



SECRETS

for

Negotiating Texas
Groundwater Leases

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In the past, acquiring all or a part of mineral rights was a prime consideration when purchasing rural Texas property. Mineral ownership represented possible financial gain and control of the surface. Although mineral ownership is still important, now purchasers want assurances that the groundwater rights accompany the surface conveyance. Groundwater ownership may be more valuable than the mineral rights.

The interest in groundwater results from an increased demand by cities and municipalities for supplemental water supplies. For a time in the 1990s, San Antonio led the demand when a drought and pumping restrictions stemming from enforcement of the Endangered Species Act threatened its water supply from the Edwards Aquifer. El Paso experienced a similar shortage. The surface water supply for many smaller towns literally evaporated during the drought. Cities and smaller municipalities began vying for groundwater leases to supplement existing water supplies.

Until recently, the opportunity to lease groundwater was confined to large ranches in North and West Texas. Now ownership of groundwater represents an economic opportunity for more Texas landowners.

Similarities Between Ownership of Minerals, Groundwater

The rules governing exploration and production of minerals apply, in part, to exploration and production of groundwater. Knowledge of oil and gas law is helpful in understanding the groundwater rules. For example, groundwater is subject to the rule of capture, which allows drainage without liability, in

some cases. Under certain conditions, groundwater, like oil and gas, may be drained from beneath a neighbor's land without liability.

Likewise, groundwater is subject to both state and local regulations. But no state agency possesses the same broad authority to manage and regulate groundwater as the Railroad Commission of Texas has to regulate oil and gas production. Certain state agencies have limited power, though. For example, the Texas Natural Resource Conservation Commission (TNRCC) protects groundwater quality. The Edwards Aquifer Authority manages and controls exploration of and production from that Central Texas aquifer. The Texas Department of Licensing and Regulation has statewide authority to set spacing, capping and plugging requirements for private water wells (see Title 16, Texas Administrative Code, Sections 76.1000 and 76.1004).

The greatest control over groundwater exploration and production is exercised by local groundwater conservation districts. Chapter 36 of the Texas Water Code authorizes the creation of groundwater conservation districts with the power to set spacing requirements and pumping limits. Once implemented, these rules affect the amount of groundwater that can be produced. Presently, the creation of a local groundwater conservation district depends on a county-by-county vote.

Who Owns Groundwater?

Surface owners may or may not own the groundwater. Like minerals, groundwater is a separate estate (or interest) in real property that may be conveyed or reserved apart from the other interests. In areas where oil and gas production has occurred, surface owners rarely

own the minerals. The same may become true of groundwater. In areas where groundwater leases are in demand, prior owners reserve groundwater rights when selling the land.

This raises an interesting legal question. If the mineral interests have been severed from the surface, who owns the groundwater — the mineral owner or the surface owner?

According to Texas case law, the groundwater belongs to the surface owner in most cases. The Texas Supreme Court ruled that the term *minerals* includes oil, gas and uranium. The term **does not include** sand; gravel; limestone; caliche; surface shale; building stone; near-surface coal, lignite and iron ore; **and water**, regardless of whether the water is located above or below the ground.

This does not mean the mineral owner cannot own groundwater. If the language in the instrument that reserved mineral interest used the word *minerals* or the term *oil, gas and other minerals*, then the mineral interest includes ownership of the oil, gas and uranium — but not water. However, if language specifically reserves “oil, gas, uranium and groundwater,” the mineral owner owns the groundwater. Wording is extremely important.

Surface owners who own the water and no minerals further divide the ownership of the property by reserving water rights when selling the land. This may lead to a three-tiered ownership of the property. One person may own the surface, another the minerals and a third the groundwater.

Comparing Oil and Gas, Groundwater Leases

Landowners familiar with oil and gas leases have an advantage when it comes

to groundwater leasing, because many of the newer groundwater leases use a similar format. There are some differences, however.

One obvious difference is that oil and gas leasing has occurred for a longer period and on a larger scale than groundwater leasing. The Spindletop oilfield ushered in mass oil and gas exploration and production in Texas in 1901. This was followed by the discoveries of the Ranger oil field in 1917 and the East Texas oil field in the early 1930s.

Except for limited groundwater leasing between large ranchers and municipalities in West Texas, the concept is relatively new. To date, no standard lease form comparable to the Producers 88 form used by oil and gas companies has emerged.

Another difference is the number of purchasers for the product. Oil and gas purchasers are numerous, so energy companies generally begin production before seeking a purchaser. Groundwater purchasers are limited, so a buyer must be found before exploration begins. This is partly because groundwater producers have no power to condemn easements for pipelines to transport the water.

With no central market for water, the price is strictly negotiable between the parties. With oil, purchasers post the price they are willing to pay for a certain grade and quality of oil from a field. With gas, the price is tied to the price paid at the Houston Ship Channel. No similar pricing structure exists for groundwater. However, landowners may wish to find out what cities such as San Antonio and El Paso are paying before finalizing a groundwater lease. Prices may or may not reflect transportation costs, however.

Potential longevity of the leases is another difference that may concern landowners. With oil and gas, there is a finite amount in the ground; it does not recharge. An average well produces for seven to ten years, then the lease terminates. With groundwater, the amount is finite but rechargeable. Thus, the potential duration of a groundwater lease is much greater than an oil and gas lease. For this reason, groundwater owners should approach a lease with great caution. Their decisions may affect several generations.

Surface control highlights another difference between mineral and groundwater leasing. According to Texas case law, energy companies holding oil and gas leases have the right to use as much of the surface as reasonably necessary to explore for and produce the minerals. This privilege comes without securing independent permission from the surface owner(s), without having to pay surface damages, and without having to clean up or restore the surface when operations cease. (See Real Estate Center publication 840, "Minerals, Surface Rights and Royalty Payments" for details.)

While there are exceptions to this rule, no similar privilege accompanies groundwater leases. The company securing the groundwater lease (the lessee) must get permission from the surface owner(s) before entering to explore and produce. Surface owners may exact a price for the privilege and limit the scope of the activities.

