's written acceptance of the provisions of Chapter 111 of the Texas Natural Resources Code and express agreement that it was a common carrier, filed with the TRC; and affidavit testimony regarding Denbury Green's negotiations with other entities to transport carbon dioxide. The court concluded that Denbury Green had established its common carrier status as a matter of law.

Texas Rice argued that there was no evidence that Denbury Green would actually operate the pipeline as a common carrier, but in fact the pipeline would be used solely for private purposes. Because Denbury Green's pipeline was not completed or operational, there was no evidence regarding Denbury Green's actual use of the pipeline. The court rejected Texas Rice's argument, saying "[e]ven if there was such evidence in the record, when determining public use, the existence of the public's right to use the pipeline controls over the extent to which that right is, or may be, exercised."

The case was appealed to the Texas Supreme Court which decided in Texas Rice Land Partners, LTD v. Denbury Green Pipeline-Texas, LLC, 363 S.W.3d 192, (Tex. 2012) which reversed the summary judgment which had been affirmed by the Court of Appeals and remanded the case for further proceedings. Their holding was that the T-4 permit alone did not conclusively establish Denbury Green’s status as a common carrier with the power of eminent domain. They cited the fact that the Commission process undertook no effort to confirm whether the applicant’s pipeline will be public rather than private. They concluded that Denbury Green was not entitled to common-carrier status simply because it obtained a common-carrier permit, filed a tariff, and agreed to make the pipeline available to any third party wishing to transport its gas in the pipeline and willing to pay the tariff. Thus, the summary judgment was reversed and remanded.

While many make much of this decision, it is too early to tell if this signifies a major change or simply stands for the proposition that the clerical function of checking a box indicating an entity is a common carrier is not sufficient to survive summary judgment, it remains to be seen what kind of showing will be necessary to prove common carrier status. In the meantime, it will certainly make it more expensive for companies to maintain they are a common carrier for purposes of surviving a summary judgment motion.

E. Surface Owner Right to Permit for Disposal Well

Rosenthal v. Railroad Commission of Texas No. 03-09-00015-CV, 2009 WL 2567941 (Tex. App.—Austin August 20, 2009, pet. filed) (mem. op.)

The court held that ownership of the surface was sufficient to establish a "good-faith claim" to the right to commercially dispose of salt water by injecting it in non-producing intervals under a Texas Railroad Commission ("TRC") disposal permit. The surface owner owned an existing wellbore and sought a TRC disposal permit for the purpose of operating a commercial salt water disposal well for offsite salt water. The owner of the mineral rights in the disposal tract contested the application for the disposal permit. The TRC granted the surface owner a permit to dispose of the salt water by injecting it in the non-productive intervals of the wellbore.

On appeal of the TRC's permit issuance, the mineral owner argued that the surface estate owner did not establish a good-faith claim to the right to use the subterranean property for salt water disposal. The court recognized the limited authority of the TRC to grant permits, saying: the TRC may not "…determine or affirmatively create title or a right of possession…" In addition to other statutory requirements to grant a permit, the TRC must be satisfied by substantial evidence that a permit applicant has made a reasonably satisfactory showing of a good-faith claim of ownership in the property. "[A] permit applicant is not required to prove title or right of possession in the property affected by the permit, and the commission has no power to decide that question, the applicant nonetheless must make 'a reasonably satisfactory showing of a good-faith claim of ownership' in the property."

"The underlying substantive title question of 'how much control a mineral owner has over the underground strata where the surface owner seeks to use a well for commercial injection of [salt watery is unsettled." The court found there was no dispute as to the validity of the surface owner estate. The issue was what parameters the surface estate granted its mineral lessee. That issue must be resolved in the courts. The court characterized that dispute as a "quintessential title dispute," a dispute that is outside the jurisdiction of the TRC Nevertheless, "the commission's authority to grant permits is negative in nature–the commission, through a permit, merely removes a barrier the conservation laws otherwise would impose on use of the property, but does not determine or affirmatively create title or a right of possession in the property itself." Citing Emery v. United States and Humble Oil & Refining Co. v. West and the fact of undisputed surface ownership, the court upheld the TRC's grant of a permit based on substantial evidence to support a good faith claim that the surface estate includes geological structures beneath the surface suitable for storing non-native gas.

