TEXAS APPELLATE COURT HOLDS THAT PRODUCED WATER BELONGS TO MINERAL OWNERS

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Produced water—a substance traditionally considered to be a useless byproduct of hydraulic fracturing—has recently become a valuable product that can be treated and sold to operators for drilling. As background, many areas in Texas contain shale formations that are dense and have poor permeability. To extract minerals from those formations, operators utilize fracing, which involves pumping certain fluid into a well at a high pressure so that fractures are created in the formations, thereby releasing the minerals that were trapped therein. But more than minerals are released. Water containing certain substances (such as sodium, calcium, potassium, and lithium) that was trapped in the formations alongside the minerals is also released by fracing. The minerals and the water flow to the wellbore as a single product stream, after which they are separated. What remains after the minerals are separated is known as produced water. This substance can be dangerous to the environment, so operators are required to carefully dispose of it—a costly endeavor. While technology existed that would have allowed produced water to be treated for further use by operators in drilling, doing so was not economically feasible. That is, until the last few years. Recent technology has made the process of treating produced water inexpensive enough that it can be sold to operators for a profit. Produced water can also contain certain critical minerals that can be used for the development of clean energy technologies.[1] Thus, conflicts arose between surface owners and mineral owners over the ownership of produced water. In response, the Texas Legislature amended Tex. Nat. Res. Code § 122.002 on September 1, 2019, to grant title to produced water to whoever takes possession of it for the purpose of treating it for subsequent beneficial use, unless a conveyance instrument expressly provides otherwise. This statute, however, only applies to instruments executed after September 1, 2019. Conflicts between parties to conveyances executed prior to that date were left unresolved.

One such conflict arose between Cactus Water Services, LLC (Cactus), and COG Operating, LLC (COG). COG owned the minerals under four leases in Reeves County, Texas executed between 2005 and 2014. Those leases granted COG the exclusive right to produce "oil and gas" or "oil, gas and other hydrocarbons." Two of the leases limited COG's right to use water from the premises to only that which was necessary for its drilling operations, and a third prohibited COG from using any water from the premises without the lessor's written consent. COG also entered into surface use compensation agreements and right-of-way agreements to facilitate its use of the surface when it transported products and waste from the property. COG utilized fracing in its operations and, since commencing same, was responsible for disposing of produced water produced therefrom. In 2019 and 2020, the property's surface owners transferred all of their water rights to Cactus, including the right to any water produced from oil and gas wells. After Cactus informed COG of its right to the produced water in 2020, COG filed a declaratory judgment action against Cactus seeking a determination that its leases gave it the sole right to the produced water. Cactus, in turn, asserted a counterclaim against COG claiming that it owned the produced water by virtue of its agreement with the surface owners. The trial court

[1] *See Managing and Advancing Treatment Technologies for Produced Water*, OFFICE OF FOSSIL ENERGY AND CARBON MANAGEMENT (Apr. 12, 2023), https://www.energy.gov/fecm/articles/managing-and-advancing-treatment-technologies-produced-water.

granted summary judgment in COG's favor, leading Cactus to file an appeal with the El Paso Court of Appeals.

In its opinion in *Cactus Water Services, LLC v. COG Operating, LLC*, No. 08-22-00037-CV, 2023 WL 4846861 (Tex. App.—El Paso July 28, 2023, no pet. h.), the El Paso Court of Appeals held that COG's leases, when viewed in the context in which they were executed, granted COG the sole right to produced water extracted from the property. The court began its opinion by looking to the statutory and regulatory definitions of "water" and "produced water" because neither were defined in COG's mineral leases. The Texas Natural Resources Code, the Texas Water Code, and the Texas Railroad Commission's rules all defined "oil and gas waste" as, effectively, waste containing saltwater or other materials arising from drilling operations. Further, the Water Code and the Railroad Commission's rules defined "water" as, effectively, usable water percolating below the earth's surface. The court viewed those definitions as drawing a clear distinction between produced water and groundwater because produced water fell under the definition of "oil and gas waste," so it could not also constitute "groundwater." Additionally, the Railroad Commission's rules made operators responsible for properly disposing of oil and gas waste to protect usable water, which showed the legislature's intent to distinguish "produced water" from "water." Finally, industry practice historically treated produced water as a liability and not an asset, and no surface owners asserted a right to produced water until it was perceived as a substance with value. To grant Cactus ownership of the produced water would have been to give it the "benefit of costs and risks [COG] voluntarily undertook."