Little legal precedent exists for groundwater leasing. Texas courts have not analyzed the terms and conditions of groundwater leases as they have with oil and gas leases. Texas courts have developed a body of law that defines and construes the meaning of nearly all terms and conditions used in oil and gas leases. The courts have even developed implied covenants for oil and gas leases to protect mineral owners' interests.

Because nothing similar to a Producers 88 lease form has emerged for groundwater leasing in Texas, much of the terminology and provisions lack legal definitions and precedents. Perhaps this is why newer groundwater leases are patterned after oil and gas leases. Groundwater companies are hoping Texas courts decide that the wording taken from oil and gas leases has the same meaning when applied to groundwater leases.

Guidelines for Negotiating Groundwater Leases

Groundwater owners occupy a precarious position when asked to negotiate groundwater leases. They want to secure a financial benefit, but at the same time protect their property interests. Because groundwater leasing is relatively new, few rules exist to accomplish these objectives. The

following guidelines attempt to bridge that gap.

- Avoid use of vague or ambiguous terms that may lead to misunderstanding and possible litigation. For example, some leases require groundwater companies to compensate landowners for "actual damages" to the land. However, no mention is made of how to calculate the damages, of when the damages are due and payable or how to set damage claims when a dispute arises.
- Make sure that any terms or provisions negotiated by the groundwater owner are placed in writing and attached to the lease form. Do not accept oral modifications to a lease. Generally, oral agreements are unenforceable. Written changes can be made one of three ways.

First, for small changes, such as changing the royalty from one-tenth to one-eighth, strike the "one-tenth" in the text and insert the figure "one-eighth." Make sure both parties acknowledge the alterations by initialing and dating the margin of the page where the change occurs.

Second, if the changes are more monumental, draft an addendum and attach it to the lease. The addendum begins with the language, "Notwithstanding anything to the contrary in the foregoing groundwater lease dated ____, by and between the [name of landowner] (the lessor) and the [name of the water company or entrepreneur] (the lessee)], the following terms and provisions prevail." Thereafter, the negotiated changes are listed item by item.

Landowners may draft their own groundwater lease form and present it to the water company. While this may be an option for large ranches, the cost of drafting a groundwater lease may not be economically viable for smaller landowners.

- Remember all proposed provisions in the lease are subject to negotiation. This does not mean the groundwater owner can necessarily negotiate desired changes. The

owner's power to negotiate depends on the amount of land owned; the amount, quality and depths of commercial groundwater; and the number of companies vying for the lease. Because of the nature of the groundwater market, there is usually only one company seeking a lease.

- Remember that the first offer the company makes may not be the best offer. It may be the best offer the company can make financially but not in terms of lease provisions. For example, the company pays the same for a lease whether or not restrictions are placed on the depths of production. However, the restriction could mean significantly more income in the future by having different leases at different depths. Never be in a hurry to sign. Time is generally the landowner's ally.
- Be conscious of the difference between negotiating a *lease covenant* and a *lease condition*. The distinction lies in the remedy for a breach. If a covenant is breached, the only remedy is to sue for damages. If a condition is breached, the contract (the lease) terminates automatically. When possible, negotiate lease conditions, not lease covenants.

Texas courts have taken a dim view of lease conditions. Texas case law holds that when in doubt, the courts construe a provision to be a lease covenant, not a lease condition. Consequently, draft lease conditions clearly, concisely and without ambiguity. The provision must state that the lease terminates if a certain event or breach occurs.

- If the groundwater company tenders bonus payments via sight drafts, negotiate the length of the sight drafts. Attempt to limit the length to no longer than 15 days. Generally bonuses are tendered by sight drafts, not by check or cash. Sight drafts (which appear similar to checks) are funded, if at all, after the expiration of the designated number of days printed in the upper left hand corner of the document. The "number of days"

refers to banking days, not calendar days. A 30-day sight draft equals 42 calendar days.

- Be careful to sign a groundwater lease, not a groundwater deed. Many times the wording of a lease and a deed appears similar. The owner may be selling the water rights, not leasing them.
Leases, generally "grant, lease and let" to the company the right to explore, produce and sell water for a limited time. Deeds "grant, sell and convey" the water or water rights to the company forever. The words "lease" and "let" are not used. No time limits are placed on the duration of the conveyance. When in doubt, landowners may wish to seek legal counsel on this issue.
- Consider filing a memorandum of lease in the deed records (sometimes referred to as the official groundwater lease. A memorandum of lease recites the essential lease provisions, such as the parties, length of the lease and legal description of the property. This gives constructive notice of record of the lease's existence without disclosing the lease provisions.

A memorandum of lease benefits owners several ways. Sometimes companies decline to grant an owner a requested lease provision because "all the owners in the area would then ask for it." The owner can counter by insisting a memorandum of lease be filed of record. That way, other landowners cannot discover what provisions were granted. The lessee has no legal reason to decline the request. Likewise, if the landowner subsequently enters another groundwater lease, the next company does not know what terms and conditions the owner agreed to earlier. Negotiations begin from scratch.

Negotiating Groundwater Leases, Paragraph By Paragraph

The following suggestions come from reviewing many existing and proposed

Texas groundwater leases and from negotiating oil and gas leases. The latter is important when companies pattern their proposals after oil and gas leases.

Granting Clause

The beginning clause of the lease is known as the granting clause. The clause either expressly or impliedly covers a number of both innocuous and important provisions.

In the innocuous category, the granting clause specifies the effective date of the lease and identifies, by name and address, the groundwater owner (lessor) and the company taking the lease (the lessee). If the lessee is a person, not a company, corporation or partnership, this probably means the lease will be assigned to some other person or entity before operations commence. The clause contains the legal description of the leased property.

Items requiring scrutiny begin with the substances granted for exploration and production. Here is a sample of some of the wording used:

- all commercial groundwater rights,
- all underground fresh water now or in the future located under the tract,
- water that may be found and produced under the tract,
- all water in, under and that may be produced under the tract or
- all potable water or water capable of being made potable.