F. Duty of Executive Rights Holder to Non-Executive Mineral Owner

Veterans Land Board of the State of Texas et al. v. Lesley et al., 281 SW3d 602 (Tex. App. – Eastland 2009, pet. filed).

The issues in this case were whether the holder of executive rights has a duty to the non-executive mineral interest owners and, if so, was it violated. The trial court held there was a duty to lease on the part of the executive rights holder under the circumstances. Under the facts presented, the non-executive rights owners in the

dispute had previously owned both the surface and the minerals under the subject 4,100 acre ranch question. They sold the surface, a portion of the minerals and the executive rights to their grantee. Subsequently an additional interest in the surface was sold and an interest in the minerals and executive rights were then sold to a real estate developer. The real estate developer began developing the property and a portion of the surface was then sold to the Veteran's Land Board of the State of Texas, individual purchasers and a property owner's association each of whom acquired pursuant to the chain of title. The trial court held that the defendants, the mineral interest owners which were holders of the executive rights owed a duty of utmost good faith to the non-executive mineral owners and that such duty was fiduciary in nature including the duty to lease all of the minerals. Here one of the owners in the chain of title, the developer, had created covenants and restrictions on the property which prohibited the mineral development of any portion of the property. The trial court granted the appellee's summary judgment motion finding both that there was a duty to lease the minerals by the executive rights holders which was breached and that there was a need for the reformation of the deed creating the covenants and restrictions against drilling which were held to be unenforceable. There was a sub-issue as to which party owned the executive rights. On a collateral point, the court, citing previous cases, held that in the absence of a reservation of executive rights they passed to the grantee with the minerals.

The court of appeals reversed the judgment stating that the holder of executive rights does not have an affirmative duty to lease the minerals. The Court of Appeals also determined the appellees should take nothing on the breach of fiduciary duty claim.

On September 15, 2010, the Texas Supreme Court, at 352 S.W.3d 479 (Tex. 2011) affirmed the court of appeals in part and reversed in part. They stated that the court of appeals held that the developer, never having undertaken to lease the minerals, had not exercised the executive right and therefore owed no duty to the other mineral interest owners. The Supreme Court disagreed and accordingly reversed and remanded the case to the trial court. The court cited the fact that there was active mineral development in the area and the holder of the executive rights, at the time, created a restrictive covenant to benefit the surface development which forbade "commercial oil drilling, oil development operations, oil refining, quarrying or mining operations." The court examined the nature of the duty that the owner of the executive right owes to the non-executive interest owner, and whether that duty had been breached in the case. The court did not agree that the holder of the executive rights is shielded from all inaction. They went further and said that, " if the refusal is arbitrary or motivated by self-interest to the non-executive's detriment, the executive may have breached his duty." Here the holder of the executive rights did not simply refuse to lease, but imposed restrictive covenants prohibiting mineral development. They held that the duty was breached and the remedy should be, "cancellation of the restrictive covenants."

G. Rights of Wellbore Assignee

Petro Pro, Ltd. et al., v. Upland Resources, Inc. et al., 279 S.W.3d 743 (Tex. App. – Amarillo June 14, 2007, no pet.).

This case involved wellbore assignments. The subject assignments expressly limited the assigned interests to 'rights in the wellbore' in a given well." The district court granted summary judgment in favor of

the appellees. The Court of Appeals reversed and rendered for appellants holding that the grantee of the wellbore assignment was not entitled to rights outside the wellbore. Here the subject well was completed as a gas well in the Cleveland formation between 6,500 and 6,600 feet subsurface. Medallion, the lessee at the time, pooled 500 acre tract with a 204 acre tract. Due to its determination that the well was no longer economic, the wellbore was sold to assignee and others. The assignor then farmed out the subject tract to L&R which drilled and completed two wells in the shallower Brown Dolomite formation. L&R sought clarification with respect to the interests and the wellbore. The wellbore assignee filed a suit claiming that it had the exclusive right to produce gas from the entire unit from the surface to 6,800 feet (including the Brown Dolomite formation) and sought a declaratory judgment as to the property rights and an accounting and requesting that funds be placed in the court registry until resolution. The trial court ruled that the wellbore assignments were unambiguous and granted Appellee, Upland's, motion for summary judgment. The Court of Appeals rendered a judgment declaring that the wellbore assignments in question transferred to the wellbore assignee an estate that extends to the physical limits of the wellbore only, together with all the appurtenant rights incident to the underlying lease. The wellbore assignee did not acquire title to the gas in place outside the wellbore in other areas of the lease. The claims of trespass, conversion and money had and received were dismissed.

