



# Oil and Gas Basics

*Understanding the sticks to avoid stones and broken bones.*

BY DEREK COOK AND JENNIE K. MARTIN

**IN TEXAS, OIL AND GAS DEVELOPMENT IS REACHING UNPRECEDENTED HEIGHTS DUE TO THE UTILIZATION OF INNOVATIVE TECHNOLOGY LIKE HORIZONTAL DRILLING AND HYDRAULIC FRACTURING.**<sup>1</sup> This technology allows

operations to move into spaces previously filled with dry holes and the lost hope of meaningful mineral production.<sup>2</sup> As the industry expands into new areas and enhances production in others, the chance of oil- and gas-related conflict also increases, which creates a greater need for attorney involvement. A 30-year general practitioner in Abilene may be asked to negotiate an oil and gas lease for the first time in his career, while a first-year associate in Midland may be asked to revise a complex joint operating agreement. Whatever the case may be, Texas attorneys must have a basic understanding of oil and gas principles so they can diagnose a client's problem and recognize available remedies.

## SEPARATING THE WORKING INTEREST FROM THE BUNDLE

To understand the impact of an oil and gas lease, imagine an individual receiving a fee simple absolute grant of land under a land patent. Under the common law *ad coelum* doctrine, that person would own the surface of the land, all of the space above it, and everything below it, including the mineral estate.<sup>3</sup> Before the execution of an oil and gas lease, the owner would possess the entire “bundle of sticks” in the mineral estate, i.e., the rights to: (1) execute an oil and gas lease; (2) receive bonus for executing a lease; (3) receive delay rental payments; (4) receive royalty payments; and (5) produce oil and gas from the property (including necessary rights of ingress and egress).<sup>4</sup>

Given the amount of expense and expertise necessary to profitably produce oil and gas, mineral owners typically convey the right to produce, known as the working interest, to an experienced operator via an oil and gas lease. While “lease” carries the connotation of granting a limited right of possession for a defined period of time, an oil and gas lease effectuates a fee simple determinable conveyance of the working interest to the lessee.<sup>5</sup> Given the conveyance's determinable nature, in theory this transfer could last into perpetuity or, typically, terminate upon the occurrence of some future condition, thus causing the working interest to revert to the mineral owner.<sup>6</sup>

By acquiring the working interest, the lessee gains the right to a net revenue interest from hydrocarbon production.<sup>7</sup> This is typically 100 percent less the value of the royalty interest retained by the lessor.<sup>8</sup> Since the lessee bears all production and operating costs, it may assign a portion of the working interest to other operators or investors in order to gain capital.<sup>9</sup> In such a case, a joint operating agreement may be necessary to outline cost participation guidelines and other rights and obligations between the leasehold owners.<sup>10</sup>

Generally, a lessee has a two- to three-year period, known as the primary term, during which to drill and attain profitable mineral production to avoid termination of the lease.<sup>11</sup> Given the great cost associated with drilling wells, lessees with an excess of leased acreage may participate in farmout agreements, term assignments, or area of mutual interest agreements with other operators.<sup>12</sup> These tools allow lessees to retain some interest in production while bearing less cost.<sup>13</sup>

If profitable production is accomplished at the end of the primary term, the lease is then “held by production” into the secondary term and, generally, will terminate if and when oil and gas production ceases, either totally or profitably.<sup>14</sup> If production is not attained by the end of the primary term or ceases during the secondary term, certain savings provisions, such as a shut-in royalty clause, a dry-hole clause, or an operations clause, may perpetuate the



lease until production begins or resumes.<sup>15</sup> Given that an oil and gas lease contains many terms of varying effect, it is important to advise all parties as to whether an obligation is a covenant giving rise solely to money damages in the event of a breach or whether it is a condition, which, if not complied with by the lessee, could result in lease termination.<sup>16</sup>

## THE ROYALTY INTEREST

Once a lease is executed, the lessor retains the royalty interest.<sup>17</sup> This allows the lessor to receive a fraction of mineral production revenue free from drilling and operating expenses.<sup>18</sup> Lessees typically send royalty owners division orders seeking agreement as to the fraction owed.<sup>19</sup> While terminable by either party at any time, signed division orders generally shield the lessee from claims of misallocation of royalty payments.<sup>20</sup>

Royalty owners may have claims that their payments are misallocated,<sup>21</sup> not timely,<sup>22</sup> incorrectly include deductions for production costs,<sup>23</sup> or not properly based on fair market value at the time and place of sale.<sup>24</sup> Despite the typically unsophisticated nature of royalty owners, Texas courts have maintained that royalty owners have a duty to discover most payment issues within the applicable four-year limitations period.<sup>25</sup> When advising royalty owners, one must stress the need for constant diligence so they are not left begging for the rare application of the discovery rule.<sup>26</sup>

## SURFACE ISSUES

Oftentimes the mineral owner is also the surface owner.<sup>27</sup> Under Texas law, the mineral estate is dominant, and, thus, a mineral lessee has the right to use so much of the surface as is reasonably necessary to access the mineral estate.<sup>28</sup> This can include building new roads, utilizing sand or caliche, accessing the property at unknown times, or even injecting disposed salt water back into the land.<sup>29</sup> Surface use agreements may be necessary to define land usage parameters and lay out applicable surface damages.<sup>30</sup> It is important to remember, however, that no surface use agreement is better than a bad surface use agreement. Ultimately, as with many oil and gas disputes, the exercise of common courtesy between each stick owner is usually the best means of avoiding any slinging of stones or breaking of bones.<sup>31</sup> **TBJ**