This language raises several concerns for the owners. It is imperative for landowners to protect their personal sources of water. This includes uses for household and domestic purposes, for watering livestock and possibly irrigation. If **all** groundwater can be produced and sold by the lessee, what is left for the owner? Can the owner drill new water wells in an aquifer being produced by the lessee? Must the present usage from existing wells be curtailed once production begins? What happens if the lessee taps the same aquifer being used by the landowner and produces all available water? Does the owner have the right to tap the lessee's water pipelines to take a given quantity of fresh water for personal and possibly commercial irrigation purposes? All these issues need to be addressed.

Perhaps a workable solution is to require any water produced by the lessee to be taken from an aquifer or aquifers lying below the one(s) presently used by the owner. Then, the owner may wish to lease each aquifer strata by strata. For example, the owner may allow the production of water from depths exceeding 1,000 feet and then only from a designated aquifer.

If a certain strata is leased, place certain parameters above and below it. Many times it is unclear where one formation begins and another ends. Groundwater companies may maintain one formation is an extension or substrata of another. For this reason, name the aquifer being leased and then limit production to specified depths — between 1,500 and 2,500 feet, for example.

Beware of allowing the lessee to take from “all sources” of fresh water beneath the property. In some instances, groundwater may be owned by the State of Texas. Consequently, limit the wording to “all **privately owned** water lying beneath the property” and then only between given depths or within a designated aquifer or aquifers.

Define the terms *fresh* and *potable*, if used, to avoid future problems. When does the level of impurities make the water no longer fresh? A scientific definition of each term needs to be stated in parts per million. The definitions determine when the lessee no longer has the right to produce and sell water. The owner can then seek another lessee for the “impure water.”

Another looming problem lies with the right of oil and gas companies to take water, either from above or below the ground, as reasonably necessary for the exploration and production of the minerals. As mentioned earlier, this is an automatic implied right of the mineral lessee. Surface owners, who own no minerals, are powerless to prevent oil companies from exercising this right. Consequently, the groundwater owner may wish to reserve from the lease the rights oil companies have to take water. This avoids future conflicts.

If the owner permits the company to take water from the same aquifer, the owner may wish to negotiate a clause allowing the owner to take *in kind*. By this, the owner receives his or her share of the production, not in royalty

payments, but in the actual delivery of water. It may be worth more at times to have the use of the water than to receive a royalty check. The owner may negotiate the right to take minimum amounts of water from the aquifer during periods of water scarcity.

The granting clause also describes the lessee’s permitted surface operations. Here is a sample of wording:

- all surface activities necessary to investigate, explore, prospect, drill, produce, store, take care of, transport, treat and remove groundwater;
- the right to lay, maintain, operate, repair, remove, replace pipelines, loading racks, pumping facilities, tanks, telephone lines, electric lines and any other structures necessary for the maintenance thereof;
- the right to use existing roads and the right to construct and maintain new ones necessary to ingress and egress the property and all property contiguous and adjacent thereto owned by the lessor to explore for and produce the groundwater; and
- exploring, investigating, conducting geologic, hydrogeologic and geophysical surveys and tests; drilling for, producing, recharging, storing and owning groundwater; constructing and operating wells and waterworks; storing and transporting water; laying water gathering and transportation pipelines and electric lines; installing metering devices, building storage tanks and treating facilities, establishing power and pumping stations, telephone lines, roads, and all other structures necessary and useful in lessee’s operations to find, produce, sever, save, care for, measure, recharge, store, treat and transport groundwater over said land, including the right to install and place wells, pumps, pipes, tanks, treatment facilities and interconnecting facilities, transportation, distribution or utility systems, together with the right of access for ingress and egress reasonably necessary to conduct the foregoing activities.

As mentioned earlier, groundwater leases differ from mineral leases because

the water (including groundwater) is a surface substance, not a mineral. The groundwater lessee does *not* have the implied right to use as much of the surface as reasonably necessary to explore for and produce water without asking for permission and paying for damages. Groundwater lessees have only the surface rights granted in the lease; none are implied.

But which company has superior rights to use the surface when both an oil and gas lease and a groundwater lease exist simultaneously on the same property? Does the first in time prevail? Existing Texas case law suggests that the groundwater lease is subordinate to the mineral lease, regardless of when it is placed on the property. The courts base the ruling on the fact that groundwater is a surface substance, and the surface is subordinate to the mineral estate.

To avoid being caught between oil companies and groundwater companies regarding surface usage, the lease should state that any surface rights granted to the groundwater company are subject to mineral exploration and production.

Groundwater companies are not totally helpless, though. They can expect some benefit from the Accommodation of the Estates Doctrine expressed by the Texas Supreme Court in *Getty Oil Co. v. Jones*, 470 SW2d 618. This doctrine requires oil and gas companies to accommodate existing surface uses when such accommodations are reasonably possible, consistent with industry practices and practicable on the leased premises.

Also, groundwater companies can expect some protection from oil companies intruding near each water well site according to Title 30, Chapter 290 of the Texas Administrative Code (TAC).

While groundwater companies receive protection under the TAC, landowners are restricted in the use of their land for up to 500 feet from the water well site. For example, no cattle are permitted within 50 feet of the well. A mandatory sanitary control easement must be imposed 150 feet around each well site. No feed lots, solid waste disposal sites, or the like are allowed within 500 feet.

Appendix A contains part of 30 TAC 290.41, which provides some of the

more important land-use restrictions pertinent to landowners. Appendix B reproduces the prescribed sanitary control easement imposed around each well site. Each landowner owning property within 150 feet of the well must sign this agreement. It is then recorded in the county deed records.

Here are more suggestions to consider when granting surface-usage rights.

- Owners should keep two objectives in mind when considering surface activities. Limit the scope of surface activities to those absolutely necessary and then require timely compensation. Require clean up and restoration when the operations cease.
- Require the lessee to confer with the surface owner prior to any operations, such as building roads, drilling wells and laying pipelines. The two parties must agree on the locations, but the lessor's consent cannot be unreasonably withheld. Cattle guards must be installed at new entries to the property. All gates used by the lessee must be kept closed.
- Existing roads used by the lessee must be maintained. New roads built by the lessee must be maintained and turned over to the owner at the conclusion of the lease. During the lease, the owner may use all roads built by the lessee. All fences must be braced before cutting.
- Drill sites for water wells must be cleaned up and returned as nearly as possible to their original conditions as soon as possible. All machinery, equipment, improvements and so forth placed on the property must be removed within 90 days (or some specified period) after the lease terminates or be forfeited.
- Wells may not be drilled within a certain distance of dwellings or stock tanks. The lessee must get prior written consent from the surface owner to conduct geophysical tests such as seismic tests. At that time, the owner may negotiate a separate agreement for allowing seismic tests. Center publication 840, "Minerals, Surface Rights and Royalty

Payments," has suggestions on negotiating terms for seismic tests.