H. Adverse Possession of Minerals

<u>Natural Gas Pipeline Co. v. Pool</u>, 124 SW3d 188 (Tex. 2003)

This case dealt with a claim of adverse possession with respect to the minerals held by lessors held under three oil and gas leases. During the life of the lease, there had been 30 day and a 153 day lapse in production for which the lessors claimed the leases had terminated. The trial court granted a partial summary judgment with respect to the claim that the leases had terminated due to cessation in production and rendered a judgment declaring that the leases had terminated. The Court of Appeals held that the leases had terminated and denied lessee's claim of adverse possession since lessee could not establish that lessor received notice of repudiation of lessors' title and further found laches was not a defense.

In its review, the Supreme Court discussed the 10 year statute of limitations, the five year and three year statutes of limitations and what constituted adverse possession. They held that to satisfy the 10 year statute, as defined in the Civil Practices and Remedies Code, "an actual and visible appropriation of real property commenced and continued under the claim of right that is inconsistent with and is hostile to the claim of another person is required. The issue here was whether lessee had notice of the repudiation of the claim of the lessor. The court also discussed what constitutes open and notorious. The Supreme Court held that the court of appeals erred in failing to hold that the lessees acquired leasehold interests by adverse possession. The Supreme Court held that a jury may infer notice where a long continued possession exists and there is no assertion of claims by the titleholder. It then went on to say that, as a matter of law, the lessors were put on notice that lessee's claims were hostile. The Supreme Court further held that the lower courts erred in failing to hold that the lessee acquired fee simple determinable title to the mineral estates by adverse possession.

I. Perpetuation of Lease By Shut-in

Payments

Vorh Exploration Co., Inc. v. EOG Resources, Inc. et al., 2009 WL 1522661 (Tex. App. – Eastland May 29, 2009, no pet.) (mem. Op.).

This case involved the question of whether, under the circumstances, a shut-in payment perpetuated the lease. The lease contained a shut-in payment provision. The trial court granted summary judgment for lessor where the habendum clause in an oil and gas lease automatically terminated the lease upon cessation of production. While the subject well had produced for several years, the well had not produced since at least November of 2001 when a gas purchaser disconnected the well. The court held that the unavailability of a market did not excuse the lessee's failure to produce. For a shut-in payment to perpetuate a lease the well must be capable of producing into a pipeline. The Court of Appeals held that the trial court correctly granted summary judgment in favor of the lessor. The well had not been produced in excess of the two-year limitation and the lessee's claim the unavailability of market did not excuse this lessee's failure to produce.

J. Lease Termination-No Adverse Possession

Sun-Key Oil Co. Inc. v. Cannon et al., 2009 WL 626071 (Tex. App. – Eastland March 12, 2009, no pet.) (mem. Op.)

The State of Texas brought an action against an oil and gas company to recover funds expended by the state agency in plugging a gas well owned by the company. The District Court granted partial summary judgment for the State. Here the Court of Appeals agreed with the District Court's decision that the oil and gas lease terminated as a result of the total cessation of production after the primary term and the trial court did not err in granting partial summary judgment. There was no production of gas from 1995 until June of 1997, when lessor entered into a new lease. The only issue was whether the evidence was sufficient to support this partial summary judgment. The State had a right to rely on the operator designation form conclusively establishing that the company was in control of the well and the trial court did not err in their decision which is affirmed.

K. Lease Termination –Commencement Operations Insufficient to Perpetuate Lease

Veritas Energy LLC v. Brayton Operating Corp. et al., No. 13-06-061-CV (Tex. App. – Corpus Christi Feb. 14, 2008, pet. Denied).