## NOTES

1. See Martin S. Raymon & William L. Leffler, *Oil and Gas Production in Nontechnical Language*, 10-16, 216-18 (3d ed. 2006).
2. See *id.*
3. See 2 William Blackstone, *Commentaries on the Law of England* 18 (William Draper Lewis ed., 1902).
4. *French v. Chevron U.S.A. Inc.*, 896 S.W.2d 795, 797 (Tex. 1995).
5. *Jupiter Oil Co. v. Snow*, 819 S.W.2d 466, 468 (Tex. 1991).
6. See *id.*

7. See *Paradigm Oil Inc. v. Retamco Operating Inc.*, 372 S.W.3d 177, 181 & n.2 (Tex. 2012).
8. *Concord Oil Co. v. Penzoil Exploration and Prod. Co.*, 966 S.W.2d 451, 460 (Tex. 1998).
9. See, e.g., *Berchelmann v. Western Co.*, 363 S.W.2d 875 (Tex. Civ. App.—El Paso 1962, writ ref'd n.r.e.); *Smith v. L.D. Burns Drilling Co.*, 852 S.W.2d 40 (Tex. App.—Waco 1993, writ denied); *Lavy v. Pitts*, 29 S.W.3d 353 (Tex. App.—Eastland 2000, pet denied); *Mulvey v. Mobil Producing Tex. & N.M. Inc.*, 147 S.W.3d 594 (Tex. App.—Corpus Christi 2004, pet. denied).
10. *Yates Energy Corp. v. Enerquest Oil and Gas, L.L.C.*, 2005 WL 1530510, \*1 (Tex. App.—Corpus Christi 2005, no pet.).
11. *King v. Swanson*, 291 S.W.2d 773, 776 (Tex. Civ. App.—Eastland 1956, no writ).
12. See *Young Refining Corp. v. Penzoil Co.*, 46 S.W.3d 380, 389 (Tex. App.—Houston [1st Dist.] 2001, pet. denied).
13. *Id.*
14. *Anadarko Petroleum Corp. v. Thompson*, 94 S.W.3d 550, 554 (Tex. 2002).
15. *Krabbe v. Anadarko Petroleum Corp.*, 46 S.W.3d 308, 316 (Tex. App.—Amarillo 2001, pet. denied).
16. See *Rogers v. Ricane Enters. Inc.*, 772 S.W.2d 76, 79 (Tex. 1989).
17. See *Alamo Nat'l Bank v. Hurd*, 485 S.W.2d 335, 338 (Tex. Civ. App.—San Antonio 1972, writ ref'd n.r.e.).
18. *Id.*
19. *Gavenda v. Strata Energy Inc.*, 705 S.W.2d 690, 691 (Tex. 1986).
20. See *id.*; see also Tex. Nat. Res. Code Ann. § 91.402(g) (Vernon 2012).
21. *Coghill v. Griffith*, 358 S.W.3d 834, 838 (Tex. App.—Tyler 2012, pet. denied).
22. Tex. Nat. Res. Code Ann. § 91.402(a).
23. *Hurd*, 485 S.W.2d at 338.
24. *Yzaguirre v. KCS Resources Inc.*, 53 S.W.3d 368, 372-73 (Tex. 2001).
25. *Wagner & Broun Ltd. v. Horwood*, 58 S.W.3d 732, 734-737 (Tex. 2001).
26. See *id.*
27. In our example, if the mineral owner were to convey the property yet reserve the entire mineral interest, this would effectuate a severance of the surface and mineral estate such that the surface owner and mineral owner would be different persons. *Flag-Redfern Oil Co. v. Humble Exploration Co. Inc.*, 744 S.W.2d 6, 8 (Tex. 1987).
28. This principle is limited by the accommodation doctrine in relation to certain preexisting surface uses. *Getty Oil v. Jones*, 470 S.W.2d 618, 621-22 (Tex. 1971).
29. See, e.g., *Brown v. Lundell*, 344 S.W.2d 863 (Tex. 1961); *Humble Oil & Refining Co. v. Williams*, 420 S.W.2d 133 (Tex. 1967); *Sun Oil Co. v. Whitaker*, 483 S.W.2d 808 (Tex. 1972); *TDC Eng'g Inc. v. Dunlap*, 686 S.W.2d 346 (Tex. App.—Eastland 1985, writ ref'd n.r.e.).
30. See University of Texas Field Manual of Required Operating Procedures for Oil & Gas Leases, [utlands.utsystem.edu/forms/pdfs/FieldManual.pdf](http://utlands.utsystem.edu/forms/pdfs/FieldManual.pdf) (last visited Jan. 31, 2013); see also University of Texas Rate and Damage Schedule, [utlands.utsystem.edu/forms/pdfs/Rate\\_Damage\\_Schedule.pdf](http://utlands.utsystem.edu/forms/pdfs/Rate_Damage_Schedule.pdf) (last visited Jan. 31, 2013).
31. See Harper Estes & Doug Prieto, *Contracts as Fences*, *Texas Bar Journal*, May 2010, 378-87.



### DEREK COOK

is an associate in the trial section of Lynch, Chappell & Alsup, P.C., in Midland. His practice is concentrated in the areas of oil and gas and commercial litigation.



### JENNIE K. MARTIN

is an associate in the oil and gas section of Lynch, Chappell & Alsup, P.C., in Midland. Her practice is concentrated in the preparation of title opinions and the acquisitions and divestitures of oil and gas properties.