- Timely compensation (payment of surface damages) is a difficult issue. Generally, the operator prefers paying damages after production ceases from the well or at the end of the lease, whichever is later. The company promises to restore the property and compensate the surface owner for any damages at that time. The drawback is that this is a covenant, not a condition. If the company does not clean up, restore and pay damages, the owner's only recourse is to sue. At that point, the company may be judgment proof (unable to fund payment of any judgment), or the company may have assigned the lease to a marginal company that has gone out of business. Sometimes the owners of the company cannot be found, much less sued.

Owners need to secure payments of surface damages at the beginning of the lease or at the beginning of drilling operations while the company has available funds. For drill sites, the owner may require a payment equal to the fair market value of the surface before or within ten days after entry. Base the payment on the number of acres used for the drill site or for the sanitary control easement, whichever is greater. If payment is not received within the designated period, the owner may terminate the lease. The company forfeits all equipment on site.

For damages outside the drill site area, require payment within six months after the damages are inflicted. This would cover damages to roads, fences and other improvements as well as injury or death of livestock. The amount of the damages should be mutually agreed upon; otherwise an appraiser would be hired. The appraiser's fees will be split between the parties. The owners may wish to address separately any damages caused by the company's contamination of the groundwater.

- For pipelines, an agreed sum per rod or per foot may be negotiated

and placed in the lease agreement based on the size and number of pipes. Other factors such as depth buried, removal of debris and rocks from the easement, and the use of the double-ditch method to dig and cover the pipeline should be addressed.

- Owners may question and possibly remove a provision that allows the company to cross adjacent property. This provision gives the company the right of ingress and egress across any land owned by the lessor in the immediate vicinity of the leased premises even though the property is not under lease. The provision allows the company to cross without securing independent permission and without paying for the privilege.
- A questionable clause that appears in recent groundwater leases deals with title to well sites. Basically, the clause automatically gives the company ownership to a quarter of an acre immediately surrounding each well site. Title to the well site reverts to the owner when the lease terminates. The reason for the clause is unclear, but the legal implications are important for two reasons.

First, if the water rights are condemned, **all** the proceeds go to the water company. None go to the owner. Another provision in the lease reiterates this fact. Second, under Texas rule of capture, ownership of the groundwater belongs to the landowner who first captures the it on the surface. Thus, the company becomes the outright owner of the groundwater by virtue of this provision. Owners may lose more than they gain by consenting to this provision.

- Owners may consider requiring the company to fence all well sites to prevent entry of and injury to cattle, especially within the 50 feet required by the sanitary control easement. Likewise, the owners may want to assume control of the well and casing when the lease terminates or when production drops below a commercial level. The owners may then use the

water well for personal and agricultural purposes. However, landowners must also assume the liability for plugging the well according to Texas law.

Habendum Clause: How Long Will the Lease Last?

Groundwater leases are divided into two terms, a *primary term* and a *secondary term*. The length of the primary term is negotiable and generally lasts five to 15 years. Some leases require the payment of *delay rentals* for each year that production or operations are not being conducted during the primary term. The amount of the delay rentals is negotiable based on the number of leased acres.

At the end of the primary term, the company must be drilling or producing a well on the leased premises or on acreage pooled with it; otherwise the lease terminates. If drilling or production is occurring (sometimes referred to as “operations”) at the end of the primary term, then the lease lasts for so long as drilling, production or operations continue whether or not in paying quantities with no cessation for 90 consecutive days.

While the length of the primary term is negotiable, the length of the secondary term and the number of acres held during that period can be onerous. For this reason, landowners may attempt to negotiate a minimum royalty clause during the secondary term. The clause provides that whenever the owner’s annual royalties fall below a stated amount, the company must pay the difference or lose the lease.

For example, assume the owner has 100 leased acres and negotiates a \$20 per acre annual minimum royalty payment. If the annual royalties drop below \$2,000 a year during the secondary term, the company must pay the difference to continue the lease. This avoids having the lease held indefinitely with marginal production and minimal royalty payments.

If a minimum royalty clause cannot be negotiated, owners must examine how much annual production is needed to maintain the lease during the secondary term. As noted earlier, some leases state the lease will last as long as production or operations continue, whether or not

in paying quantities, with no cessation for 90 consecutive days. Unless some acceptable formula can be drafted and placed in the lease designating the minimum amount of production, owners may choose not to sign the lease to avoid tying the land up forever with a ground lease that pays little or no royalties.

Likewise, the length of the grace period needs to be examined. Generally, after the groundwater company makes a bona fide effort to produce water during the secondary term and the endeavor fails or comes to an end, the lease does not terminate at that point. The company has a designated period in which to attempt to re-establish production. This is known as the grace period.

In oil and gas leases, grace periods average 90 days although some last 180 days. Some ground leases, however, contain grace periods of a year or more. This means that if a water well stops producing or a drilled well is a dry hole, the company has 12 full months to begin reworking the well or drilling another before the lease terminates. Once an effort is made to rework or drill a new one, the company acquires another 12-month grace period after these efforts cease. Consequently, owners should question any grace period exceeding 90 days.

Royalty Clause: The Landowner’s Percentage of Production

The greatest potential for wealth under the groundwater lease stems from the *royalty clause*. This is generally the third paragraph in the lease. The paragraph specifies the percentage of production going to the owner. The percent is negotiable. For oil and gas leases, royalty payments average between one-sixth and three-sixteenths. Parameters for groundwater leasing have not been established.

The royalty clause directly or indirectly addresses many other issues besides the landowner’s percent of production. Here are a few issues owners may wish to negotiate.

Determine how production is evaluated for royalty payments. Before the landowner receives a royalty payment, the production must be

converted into a monetary equivalent. The oil and gas industry uses two standards for making this conversion, *market price* and the *amount realized*.