This was a lease termination case where the issue was whether the operations conducted by the lessee were sufficient to extend the lease. As the primary term of the lease was expiring, the lessee claimed that the lease was preserved when lessee's agent "back dragged" the grass from a curve in the road to the highway. This activity took place over the end of the primary term of the lease. This activity was commenced by the agent on June 5, 2003. Lessee was unable to complete the work due to a light rain. On June 7, 2003, lessors executed a new oil and gas lease. On January 8, 2004, the original lessee filed its original petition against Lessors seeking trespass, conversion and tortuous interference. The trial court signed a judgment granting all summary judgment motions in favor of lessor and the new lessee. The Court of Appeals cited the lease which defined operations as being "for and any of the following: drilling, testing, completing, reworking, recompleting, duping, plugging back and repairing a well in search for or in an endeavor to obtain

production of oil and gas." The Court of Appeals held that the actions of the original lessee failed to extend the lease. The backhoe work was the only activity on the lease for some period of time and a well had been drilled by the new lessee before the original lessee made its claim. The court held that the operations of the lessee of the first lease in question were insufficient to perpetuate the lease.

IX. WATER RIGHTS IN RECYCLED WATER

Sometimes new solutions bring new problems. With the energy industry's ever increasing demand for water, new desalination and purification processes have been developed. New water recycling technologies have the potential to help ameliorate water shortages and disputes over water rights arising from the increasing use of hydraulic fracturing in oil and gas exploration. It appear, however, that current Texas real property law limits full adoption of these technologies. To best serve their clients, attorneys need to understand these limitations and craft solutions.

Whether lawyers represent oil and gas lessees or lessors, and whether these lessors are fee simple or mineral owners, it is critical to understand the rights and relationship of these interests. Texas law treats these interests uniquely with respect to each party's rights regarding the surface acreage covered by an oil and gas lease. Understanding these nuances is critical in light of the extensive use of hydraulic fracturing and use and reuse of water.

The ever-increasing competition between for a finite water supply and the dramatic increase in hydraulic fracturing has caused hydraulic fracturing to become increasingly controversial. The large volumes of water consumed by hydraulic fracturing and its permanent disposal upon recovery into injection wells has fueled the controversy, especially during the droughts Texas has been suffering. The industry faces growing regulatory and political pressure from an increasingly environmentally conscious and water thirsty society.

Fortunately, recent technologies appear to be helping. Onsite and nearby water treatment technologies can treat and recycle wastewater backflowed from hydraulic fracturing process so that it is not lost forever. The benefits of this technology include reduced water purchasing costs and the creation of new markets for the sale of recycled used, often referred to as "wastewater" for alternative uses. Additionally, wastewater traditionally disposed into injection wells can be reused or returned to the hydrologic cycle, thereby lessening the depletion of the water table.

In an interesting twist, absent an agreement between the surface owner and the oil and gas lessee regarding the sale and ownership of wastewater, Texas real property law could inhibit an oil and gas lessee's efforts to fully adopt water treatment technologies. For our purposes here, I will focus specifically on groundwater produced from the surface estate of a tract where an oil and gas lessee is producing minerals and address the correlative rights between the oil and gas lessor and lessee and the surface owner (where the surface owner differs from the oil and gas lessor). Keep in mind that the issues highlighted here represent just one piece of a broader comprehensive puzzle, including regulatory law and the jurisdictional power of groundwater control districts. Ultimately, lawyers, and perhaps the Texas legislature, must address these interlocking pieces to facilitate and encourage widespread

acceptance and adoption of water treatment technologies.

Correlative Rights: The Implied Right of Surface Use

Texas follows the theory of mineral ownership in place. The owner of fee simple title owns all of the substances underneath his or her acreage subject to their migration across property lines. In the recent 2012 decision, *Edwards Aquifer Authority v. Day*, 369 S.W.3d 814 (Tex. 2012), the Texas Supreme Court confirmed that groundwater is an attribute of the surface estate. In the event of a severance of the fee simple estate (as in the case of an oil and gas lease), the surface estate owner continues to own the groundwater in place. As a general rule of thumb, the surface estate constitutes all of the interest in the fee simple title except the mineral estate that has been severed, thus leaving ownership of the minerals in place. Upon severance, the mineral estate is the dominant estate and the surface estate is the servient estate.

