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Texas Produced Water Ruling Helps Clarify Oil, Gas Leases

By **Michael Lennon, Philip Lau and Susan Alkadri** (September 6, 2023, 5:50 PM EDT)


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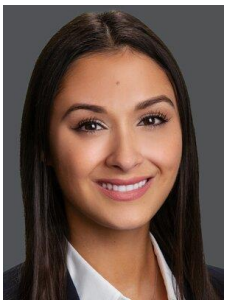
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On July 28, the Court of Appeals for the Eighth District of Texas, in El Paso, issued its opinion in Cactus Water Services LLC v. COG Operating LLC, holding that the mineral lessee under an oil and gas lease owns the water extracted simultaneously with oil and gas during production operations, known as produced water.

The court's decision is the first step — albeit a significant one — toward clarity on an issue that has divided the midstream industry, and cast doubt as to the viability and enforceability of certain produced water contracts that provided for the transfer of title in and to produced water, from a producer of hydrocarbons to a provider of midstream services.

Case Background

COG is the operator and mineral lessee under four leases executed in 2005, 2010 and 2014, covering approximately 37,000 acres in Reeves County, Texas. The lessors retained rights over the surface land.

Since beginning operations, COG had disposed of its oil and gas waste — including 52 million barrels of produced water — at a cost of over $20.5 million. COG also executed surface use compensation agreements and right-of-way agreements with the surface owners to facilitate its use of the surface estate in conjunction with the transport of hydrocarbons and associated waste from COG's wells.

In 2019 and 2020, however, the surface owners transferred all the surface estates' water rights in the leased lands to Cactus Water Services. These water leases gave Cactus ownership and the right to sell all water "produced from oil and gas wells and formations on or under the [covered properties]."

In early March 2020, Cactus informed COG of the produced water leases. COG then sued, seeking a declaratory judgment that COG has the sole right to the produced water by virtue of its mineral leases and surface use compensation agreements, and under common law.

Cactus counterclaimed, asserting ownership over the produced water under the produced water leases — which, if upheld, would effectively negate any claim of COG that it owned the produced water by virtue of the underlying mineral leases.

The parties cross-moved for summary judgment. The trial court granted summary judgment in COG's favor. The parties voluntarily dismissed their remaining claims, and the trial court entered a final judgment that, by virtue of its mineral leases, COG owns and has the exclusive right to possess, control and dispose of the produced water, and that Cactus has no rights in the COG product stream from COG's wells, including the produced water. Cactus appealed.

The Court of Appeals' Decision

In a 2-1 decision, the majority held that, pursuant to the mineral leases, "COG has the exclusive right to the oil and gas product stream, including the produced water." Accordingly, "[t]he subsequent leases purporting to convey produced water rights to Cactus were thus ineffective."

Because the mineral leases did not define the term "water," the court was tasked with analyzing the parties' intent. The majority's analysis centered on determining, as a matter of law, whether produced water is properly classified as waste, and thus part of the mineral estate, or groundwater, and thus part of the surface estate.

After evaluating the legal and regulatory framework, common industry practice, and the course of dealing between COG and the surface owners, the majority determined that "produced water is more accurately classified as a waste byproduct of oil and gas production."

First, the Texas Natural Resources Code, Texas Water Code and Railroad Commission rules each define "oil and gas waste" to include salt water, produced water, and other liquid or semi-liquid waste. And the Texas Water Code and Railroad Commission rules define "water" to mean fresh water, groundwater, and/or surface or subsurface water.

The Railroad Commission rules forbid causing or allowing pollution of surface or subsurface water in Texas, while also requiring a permit for any disposal of oil and gas wastes. The rules place liability for improper disposal of oil and gas wastes on the operator — here, COG.

Second, the majority was also persuaded by oil and gas industry practice of characterizing produced water as oil and gas waste, rather than groundwater, and acknowledged that produced water has long been treated as a costly liability in the industry.

In this regard, the majority recognized that while COG was spending tens of millions of dollars to handle, treat and dispose of the produced water byproducts from its fracking operations, over the life of the mineral leases, the surface owners had never tried to claim ownership over the produced water until the opportunity to profit from it arose in the produced water leases with Cactus.

The majority also acknowledged that in 2019, the Texas Legislature amended Section 122.002 of the Natural Resources Code to clarify that produced water is typically conveyed as part of the mineral estate. Section 122.002 clarifies that whoever takes possession of the fluid oil and gas waste — including produced water — to treat it for "subsequent and beneficial use" owns the produced water.

This amendment codifies the understanding that under Texas law, produced water is an oil and gas waste byproduct, and not "water." But, because the mineral leases at issue in this case were executed before the legislative amendment, the court recognized Section 122.002 did not affect ownership rights in the present case.

The dissent disagreed with the majority's fundamental premise of transferred ownership, instead opining that, under Texas law, water is part of the surface estate, unless there is an express conveyance or reservation otherwise.

The dissent narrowly interpreted the express language of the mineral leases as conveying oil, gas and hydrocarbons produced from the leased land, but not the water incidentally recovered from the subsurface after the removal of oil and gas.

However, the dissent differentiated ownership from use, and acknowledged that the mineral lessee had a right to use the water to the extent reasonably necessary for the production of its minerals under Texas law. This narrow use right, the dissent concluded, was supported by the surface use compensation agreements and right-of-way agreements that simply gave COG the right to use the water without transferring ownership.

Cactus has indicated that it intends to appeal the decision to the Texas Supreme Court, but no petition for review has been filed as of the publication of this article. The time to do so has not expired.

Because the court's decision is not binding on other jurisdictions in Texas — unless or until the Texas Supreme Court settles the question — industry clients may see continued litigation over produced water ownership in other courts statewide, particularly as produced water is increasingly treated as a monetizable asset by producers and surface owners.

This litigation is most likely to affect lessees with mineral leases executed or amended prior to Sept. 1, 2019, the effective date of the Section 122.002 amendments to the Texas Natural Resources Code, assuming the validity of these amendments is not challenged.

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