Market price (sometimes referred to as market value) means the price generated by sales comparable in time, quality, quantity and availability of market outlets. Because of the large number of purchasers for oil and gas, comparable sales data are available. However, the number of purchasers for groundwater may be limited and no comparisons are available.

The amount realized (sometimes referred to as proceeds) means the actual price the company receives from the purchaser regardless of what the market price may be. In all probability, this is the standard used in groundwater leases.

Landowners need some objective standard to measure whether production is being converted to royalties based on a fair value. This is difficult because of the lack of central groundwater markets. The city or municipality purchasing the water may be the only purchaser in an area. Comparing water prices in East Texas where water is plentiful with prices in West Texas where water is scarce is not practical.

In older groundwater leases in which large ranches sold water directly to municipalities, the standard for evaluating royalties was based on the price paid by commercial users. Landowners may wish to negotiate a similar provision based on the price paid by commercial purchasers in a nearby city.

Another approach is for owners to reserve the option to take their share in kind as discussed earlier. Instead of using the water, the owners could seek to market and sell their share to another purchaser. Of course, groundwater, like gas, is dependent on a pipeline for transportation, limiting the feasibility of this option.

Describe what costs and expenses may be deducted from the royalty payments. In the oil and gas industry, the costs associated with exploration and production are divided into two groups: those borne entirely by the oil company and those shared by the royalty owners. As a rule, all exploration and production costs necessary to get the oil or gas out of the ground are

borne by the oil company. Costs subsequent to production, those necessary to make the product marketable and move it to market, are shared based on the size of the royalty. For example, if the lease royalty is one-sixth, the owner bears one-sixth of those costs subsequent to production.

To gain a larger royalty check, sophisticated mineral owners negotiated provisions making royalty payments free of **all** costs. However, the Texas Supreme Court ruled such clauses were unenforceable when the royalty is set at the well or wellhead. It is unclear whether the high court would rule the same way when confronted with the same issue in groundwater leases.

In the meantime, owners should attempt to negotiate a provision in the groundwater lease making the royalty free of all costs. State that the royalties will **not** be based at the well or wellhead. Strike any provisions making the owner share in purification costs, pipeline costs or any similar post-production expenses. Should the Texas Supreme Court ever rule that the clause is unenforceable, allow the deduction of such costs, but make the company reimburse them on a quarterly basis.

Some groundwater leases permit the company to deduct a “reasonable” amount for overhead and employee’s wages. Others specify that the company may deduct reasonable allowances, determined in good faith, for contingencies. What is reasonable to the groundwater company and what is reasonable to owners may vary. Do not allow such leeway in the lease. Headlines abound with questionable accounting practices. Do not trust the groundwater company to do “the right thing.” Either specifically limit what can be deducted or avoid the lease entirely.

Another issue not usually addressed in groundwater leases that must be discussed and resolved is how property taxes are treated, and how export and production fees imposed by local groundwater conservation districts will be handled. These are costs imposed on the project by governmental authorities.

With oil and gas production, these costs and expenses are shared based on the size of the owner’s royalty. However, nothing in the oil and gas lease explicitly addresses the question. Consequently, owners need to raise the issue with the

groundwater company when negotiating the lease. The best scenario for owners is for the groundwater company to bear all the taxes and fees levied on the project. Of course, getting such an agreement depends on the negotiating power of the landowner.

Pipelines needed to transport groundwater are treated differently in Texas than cross-country pipelines used to transport oil and gas. Cross-country oil-and-gas pipelines have the power of eminent domain while cross-country pipelines transporting water do not. Only cities and municipalities have this power in Texas.

Pipeline costs may factor into the price cities and municipalities pay for the water. Landowners should determine how pipeline costs and royalty payments interact before signing the lease. Make sure the determination is part of the lease document.

With every royalty payment, require a sworn statement from the company as to the amount of water produced during the period, the price received from the sale and the number of acres in pooled units when the production occurred. This provision gives owners some assurance of the level of production, the pricing structure for sales and this share of the production. Owners may wish to get permission in the lease to place private meters on wells and to get copies of all sales contracts. Presently, there is no public source for ascertaining this information.

With oil and gas production, the producer must file monthly production reports with the Railroad Commission of Texas. These production records are online.

State that any division order tendered to the landowner cannot alter the terms of the lease. With oil and gas production, either the producer or the purchaser sends division orders to the royalty owners prior to the payment of the first royalty. The division order describes the owner’s percent of the production in a seven-digit fraction. Other terms and conditions may be included in the division order.

Generally, royalty owners must sign the division order as a condition to receive royalty payments. If the terms and conditions in the division order contradict the lease, the terms in the division order control. Without this

provision in the groundwater lease, owners could unknowingly lose beneficial terms negotiated in the lease by signing the division order.

Find out if a division order is going to be tendered prior to receiving the first royalty check. Again, make sure this is stated in the lease. Without a division order, landowners have no way of knowing how their share of the production is determined.

Specify how soon after production begins the first royalty payment must be tendered, and describe the consequences for a breach. With oil and gas production, Sections 91.402 and 91.403 of the Texas Natural Resources Code require the first royalty payment to be tendered within 120 days after the end of the month of first sale. If not tendered, the royalty accrues interest at 2 percent above the percentage rate charged on loans to depository institutions by the New York Federal Reserve Bank, unless a different percent is specified in the lease. No statute mandates the lease will terminate if royalty payments are never tendered. No legislation addresses royalty payments for groundwater leases. Owners must protect themselves when negotiating the lease.

Landowners may wish to specify that royalty payments must be tendered within 90 days after the end of the month that production first leaves the premises or from land pooled with it. Otherwise, the unpaid royalty accrues interest at 15 percent per annum. If royalty payments are not tendered within 180 days after the end of the month the first production leaves the premises or from land pooled with it, the landowner may terminate the lease.

The frequency of payments after the initial royalty payment should also be addressed. Royalty payments should be tendered within 30 days after the end of the month the production leaves the premises or draws interest. Delinquent payments exceeding 60 days may be grounds for lease termination.