Absent express language contained in the title or interest-creating documents, the oil and gas lessee has the implied right to use as much of the surface as is reasonably necessary in conducting its operations (this was discussed in this paper above), while giving due regard to the surface owner's use of the surface. In the absence of this implied right, ownership of the mineral estate would be worthless since the minerals would not be able to be accessed. The scope of the implied right in the mineral owner is limited by the following four principles.

Limitations

1. Use of the surface must be reasonable and not negligent. When an oil and gas lessee conducts its operations, it must use only as much of the surface estate as is reasonably necessary to develop the minerals it owns or has leased, and must do so in a manner that is not negligent. This requires that the oil and gas lessee conduct operations in a manner that is appropriate in character and scope given the circumstances.

In the context of hydraulic fracturing, this means an oil and gas lessee may use groundwater for its operations where such use is reasonably necessary and not negligent. Based on the historical approval by the courts, the use of water use in oil and gas operations, even where large quantities of water are used for hydraulic fracturing it is unlikely that such use will be held to violate these limitations.

2. Courts will apply the accommodation doctrine. (again, discussed above in this paper) The accommodation doctrine focuses on balancing the rights of the mineral and surface owners. It generally requires the oil and gas lessee to give due regard to the surface owner's existing use of the surface.

In certain instances, the accommodation doctrine may require an oil and gas lessee to adopt an alternative use of the surface. The court must determine whether use of the surface by the oil and gas lessee precludes or impairs the surface estate owner's existing use and whether, under established practices in the industry, reasonable alternatives exist that still permit the oil and gas lessee to comply with its lease obligations. The burden of proof under the accommodation doctrine rests with the surface owner.

3. Use of the surface must benefit the mineral estate. The implied right confines surface use by the holder of the mineral rights to only that which benefits the mineral estate of that tract or lands pooled with that tract. Absent language to the contrary in the

title or interest-creating documents, an oil and gas lessee cannot use the surface of one tract for the benefit of another tract.

In the context of hydraulic fracturing, this means an oil and gas lessee may use water from the acreage covered by the lease (or pooled acreage) to accommodate hydraulic fracturing for wells located on that acreage or pooled with it. However, the oil and gas lessee may not use that water to complete wells located on other acreage not covered by the lease or pooled with it or for any other commercial or economic advantage.

4. Surface use does not create ownership. The implied right of surface use does not grant any right of ownership, in this case in the water, to an oil and gas lessee. Thus, an oil and gas lessee can only use water on the lease, not use it elsewhere or sell it. Absent an agreement between the surface owner and the oil and gas lessee, the lessee cannot sell recycled wastewater and therefore cannot gain further economic benefit from using water treatment technologies. There is support for this position, notwithstanding the court's likely deference toward the reasonably necessary use of water in hydraulic fracturing, oil and gas lessees and the utilization of water treatment technologies to treat and conserve wastewater. If this position is sustained, it could prevent lessees from treating wastewater, since the wastewater would remain the property of the surface owner.

Solution

Water treatment technologies are quickly becoming one of the most economically, environmentally, politically, and strategically significant developments in the oil and gas industry. To encourage oil and gas lessees to utilize wastewater treatment technologies and for the economic and environmental benefits to be fully realized, an oil and gas lessee must ultimately obtain ownership of the water.

An agreement, perhaps in the lease itself or mineral severance or after the fact with the surface owner is necessary to permit the oil and gas lessee to sell treated wastewater or realize the full cost savings created by such technologies. In the alternative, the oil and gas lessee would be liable for damages to the surface owner in the amount of the value of the water that was sold without the surface owner's consent. If actions are brought, it will dissuade widespread acceptance, implementation, and use of water treatment technologies in oil and gas operations in Texas.

I would like to acknowledge the assistance of PETER E. HOSEY and JESSE S. LOTAY of my firm in their assistance with portions of this paper

SCHEDULE A

SUMMARY OF
TYPICAL OIL AND GAS LEASE PROVISIONS

While leases are not always in this order, they do generally all contain provisions of this nature

PARAGRAPH CONTENTS

1. Granting Clause: Gives lessee the right to explore for and produce oil and gas, along with the right to use the surface in conducting such operation. See also Paragraph 8. .

