Chapter X
DEANS OF OIL AND GAS PRESENTATION
OIL AND GAS LAW: A CRITIQUE

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§ 1.01 Introduction

[1] Thank You

Thank-you for this honor. If you hang around long enough, people recognize you for having been around a long time.

[2] The Importance and Impact of CAIL

As a young oil and gas lawyer at Shell Oil Company, and as a law professor dedicated to the study of oil and gas law, this organization—formerly the Southwestern Legal Foundation (as it was known when I first became associated with it)—has served many important roles in my professional development. Most importantly, it brought me into contact with other professionals who have a passion for oil and gas law and the oil and gas industry. It also educated me, kept me current and thinking about new issues, and provided a platform to develop my teaching skills. This organization, and the many fine people associated with it, have helped shape me into the lawyer and professor that you have chosen to recognize today.

[3] A Special Thanks

This opportunity to speak to you today will be used in part to thank the many generous and special people who have had a direct impact on my career. People who made it possible for a guy who began his legal career as a solo practitioner in Neodesha, Kansas, and perfected the prosecution of the barking dog as City Attorney for Cherryvale, Kansas, to sit among this august group today.

It is most fitting that the person who began it all for me was the first Deans of Oil and Gas honoree, the Dean of Deans, the Honorable Joseph W. Morris. It was Joe Morris, a fellow Washburn Law School graduate (Joe was the class of 47, I the class of 77), who set me on the path to becoming an oil and gas lawyer. He hired me twice. Once while he was General Counsel at Shell Oil Company and again when he was the Senior Partner at the Gable & Gotwals law firm.

While working at Shell I had my first encounter with the person who would have a major impact on my teaching career: Professor John Lowe. Another former Deans of Oil and Gas honoree. My first glimpse of John was at a natural gas conference—here in Houston—where he

was presenting on the Natural Gas Policy Act of 1978 with Tom Johnson. There were probably 600 people attending the event with many people standing along the sides of the ballroom. John was magnificent. Only John could make the NGPA the most exciting thing on earth. I learned later he can make anything he teaches exciting. That was an important moment for me because it was when I decided I wanted to do what John was doing. I waded through the crowd after the program and patiently waited for my turn to speak to the professor. He greeted me in his warm and engaging way and I proceeded to tell him of my interest in teaching. The rest is history. John became my mentor and biggest promoter. He was instrumental in landing my oil and gas law teaching job at the University of Tulsa College of Law and we proceeded to collaborate on a number of in-house training programs for Texaco. John introduced me to Gene Kuntz, Ernest Smith, and Owen Anderson who subsequently brought me on as a co-author of their text book and other projects.

I soon learned that John's willingness to mentor and assist a new professor was characteristic of all the academicians teaching oil and gas law. In addition to Owen, Gene, and Ernest, Pat Martin and Bruce Kramer soon entered the picture to offer their support and guidance. That tradition of support and promotion continues to this day. Instead of trying to jealously guard our positions as oil and gas professors, we seem to be constantly in search of new talent to take our place—or at least to share our space. One of the most gratifying developments of the past decade has been the arrival of new, young, dedicated professors who have chosen to focus their careers on the study and teaching of oil and gas law.

The future of oil and gas law is in good hands.

§ 1.02 "Oil and Gas" Law is Still Evolving

[1] Background

Let us now explore that future by engaging in a brief critique of this wonderful discipline we call "oil and gas" law.

Judge Morris, in his 2001 Deans of Oil and Gas presentation, noted that "the law of oil and gas is relatively young." Sometimes we lose sight of that fact. We are this very day, to a large extent, still experiencing the formative stages of oil and gas law. Much remains to be done, much remains to be analyzed, discussed, and decided. Today I will examine three areas of oil and gas law and their related jurisprudence.

[2] The "Law of" Phenomenon

The first inquiry is the role of freedom of contract and oil and gas law. "Oil and gas" law has vacillated wildly when it comes to freedom of contract—and its close companion, freedom of conveyance. I have previously attributed this to the "law of" phenomenon. The basic premise of freedom of contract and conveyance is that the terms established by the parties to a transaction should be enforced unless there is some significant defect in the bargaining process, like fraud or duress.

It is possible to resolve most oil and gas issues applying contract law and property law. Departures from contract and property law results in "oil and gas" law. That is to be expected, so long as the creation of oil and gas law is not an attempt to avoid a perfectly workable contract or property principle. Courts have sometimes used the "law of" status of oil and gas law to avoid applying an otherwise applicable rule of property or contract law—usually to achieve a desired outcome. The body of implied covenant law is an example. In some instances, implied covenant law is an application of contract law. In other instances implied covenant law is used to negate contract law—and thereby negate freedom of contract in the process because a court is substituting its terms for those of the parties.