If this or a similar provision cannot be negotiated, owners need to determine what triggers royalty payments. Is it entering the contract with the city? Is it delivery of water to the city? Is it receipt of payment from the city after delivery?

In oil and gas leases, royalty payments are required after the production and

sale occur. That is why mineral owners do not participate automatically in take-or-pay contracts, as explained later, because no actual production takes place. Some groundwater leases specify that royalties are due a certain number of days after “sale.” No production is required. In such instances, defining when the “sale” occurs is critical, especially if the company receives reservation fees as discussed below.

Require participation in any take-or-pay contracts and reservation fees.

During the 1980s when the demand greatly exceeded the supply for natural gas, producers began negotiating take-or-pay contracts with purchasers. Basically, for any period the buyer did not purchase a minimum quantity of gas, the buyer still had to pay the producer for that amount. Texas courts held that unless the royalty owners negotiated a clause in the lease allowing them to participate in the take-or-pay contracts, they were barred. Consequently, landowners should add language to the groundwater lease allowing them to participate in anything similar to a take-or-pay arrangement between the groundwater companies and purchasers.

For example, a similar arrangement known as **reservation fees** appears in contracts between cities and groundwater companies. Once the parties enter the contract, it may be several years before the city actually needs water. In the meantime, to keep the contract in force, cities pay the companies an annual reservation fee. This is slightly different from the take-or-pay provisions in gas sales contracts.

Groundwater leases are silent regarding treatment of reservation fees. Generally, reservation fees belong exclusively to the company and are not treated as royalties. Some companies may plan to use the reservation fees to build pipelines to move the water when needed. The companies will use the fees to construct the pipelines and possibly deduct the amounts from the owners’ royalties as a cost subsequent to production. Landowners must be mindful of this possibility.

Although groundwater companies do not have the power of eminent domain to condemn a water pipeline, they estimate that they can purchase a 72-

inch pipeline easement for \$1 million a mile. By doing so, they get into the business of a pipeline company covered in whole or part by the reservation fees.

Consequently, owners must inquire about how reservation fees and royalties interact and whether reservation fees will be deducted from royalties if used to construct pipelines.

Protect against personal liability for overpayment of royalties. With oil and gas production, if the producer overpays a royalty owner by mistake or for whatever reason, the royalty owner is personally liable for the repayment. The royalty owner need not be aware of the mistake. Oil companies have up to four years to sue for collection after discovering the overpayment. Owners may wish to negotiate a clause in the groundwater lease removing all personal liability for an overpayment. Limit the collection of any overpayment from the owner’s share of the future production. A Texas statute permits owners to reduce the statute of limitations from four years to two if so stated in the lease.

Pooling: Will Your Land be Consolidated with Your Neighbors’ Land?

The fourth paragraph of the lease is usually the *pooling clause*. This gives the company the privilege of uniting the landowner’s land with any other land in the vicinity overlying the aquifer for the purpose of establishing production. The consolidated area is called a pool. Pooling for oil and gas production is highly regulated while pooling for groundwater production is not.

The Railroad Commission of Texas regulates pooling for oil and gas by establishing the maximum size for pools and limiting pooling to contiguous acreage. Presently, there is no maximum size for groundwater pools and no requirement that the pools contain contiguous land. Landowners must deal with these issues in the groundwater lease.

Landowners should scrutinize any pooling provisions in the groundwater lease and realize the impact the provision has on the royalty payments and the number of acres held by the lease during the secondary term.

Pooling may drastically reduce royalty payments. If the lease is pooled with

other leases or lands in the area, the calculation of the owner’s royalty depends on a formula. The landowner’s percentage of production is determined by taking the number of acres the owner has in the pool, dividing it by the total size of the pool, and then multiplying the results by the royalty specified in the lease. Giant pools decrease the owner’s royalty.

For example, assume an owner leases 200 acres for a 10 percent royalty. The groundwater company combines the acreage with other leases to form a 150,000-acre pool. If production is established anywhere on the pool, the owner’s percentage of production is $200/150,000 \times 1/10$ th or about .0133 percent. The larger the pool, the less the royalty percentage received by the owner.

But not all of the owner’s leased property may be included in the pool. Some of it may be nonproductive land. Suppose in the example only 100 acres of the owner’s 200 acres were included in the pool. Here, the owner’s percentage of production drops to .0067 percent, and according to most leases, the 100 acres not in the pool continues to be held by the lease even though it is nonproductive. The owner cannot lease the nonproductive land to another company, even though no royalties are received from it.

To protect the property in the event of pooling, the landowner may consider the following.

- Require that **all** the leased acreage be included in a pool. Alternatively, require a certain percentage of the land be included, such as a minimum of one-half.
- In the event that not all the land is included in the pool, terminate the lease as to the unpooled acreage at the end of the primary term.
- Do not forget to negotiate an annual minimum royalty per acre during the secondary term. Giant pools allow the company to hold vast quantities of land with only a small payment per year.
- Consider whether the company may change the size or shape of the pool after the end of the primary term. If changes are permissible, make sure any acreage dropped from the pool

after the end of the primary term reverts to the owner.

- Discuss whether the company has the right of ingress and egress across any acreage that is dropped from the lease after the end of the primary term or after a change in the shape or size of the pool.
- Require a plat of the pooled acreage to be placed on record in the county or counties where the land is located. This allows the owner to grasp the expanse of the project, assist in calculating royalties based on the size of the pooled unit and ascertain if any leased acreage was not included in the pool. Most groundwater companies do not file a plat of the pooled unit in the county official deed records.
- Ask for a *highest benefit clause* in the lease. This clause provides that if a pool is created, the owner's royalty will never be less than the highest royalty of any owner included in the pool.

Assignment Clause: To Whom May the Company Transfer the Lease?

Generally, leases contain a provision that allows the company to assign or transfer the lease to another company or individual. The company need not inform the landowner of the transfer. This has caused problems with oil and gas leases because landowners do not know who to contact or how to contact the new company when a question arises. For this reason, mineral owners started requiring oil companies to notify the landowner of any change of ownership before they were bound by the change. Similar provisions may be included in groundwater leases.