   A Lessor should restrict the lease to specific tracts and specific uses

2. Term Clause: Describes the primary term, a period of years in most cases "and so long thereafter…" Provides that the Lease is held so long as there is production, "in paying quantities".

3. Royalty Clause: Describes the percentage of production the Lessor will receive as well as how royalties are to be calculated on oil and gas production, and provides for payment of "shut in royalties" on nonproducing gas wells.

   Is there protection against post production costs such as transportation, storage and processing?

   * Watch out for "market value" or "market price" gas royalty provisions in Texas.

   * Is there any limitation on the shut-in royalty provision?

4. Delay Rental Clause: Provides for payment of annual rentals during primary term in lieu of drilling or production.

   In today's market, it is more typical to have a "paid up" lease with no delay rental payments during the primary term.

5. Pooling Clause: Authorizes lessee to combine all or part of the lease with other acreage to form a voluntary pool or unit.

   Consider the unit size and rule 86 for horizontal wells.

   * Watch out for the "permit-prescribe" problem in Texas regarding Railroad Commission of Texas regulations.

   * Consider Pugh or Freestone rider clauses.

6. Dry Hole/Cessation of Production/Continuous Operations Clause: Provides for continuation of lease after drilling a dry hole or production has ceased, either by resuming operations or (if within the primary term) by resuming rental payments. The provision is used to extend the lease beyond the primary term by continuous operations.

   It encourages operations, but extends the lease term.

7. Proportionate Reduction Clause: Provides for a proportionate reduction of rentals and royalties

if the lease covers less than the full mineral interest.

* Make sure the interest described in Paragraph 1 is not already shown as reduced.

8. Surface Use Clause: Supplements the Granting Clause by describing the lessee's rights and obligations concerning certain specific surface uses.

It is increasingly common to seek a non-surface use provision.

* Consider the necessity of paying "location damages" or even agreeing on drill site and easement locations.

9. Assignment Clause: Describes the effect or right of assignment by either the lessor or the lessee.

* Watch out for an "entirety clause".

10. Surrender Clause: Authorizes the lessee to surrender the lease in whole or in part.

11. Force Majeure Clause: Relieves the lessee of his obligations whenever performance is prevented by circumstances beyond his control. The description and specific exceptions should be considered.

12. Warranty Clause: The lessor warrants his title to the interest described in the Granting Clause. The advisability of giving any warranty should be considered.

* Note the inherent conflict between this warranty and the proportionate reduction clause.

Misc Data: Consider attempting the negotiation of a provision pertaining to the fracturing process for any well drilled on the lease which restricts or requires the disclosure of what chemicals will be used in the process on the property

SCHEDULE B

PRESCRIBED DIVISION ORDER
NATURAL RESOURCES CODE

TITLE 3. OIL AND GAS

SUBTITLE B. CONSERVATION AND REGULATION OF OIL AND GAS

CHAPTER 91. PROVISIONS GENERALLY APPLICABLE

SUBCHAPTER A. GENERAL PROVISIONS

Sec. 91.402.

DIVISION ORDER

TO__________________________(Payor) Property No. ________________________

_______________________________________ _______________________________________

_______________________________________ _______________________________________

_______________________________________ Effective______________________________

(Date(

The undersigned severally and not jointly certifies it is the legal owner of the interest set out below of all the oil and related liquid hydrocarbons produced from the property described below:

OPERATOR:

Property name:____________________________

County:________________________________ State:_______________________

Legal Description: ____

……………………………………………………………………………………………

OWNER NO:__________________________ TAX I.D./SOC. SEC. NO. PAYEE _____

DIVISION OF INTEREST

THIS AGREEMENT DOES NOT AMEND ANY LEASE OR OPERATING AGREEMENT BETWEEN THE INTEREST OWNERS AND THE LESSEE OR OPERATOR OR ANY OTHER CONTRACTS FOR THE PURCHASE OF OIL OR GAS.

The following provisions apply to each interest owner ("owner") who executes this agreement:

TERMS OF SALE: The undersigned will be paid in accordance with the division of interests set out above. The payor shall pay all parties at the price agreed to by the operator for oil to be sold pursuant to this division order. Purchaser shall compute quantity and make corrections for gravity and temperature and make deductions for impurities.