Texas contributed mightily to this "law of" problem when, at the inception of Texas oil and gas law the Supreme Court proclaimed the effect of all oil and gas lease granting clauses without regard for the actual terms used to make the grant. They would henceforth all create a fee conveyance even though the language used in the granting clause did not convey a fee. Therefore, language that clearly creates only a right to explore and extract oil and gas, which under property and contract law principles creates an easement—a profit—to enter and remove something from another's land, is nevertheless deemed to convey a fee simple determinable in the oil and gas in place. This is "oil and gas" law, not property or contract law. This "law of" license to ignore language would later manifest itself in states like Colorado where "at the well" often means any location but "at the well."

Think about how radical the Texas rule is regarding the classification of an oil and gas lease: to determine the true nature of the grant you ignore the granting clause language. You don't come to that conclusion by applying contract or property law—you get there only by creating "oil and gas" law.

The single biggest threat to freedom of contract is a court "interpreting" a contract or conveyance. Courts are aided in achieving a desired outcome with utterly meaningless interpretive tools such as the ambiguity test. Unambiguous contracts and conveyances are interpreted by the court without the aid of information beyond the four corners of the document. Ambiguous contracts and conveyances are interpreted using any relevant evidence that may be available. This means a contract is ambiguous whenever a majority of the court wants to use extrinsic evidence to alter the express terms of the document. A contract is unambiguous whenever a majority of the court has arrived at an interpretation of the language it feels comfortable with and therefore does not want to consider extrinsic evidence that may suggest otherwise. Because the parol evidence rule is managed by a preliminary ambiguity analysis, it is equally worthless. Lots of work remains to be done in this important area of the law.

[3] "Ownership" Within a Common Reservoir

Leaving the world of interpretation, let's look at some foundational ownership rules created by "oil and gas" law. This is where property law has been imperfectly applied—and I'm not talking about the rule of capture. I'm talking about the *ad coeleum* doctrine—the Heaven to Hell rule—that defines subsurface property rights in accordance with surface boundaries. The basic failure is to recognize that no owner of oil and gas in a connected reservoir has the exclusive possession

required to control what goes on in the reservoir. And what goes on in the reservoir can directly impact any owner's portion of the reservoir.

The waste problem and the resulting conservation regulation were the first instances to acknowledge the connected nature of the reservoir. The solution was to require that the capture game be played using squares and rectangles, and some pooling to help form the required square or rectangle. Unitization remained a largely voluntary endeavor—and still is. There has not been much need to precisely define reservoir ownership concepts. At least not until hydraulic fracturing was combined with horizontal drilling with the prospect of frac fissures crossing *ad coelum* boundary lines.

The response to this issue has been two dimensional and, in my opinion, fatally flawed. Although the Texas Supreme Court has demonstrated a desire to avoid these difficult trans-boundary issues—whether it be fracing or underground injection—the court has approached the issue in a strict trespass-or-not fashion. Either it is a trespass, or it is not a trespass. This is the ultimate question, but courts, and commentators, begin and end their analysis by determining whether the frac fissure, proppant, pressure, or waste has entered into an adjacent owner's property.

I have spent the past several years, and a lot of words on paper, arguing that this invasion of stuff onto another owner's part of the reservoir merely triggers the analysis to evaluate whether the activity giving rise to the invasion is permissible. The issue is clearly defining the injecting party's property right to use the reservoir underlying surrounding owners. All owners in the common reservoir have a correlative right to make reasonable use of the reservoir as a member of a reservoir community. The analysis is put to its greatest test in the frac hit cases where the fracing of a horizontal well in a formation with existing vertical wells causes damage or interference with the vertical wells. The initial response would seem to be a slam-dunk trespass by the horizontal well operator. But when the correct correlative rights analysis is applied, the actions of the horizontal well operator may be viewed as acceptable—and indeed desirable—conduct under a reservoir community analysis. Conduct a vertical well operator must accommodate. It is not first-in-time, first-in-right. The existence of a vertical well, which has probably also been fraced at some time, should not condemn the common reservoir to yesterday's extraction techniques and technologies.

You can still do stupid stuff in the reservoir and be liable for it. The reservoir community analysis examines the disputed conduct in the context of reservoir physics, available technologies, and how competing interests are using the reservoir. This is a much more involved analysis than just looking for an invasion of a surface boundary line extended downward into the reservoir.