Also, with oil and gas leasing, some mineral owners prefer one oil company over another one. They would sign a lease with oil company X but refuse the same lease from oil company Y. However, once X took a lease from the landowner, it would immediately assign it to Y. To avoid this, mineral owners required their prior consent for any binding assignment. Alternatively, they would prohibit the assignment of the lease to a certain company. Again, these

are considerations for groundwater leases.

But what if the company taking the lease refuses to grant a provision requiring the landowner's prior consent to assign? In such cases, the landowner may wish to negotiate a clause making the company taking the lease liable for any breaches caused by the company taking the assignment.

For example, if X assigns the lease to Y, and Y does not pay surface damages or royalties, the landowner may sue either or both X and Y. By making X responsible for Y's actions, X scrutinizes the company taking the assignment more carefully.

Warranty Clause: Landowner's Guarantee of Title

The *warranty clause* should not be overlooked when negotiating a groundwater lease. The warranty clause requires the owners to defend title to the groundwater should a dispute arise. While most of the time the landowners own the groundwater, the warranty clause places a potential financial burden on the landowner to defend title in a court of law.

There are two kinds of warranties of title. One is known as a *general warranty* in which the owners guarantee that the chain of title to the property points to them. The chain of title starts whenever the title passes from state ownership to private ownership. In some parts of Texas, this began in the early 1700s when Texas was still a part of Mexico. The key wording in a general warranty is "against all persons whomsoever."

The other type of warranty, known as a *special warranty*, is safer for owners. Here, the owner does not guarantee the chain of title but warrants that he or she still owns whatever groundwater interest they received when the property was acquired. The language that converts a general warranty to a special warranty is "in, under and through."

Most lessees prefer a general warranty but will settle for a special warranty if the landowner asks for it. Basically, the owners state that they "warrant title in, under and through themselves, and no other express or implied warranties of title are given."

Miscellaneous Provisions

Some provisions landowners may seek to negotiate cannot be tied to a particular lease clause. Here is a list of some of them.

- Place "Time is of the essence" in the lease. Without this expression, the company has a reasonable time to comply with any deadline. Texas courts have ruled that time-is-of-the-essence clauses exist in oil and gas leases even without being stated. So far, the courts have not ruled on groundwater leases. To learn more about this issue, see Center publication 1333, "Calculating Time in Promulgated Forms."
- Require the company to comply with all federal, state and local rules, regulations and ordinances when conducting operations under the lease. This is important because a violation of the rules or regulations constitutes a breach of the lease.
- Include an indemnity provision whereby the company indemnifies, saves and holds the landowner harmless from all claims, demands and causes of action stemming from the company's activities both on and off the leased premises. Make sure the agreement covers not only the company but also its employees, contractors and agents. The wording of the clause is critical. The Texas Supreme Court ruled the clause must meet three tests to be enforceable. First, it must explicitly state that the company indemnifies the owner from the company's negligence. This is known as the *express negligence doctrine*. If the word "negligence" is not used, the clause is unenforceable. Second, the language must be so clearly stated that the company receives fair notice of the provision. And finally, the provision must be conspicuously placed in the context of the agreement so that it can be readily seen. The clause cannot be buried in the fine print.
- Avoid warranting or guaranteeing the quantity or quality of the water that may be found. The lessee takes the water "as-is."

- If the company logs the water well, see if the company will share a copy of the logs with the landowner. The logs may be used to locate and produce aquifers not used by the company.
- Address whether the landowners may drill and produce water from aquifers being utilized by the company.
- Do not allow the long-term storage of water on the property without the prior consent of the landowner. This could be either above or below the ground.
- Define when “commencement of drilling operations” occurs. The issue may be critical when the company delays drilling until the end of the primary term. By the same token, define when a “completion of a well” occurs. This is important with leases containing a 90-day continuous-drilling-operation provision.
- Delete any language immediately after the legal description that allows the lessee to include any other land owned by the property owner adjacent, adjoining or contiguous to the leased acreage. This is known in oil and gas leases as the *Mother-Hubbard Clause*. It permits additional acreage to be included in the lease without the payment of additional consideration.
- Specify the consequences for the company’s breach of a covenant. As discussed earlier, the breach of a condition automatically terminates the lease. However, the breach of a covenant requires the owner to seek legal recourse. For this reason, owners may attempt to negotiate a clause requiring the company to cure any breach of covenants within 30 days after receiving notice, or the lease terminates. If this cannot be arranged, perhaps making the company liable for liquidated damages in the amount of \$500 to

\$1,000 per day if the breach is not cured within 30 days after receiving notice. This gives an added incentive to cure any default.

- Analyze and possibly limit any shut-in clause appearing in the lease. Some leases based on the oil-and-gas lease format contain shut-in provisions, which allow the groundwater company to maintain the lease when actual production and sales are not occurring. With oil and gas leases, the primary reason for shut ins are the lack of a gas pipeline. The producer shuts in the well while the pipeline is built to transport the gas. Shutting in a water well awaiting a pipeline is quite possible.

While the clause serves a legitimate purpose, it can be abused. The key is limiting the circumstances in which the well may be shut in, limiting how long the shut-in may last, and negotiating the size of the shut-in payment. If these limitations are not included in the lease, the company could conceivably shut in a well for any reason, for an annual payment of as little as one dollar per acre, in perpetuity. The lease would never terminate as long as shut-in royalties are tendered because Texas courts view the shut-in as constructive production.

For this reason, owners should state that shut-ins may occur only for lack of a pipeline, and that annual shut-in royalties will commence at \$10 an acre and escalate \$2 to \$5 each year. The aggregate time for all shut-ins during the entire lease is three years. If shut-in royalties are paid in advance, any months paid, but not used, do not create a credit. To receive credits for unused months, the company must account to the owner in writing within 30 days after the end of the prepaid period.

- Avoid any obligation or expense of securing subordination agree-

ments. According to Texas law, the first-in-time is the first-in-right with lien priority. This means that if the landowner’s property is subject to a mortgage when the groundwater lease is secured, the mortgage is superior to the lease. A foreclosure of the mortgage terminates the lease.

To avoid this possibility, groundwater companies contact the lienholder to secure a subordination agreement. By signing the agreement, the lienholder agrees that a subsequent foreclosure of the existing lien will not terminate the lease. The process is time consuming and, at times, expensive.