PAYMENT: From the effective date, payment is to be made monthly by payor's check, based on this division of interest, for oil run during the preceding calendar month from the property listed above, less taxes required by law to be deducted and remitted by payor as purchaser. Payments of less than $100 may be accrued before disbursement until the total amount equals $100 or more, or until 12 months' proceeds accumulate, whichever occurs first. However, the payor may hold accumulated proceeds of less than $10 until production ceases or the payor's responsibility for making payment for production ceases, whichever occurs first. Payee agrees to refund to payor any amounts attributable to an interest or part of an interest that payee does not own.

INDEMNITY: The owner agrees to indemnify and hold payor harmless from all liability resulting from payments made to the owner in accordance with such division of interest, including but not limited to attorney fees or judgments in connection with any suit that affects the owner's interest to which payor is made a party.

DISPUTE; WITHHOLDING OF FUNDS: If a suit is filed that affects the interest of the owner, written notice shall be given to payor by the owner together with a copy of the complaint or petition filed.

In the event of a claim or dispute that affects title to the division of interest credited herein, payor is authorized to withhold payments accruing to such interest, without interest unless otherwise required by applicable statute, until the claim or dispute is settled.

TERMINATION: Termination of this agreement is effective on the first day of the month that begins after the 30th day after the date written notice of termination is received by either party.

NOTICES: The owner agrees to notify payor in writing of any change in the division of interest, including changes of interest contingent on payment of money or expiration of time.

No change of interest is binding on payor until the recorded copy of the instrument of change or documents satisfactorily evidencing such change are furnished to payor at the time the change occurs.

Any change of interest shall be made effective on the first day of the month following receipt of such notice by payor.

Any correspondence regarding this agreement shall be furnished to the addresses listed unless otherwise advised by either party.

In addition to the legal rights provided by the terms and provisions of this division order, an owner may have certain statutory rights under the laws of this state.

Witness	Signature of Interest Owner	Social Security/ Tax I.D. No.	Address
______________	____________________	____________________	______________
______________	____________________	____________________	______________
______________	____________________	____________________	______________

Failure to furnish your Social Security/Tax I.D. number will result in withholding tax in accordance with federal law, and any tax withheld will not be refundable by payor.

(e) If an owner in a producing property will not sign a division order because it contains provisions in addition to those provisions provided for in this section, payor shall not withhold payment solely because of such refusal. If an owner in a producing property refuses to sign a division order which includes only the provisions specified in Subsection (c) of this section, payor may withhold payment without interest until such division order is signed.

(f) Payment may be remitted to a payee annually for the aggregate of up to 12 months' accumulation of proceeds if the payor owes the payee a total amount of $100 or less for production from all oil or gas wells for which the payor must pay the payee. However, the payor may hold accumulated proceeds of less than $10 until production ceases or the payor's responsibility for making payment for production ceases, whichever occurs first. On the written request of the payee, the payor shall remit payment of accumulated proceeds to the payee annually if the payor owes the payee less than $10. On the written request of the payee, the payor shall remit payment of proceeds to the payee monthly if the payor owes the payee more than $25 but less than $100.

(g) Division orders are binding for the time and to the extent that they have been acted on and made the basis of settlements and payments, and, from the time that notice is given that settlements will not be made on the basis provided in them, they cease to be binding. Division orders are terminable by either party on 30 days written notice.

(h) The execution of a division order between a royalty owner and lessee or between a royalty owner and a party other than lessee shall not change or relieve the lessee's specific, expressed or implied obligations under an oil

and gas lease, including any obligation to market production as a reasonably prudent lessee. Any provision of a division order between payee and its lessee which is in contradiction with any provision of an oil and gas lease is invalid to the extent of the contradiction.

(i) A division order may be used to clarify royalty settlement terms in the oil and gas lease. With respect to oil and/or gas sold in the field where produced or at a gathering point in the immediate vicinity, the terms "market value," "market price," "prevailing price in the field," or other such language, when used as a basis of valuation in the oil and gas lease, shall be defined as the amount realized at the mouth of the well by the seller of such production in an arm's-length transaction.