Rights in the oil and gas reservoir, and those in a rock formation possessing a commercial degree of porosity and permeability, must be defined using a correlative rights analysis—not merely an *ad coelum* analysis. The *ad coelum* analysis is used to determine membership in a reservoir community. After membership is established, rights to use the reservoir are determined applying a correlative rights analysis. I predict these concepts will receive considerable attention in the future. Oil and gas reservoirs are starting to resemble Houston's highway system—there is a lot of traffic down there.

[4] "Paying Quantities" and "Speculation"

Let's end by talking about the evils of speculation and paying quantities. It illustrates the self-inflicted harm the oil and gas industry, since its inception, has been able to heap upon itself in the form of the oil and gas lease.

Consider the industry's response to the implied covenant to test leased land during the primary term. It came up with the delay rental clause. How did that work out for the industry? Not too well. The delay rental clause has been replaced with the "paid up" lease. Who came up with that? Most of the time there is in fact no advance payment to delay development—there is merely a bonus payment. Why not simply state in the lease there is no obligation to drill a well or otherwise develop the leased land during the primary term and be done with it?

Back to paying quantities. Who would ever define the very life of the most important property right a lessee has using a parameter the lessee has absolutely no control over? What lessee has control over the world price of oil or the price of natural gas? Yet the duration of the oil and gas lease is determined largely by the price of oil and gas.

What is equally surprising is that no litigant to date has offered a paying quantities analysis that accounts for this most important variable in the life of the lease. For years I have suggested that defining the accounting period was the most important element of the paying quantities analysis. The goal is to select an accounting period long enough to reflect prices when the lease was taken or the well drilled. Too often the accounting period is so short it merely affirms what the parties already know: oil prices have been crappy and the lease is not currently generating enough revenue to cover costs.

Even with the second-look prudent operator approach taken by Texas and Oklahoma courts, prudent operator optimism for better prices in the future is rejected as impermissible "speculation." But that is at the very heart of what truly drives a prudent operator: "Prices may be crappy today—but we are at the low part of the oil price cycle—we *know* oil prices will get better. In fact, I'm willing to keep pouring money into this operation even though it may be a losing proposition at the moment." How do we legally reflect this element of legitimate, non-speculative, prudent behavior in the paying quantities equation?

The paying quantities equation is simple: Select an accounting period and then compare costs and revenues during the accounting period. If you get a negative number, in Kansas you are done, in Texas and Oklahoma you evaluate whether there is any legitimate reason for a prudent operator to maintain the losing lease. As I noted previously, the accounting period is where the lessee seeks to include some of the past good with all the recent bad. I have a better idea. Why not use the *revenue* part of the equation to reflect the reality of price fluctuations and cyclical oil markets?

Revenue consists of two components: volume and sales price. The universal practice has been to use current volumes and current sales prices. I think, with the proper evidentiary foundation, that the sales price should be a number that reflects the cyclical nature of the oil and gas industry—instead of just one end of it—the low end. Therefore, if actual sales prices during the selected three-year accounting period ranged from $29 to $32/barrel, it could be established

that a prudent operator would, before abandoning a producing lease, certainly consider sales prices during the up-side of the industry cycle, such as $90/barrel. This could then result in a blended number designed to reflect, and objectify, what a prudent operator properly considers. Therefore, instead of multiplying volume by $31 the proper number established by evidence of prudent operator behavior may be $61/barrel.

In a 1994 article I proposed a revenue formula that could be included when drafting anew the habendum clause of the lease. The analysis I offer today can be applied to all existing leases. The challenge will be assembling the evidence to objectify what courts in the past have merely dismissed as wishful thinking—mere hopes and therefore unacceptable speculation.

[5] Much Remains to be Done

My purpose in presenting these three examples today: (1) the "law of" problem; (2) defining ownership in a connected reservoir; and (3) defining "paying quantities" under the oil and gas lease, is to emphasize that much work remains to be done to develop the law governing oil and gas. Much of that work will be done—and has been done—by those of you in this room.

§ 1.03 Conclusion: Oil and Gas Lawyers Like What They Do

In conclusion, it is significant that this is the 69th Annual Oil and Gas Conference. This organization began providing oil and gas continuing legal education thirty years before most states even contemplated mandatory CLE requirements. Why is that? I know the answer. It is why I enjoy so much being an oil and gas lawyer. We are never done learning and there is a natural tendency within the oil and gas bar to seek and share knowledge. It is why there is this unique professor/practitioner relationship that does not exist in most legal disciplines.

It is why I enjoy bringing my students to oil and gas programs. It is good for students to see first-hand lawyers truly interested in their work—with a desire to do things better and expertly—not just competently. It is good for students to see lawyers, like you, who love what they do and who find fulfillment in it each day.

Thank-you again for this honor and the opportunity to share my thoughts with you today.