Some groundwater leases require the owners to secure subordination agreements for all existing liens on the property on behalf of the groundwater company. Landowners should not assume this obligation or expense. Strike any language in the lease that indicates this task is the responsibility of the owner.

- Place a severability clause in the lease. The severability clause comes into play when one or more provisions of the lease are found to be unenforceable. In such instances, the invalidity of the one or more provisions does not affect the remaining lease provisions. They continue in full force and effect.

Conclusion

Texas landowners have the opportunity to profit by leasing their water rights. However, landowners must understand how best to protect their property rights.

Because groundwater leasing is relatively new, few guidelines exist to assist landowners. This publication attempts to fill the deficit by taking suggestions from prior groundwater leases and from oil and gas leases. The task is difficult because no single lease form is used by all companies. Every suggestion may not fit every lease.

APPENDIX A

GROUNDWATER SOURCES AND DEVELOPMENT

Groundwater sources for public water supplies shall be located so that there will be no danger of pollution from flooding or from unsanitary surroundings, such as privies, sewage, sewage treatment plants, livestock and animal pens, solid waste disposal sites or underground petroleum and chemical storage tanks and liquid transmission pipelines, or abandoned and improperly sealed wells.

Mandatory Restrictions Around Each Public Water Supply (Well):

1. No well site which is within 50 feet of a tile or concrete sanitary sewer, sewerage appurtenance, septic tank, storm sewer, or cemetery; or which is within 150 feet of a septic tank perforated drain field, areas irrigated by low dosage, low angle spray on-site sewage facilities, absorption bed, evapotranspiration bed, improperly constructed water well or underground petroleum and chemical storage tank or liquid transmission pipeline will be acceptable for use as a public drinking water supply. Sanitary or storm sewers constructed of ductile iron or PVC pipe meeting AWWA standards, having a minimum working pressure of 150 pounds per square inch or greater, and equipped with pressure type joints may be located at distances of less than 50 feet from a proposed well site but in no case shall the distance be less than ten feet.
2. No well site shall be located within 500 feet of a sewage treatment plant or within 300 feet of a sewage wet well, sewage pumping station or a drainage ditch which contains industrial waste discharges or the wastes from sewage treatment systems.
3. No water wells shall be located within 500 feet of animal feed lots, solid waste disposal sites, lands on which sewage plant or septic tank sludge is applied, or lands irrigated by sewage plant effluent.
4. Livestock in pastures shall not be allowed within 50 feet of water supply wells.
5. All known abandoned or inoperative wells (unused wells that have not been plugged) within one-quarter mile of a proposed well site shall be reported to the Texas Natural Resource Conservation Commission along with existing or potential pollution hazards. These reports are required for community and nontransient, noncommunity ground water sources. Examples of existing or potential pollution hazards which may affect ground water quality include, but are not limited to landfill and dump sites, animal feedlots, military facilities, industrial facilities, wood-treatment facilities, liquid petroleum and petrochemical production, storage, and transmission facilities, Class 1, 2, 3 and 4 injection wells and pesticide storage and mixing facilities. This information must be submitted prior to construction or as required by the executive director.
6. A sanitary control easement covering that portion of the land within 150 feet of the well location shall be secured from all property owners and recorded in the deed records at the county courthouse. The easement shall provide that none of the pollution hazards covered in subparagraphs 1 through 5 of this paragraph, or any facilities that might create a danger of pollution to the water to be produced from the well will be located thereon. For the purpose of this easement, an improperly constructed water well is one which fails to meet the surface and subsurface construction standards for public water supply wells. Residential type wells within the easement must be constructed to public water well standards. Copies of the recorded easements shall be included with plans and specifications submitted for review. With the approval of the executive director, political subdivisions which have adopted and enforce equivalent ordinances or land use restrictions may substitute these documents for sanitary control easements.

APPENDIX B

SANITARY CONTROL EASEMENT

DATE: _____, 19 __

GRANTOR(S) NAME:

GRANTORS ADDRESS:

GRANTEES NAME:

GRANTEES ADDRESS:

SANITARY CONTROL EASEMENT

Purpose, Restrictions, and Uses of Easement

1. The purpose of this easement is to protect the water supply of the well described and located below by means of sanitary control.
2. The construction and operation of underground petroleum and chemical storage tanks and liquid transmission pipelines, stock pens, feedlots, dump grounds, privies, cesspools, septic tank or sewage treatment drain fields, improperly constructed water wells of any depth, and all other construction or operation that could create an unsanitary condition within, upon, or across the property subject to this easement are prohibited within this easement. For the purpose of the easement, improperly constructed water wells are those wells which do not meet the surface and subsurface construction standards for a public water supply well.
3. The construction of tile or concrete sanitary sewers, sewer appurtenances, septic tanks, storm sewers, and cemeteries is specifically prohibited within a 50-foot radius of the water well described and located below.
4. This easement permits the construction of homes or buildings upon the Grantor's property as long as all items in restrictions numbers 2 and 3 are recognized and followed.
5. This easement permits normal farming and ranching operations, except that livestock shall not be allowed within 50 feet of the water well.

Property Subject to Easement: (Volume and Page where deed to property recorded.)

TERM

This easement shall run with the land and shall be binding on all parties and persons claiming under the Grantor(s) for a period of two years from the date that this easement is recorded; after which time, this easement shall be automatically extended until the use of the subject water well as a source of water for public water systems ceases.

ENFORCEMENT

Enforcement of this easement shall be proceedings at law or in equity against any person or persons violating or attempting to violate the restrictions in this easement, either to restrain the violation or to recover damages.

INVALIDATION

Invalidation of any one of these restrictions or uses (covenants) by a judgment or court order shall not affect any of the other provisions of this easement, which shall remain in full force and effect.

FOR AND IN CONSIDERATION, of the sum of One Dollar (\$1.00) and for other good and valuable consideration paid by the Grantee to the Grantor(s), the receipt of which is hereby acknowledged, the Grantor does hereby grant and convey to Grantee and to its successors and assigns the sanitary control easement described in this easement.

GRANTOR(S) SIGNATURE



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