Added by Acts 1983, 68th Leg., p. 966, ch. 228, Sec. 1, eff. Sept. 1, 1983. Amended by Acts 1991, 72nd Leg., ch. 650, Sec. 2, eff. Aug. 26, 1991; Acts 1995, 74th Leg., ch. 681, Sec. 1, eff. June 15, 1995.

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SCHEDULE C

Pipeline Easement Language

GRANTOR reserves the right to the full use and enjoyment of the Pipeline Easement subject to the rights herein granted, provided that GRANTOR shall not construct or place on, over, under or through the Pipeline Easement any improvements of a nature which GRANTEE reasonably believes will interfere with its rights hereby granted. Notwithstanding the foregoing, it is understood and agreed that the rights granted to GRANTEE under this Pipeline Easement shall not be superior to nor in any way exclude GRANTOR'S right to install, construct, lay, maintain, repair, or replace, in whole or in part, any utilities (including water, gas, electricity, sewer, cable television and fiber optics) and to build, construct, lay, maintain, install, repair or replace, in whole or in part, any streets, roadways, sidewalks, and driveways for vehicular and pedestrian traffic over and across any part of the Pipeline or Pipeline Easement or for parks, landscaping, fences and outdoor advertising signs, or for disposal or direction of surface water or rain, provided the foregoing utility and other installations are not running parallel with and on top of the Pipeline or Pipeline Easement (but rather, to the extent reasonably practicable, perpendicular to them) and do not unreasonably interfere with the operation, repair, replacement, maintenance, location or depth of the Pipeline and further provided that three feet (3') of cover must remain between the top of the pipeline and the surface after the construction of any mutually agreeable parking areas. Notwithstanding the foregoing, any installation of underground utilities within the Pipeline Easement must be located within that five foot (5') wide section of Pipeline Easement parallel with and contiguously abutted to the Pipeline Easement boundary which is the farthest away from the Pipeline, provided that nothing herein shall be deemed to prohibit GRANTOR from installing underground or above ground utilities that intersect the Pipeline at angles of not less than forty-five (45°) degrees nor greater than one hundred thirty-five (135°) degrees with each being clearly marked across the easement. At any intersection of the Pipeline and a utility, GRANTOR shall be required to separate the Pipeline and such underground or above ground utility by a minimum space of twenty-four inches (24"). GRANTOR shall give GRANTEE reasonable advance notice of any such utility easements granted by GRANTOR. Furthermore, and regardless of any other exclusionary term or condition contained in this Agreement, GRANTOR agrees hereinafter not to grant a pipeline easement to any third party that would allow the construction and installation of a third-party pipeline of any diameter size within a distance of fifteen feet (15') from GRANTEE'S Pipeline when said third-party pipeline is traversing parallel to GRANTEE'S Pipeline. In addition, and to the extent GRANTOR does convey pipeline easements to third parties with the foregoing requirement, GRANTOR further agrees to require said third parties to construct and install their pipeline(s) that cross

GRANTEE'S Pipeline to do so perpendicular to GRANTEE'S Pipeline with a separation of not less than forty-eight inches (48"). The foregoing limitation shall not apply to easements granted prior to the date hereof or easements acquired through future condemnation proceedings against GRANTOR. To the extent that GRANTOR, its assignees, or any agents or associated parties thereto installs any utilities or pipelines of any kind on, over, under or across the Pipeline Easement, GRANTOR agrees to comply, and by any subsequent assignment of this Right-of-Way Agreement, GRANTOR'S assignees agree to comply and said assignees thereby further agree to require all of their agents or associated parties to comply with the foregoing installation guidelines for vertical line separation and angles of intersection. In the event GRANTOR, its assignees or their agent(s) or associated parties believe that it is necessary to move or otherwise relocate any part GRANTEE'S Pipeline covered hereunder to accommodate a proposed future utility or pipeline installation of GRANTOR, its assignees or their agent(s) or associated parties, written mutual agreement for the proposed installation and the impact thereto must first be achieved between GRANTEE and GRANTOR, its assignees, or their agents or associated parties; collectively, prior to GRANTEE'S consideration for any relocation of its Pipeline.