The court reasoned that COG's leases were negotiated with that backdrop in mind. Thus, the grant in COG's leases of "oil and gas" and "oil, gas and other hydrocarbons" must have included the rights and liabilities associated with oil and gas waste, including produced water, and those leases did not express any intent to deviate from that framework. As such, COG's leases confirmed that COG had the exclusive right to the produced water that was extracted with minerals, and the surface owner's conveyance to Cactus of the right to the produced water was, thereby, ineffective.

Justice Palafox filed a dissenting opinion arguing that longstanding principles of oil and gas law showed that produced water belonged to surface owners. She reasoned that COG's leases only granted it rights to "oil and gas" and "oil, gas and other hydrocarbons," not "water" or "produced water," and that in the absence of a specific conveyance, water remained part of the surface estate. She also noted that the parties recognizing both water and produced water as being distinct from oil and gas showed that the parties also recognized that produced water fell outside of the grant of "oil, gas and other hydrocarbons." Just Palafox was not persuaded by the majority's conclusion that the parties generally intended to convey all substances that flowed to the wellbore. She viewed that as a "general intent" test, which applies only when conveyances are not clear on what "minerals" encompasses and not when conveyances specifically describe the substances being conveyed. Here, COG's leases specifically conveyed oil and gas, so, in Justice Palafox's view, the "general intent" test did not apply. As such, she concluded that COG's oil and gas leases did not grant it the right to water in any form outside of what was reasonably necessary for the production of its minerals.

Justice Palafox also disputed the majority's reliance on characterizing produced water as oil and gas waste in concluding that produced water fell within the granting clauses of COG's leases. Prior Texas precedent held that deeper, mineralized water produced from a well belonged

to the surface owner, and Justice Palafox saw no distinction between it and produced water. She believed that water, even when mixed with other substances, remains water. Based on that prior precedent and on the lack of authority distinguishing between types of water owned by the surface estate, Justice Palafox would have concluded that produced water belonged to the surface owner. Further, she argued that the majority should have instead utilized the accommodation doctrine to grant COG the right to use produced water for its oil and gas production while avoiding granting COG ownership of the produced water.

Finally, Justice Palafox disagreed with the majority's usage of Texas statutes and regulations and industry custom to inform the meaning of COG's leases. First, only one statute in the Natural Resources Code specifically included "produced water" in its definition of "oil and gas waste," and that statute was passed after COG's leases were executed. As such, it could not have formed a point of reference for the parties when executing COG's leases. Second, Texas regulations only mandated that lessees were responsible for disposing of oil and gas waste—they did not purport to effectuate any transfer of the ownership rights to the oil and gas waste. That being the case, Justice Palafox did not believe the regulations had any role in determining the ownership of produced water. Finally, Justice Palafox viewed the usage of industry custom to inform the meaning of COG's leases as, effectively, a waiver argument. Under Texas law, a party allowing another party to carry out its statutory, regulatory, or contractual duties with respect to waste disposal does not necessarily reflect an intent to waive ownership rights. And while the majority rewarded COG for the "costs and risks" it undertook disposing of produced water, Justice Palafox argued that COG did not voluntarily undertake those costs and risks—COG was both contractually and statutorily obligated to properly dispose of the produced water.

No petition for review has been filed with the Texas Supreme Court as of the date of this article, but the time period for Cactus to do so has yet to expire. Subject to further determination by the Texas Supreme Court, this case establishes that for instruments executed prior to September 1, 2019, produced water is owned by mineral owners when those instruments convey "oil and gas" or "oil, gas and other hydrocarbons" without specifically reserving produced water or oil and gas waste. Of course, all instruments are unique, and certain terms or circumstances could always lead to a different result. Anyone questioning whether they own the produced water coming from their well or being produced on their property should consult with an experienced attorney for further evaluation.