

**EVERYTHING’S BIGGER (AND MORE ARDUOUS)  
IN TEXAS: AN ANALYSIS OF TEXAS’S  
UNPREDICTABLE PRECEDENT INVOLVING  
OVERHEAD COSTS AND THEIR RELATION TO A  
MINERAL WELL’S OVERALL UPSTREAM  
EXPENSE CALCULATION**

Comment\*

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The author would also like to thank his family for their unwavering support and encouragement throughout this process.

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I. SURVEYING THE WELL SITE: AN INTRODUCTION TO CALCULATING A WELL'S OVERHEAD EXPENSES	

*“Let me tell you something: this world operates on OPM—that’s ‘other people’s money,’ amigo.”*<sup>1</sup>

Roughly fifty years ago, Jed Clampett and his outlandish family became a common fixture in American pop culture in one of television’s longest running shows, *The Beverly Hillbillies*.<sup>2</sup> The show archived the Clampett family’s obscure transition from their poverty-stricken lifestyle in the Ozark Mountains, to the riches of Beverly Hills, California, after Jed fortuitously discovered massive oil reserves on his property while hunting for his dinner.<sup>3</sup> Following his discovery, Jed’s family became wealthy beyond their wildest dreams, living out the rest of their days in a carefree, extravagant lifestyle.<sup>4</sup> But if Jed Clampett’s discovery occurred in Texas—where the potential for abuse in calculating overhead expenses could have allowed an operator to pass costs on to Jed that he was not responsible for, unfairly reducing his compensation—his story may not have ended on such a happy note.<sup>5</sup>

1. Bryan Mealer, “*Y’all Smell That? That’s the Smell of Money.*”, TEX. MONTHLY, Nov. 2013, at 168, available at <http://www.texasmonthly.com/story/the-oil-boom-of-south-texas>.

2. See *The Beverly Hillbillies*, ARCHIVE AM. TELEVISION, <http://emmytvlegends.org/interviews/shows/beverly-hillbillies-the> (last visited Sept. 26, 2014) [hereinafter *The Beverly Hillbillies*].

3. See *id.*

4. See *id.*

5. See *id.*; *infra* Part V.A.

Ironically, Jed's fictional road to riches began in 1962, the same year the Texas Supreme Court overturned *Skelly Oil Co. v. Archer*—which became the first of many decisions establishing a slippery slope, making calculating overhead expenses complicated and unpredictable.<sup>6</sup> While the Clampett family began a lifestyle of opulence and security in 1962, the State of Texas began a journey down a confusing and abusive road that has unquestionably dealt a painful blow to Texas mineral owners and operators.<sup>7</sup>

For over a century, the oil and gas industry has encompassed such a predominant part of Texas's identity that “oil production” and “Texas” have become nearly synonymous.<sup>8</sup> As a result, Texas currently has one of the strongest economies in the United States.<sup>9</sup> Because of the industry's prevalence, a substantial amount of legislation, administrative statutes, and litigation address virtually every facet of oil and gas production in Texas.<sup>10</sup> Accordingly, the state delegated authority to regulate the industry to the Texas Railroad Commission.<sup>11</sup> Although oil and gas production is one of the largest subjects of scrutiny in Texas, substantial ambiguities still exist regarding the laws that govern the industry.<sup>12</sup>

A common situation in which such questions arise involves calculating upstream production expenses.<sup>13</sup> Whether determining a well's level of production, calculating royalty payments, or otherwise, the vast majority of expense calculation disputes involve calculating “overhead, depreciation, and rate-of-return line items.”<sup>14</sup> Even when parties draft lease provisions addressing expense calculation ad nauseam, the element of ambiguity is often a risk practitioners cannot avoid.<sup>15</sup> Because the Railroad Commission lacks authority to resolve conflicts involving lease provisions, Texas courts—notably

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6. See *Skelly Oil Co. v. Archer*, 163 Tex. 336, 336 (1961) (judgment set aside Feb. 21, 1962); *The Beverly Hillbillies*, *supra* note 2; *infra* Part V.

7. See sources cited *supra* note 6.

8. See *infra* Part II.A.

9. See *infra* notes 31–32, 55–58 and accompanying text.

10. See *infra* Part III.

11. *An Informal History Compiled for Its Centennial (April 1991): Creation of the Railroad Commission of Texas*, RAILROAD COMMISSION TEX., <http://www.rrc.state.tx.us/about-us/history/informal-history-toc/creation-of-the-rrc/> (last updated May 5, 2014); *An Informal History Compiled for Its Centennial (April 1991): Oil & Gas*, RAILROAD COMMISSION TEX., [www.rrc.state.tx.us/about-us/history/informal-history-toc/oil-and-gas/](http://www.rrc.state.tx.us/about-us/history/informal-history-toc/oil-and-gas/) (last updated May 8, 2014) [hereinafter *Oil & Gas*]; see *infra* Part III.A.

12. See *infra* notes 13–19 and accompanying text.

13. See generally Jonathan A. Hunter & Cheryl M. Kornick, *Operator Liability in the 21st Century: Is Being in Charge Still Worth It?*, 51 ROCKY MTN. MIN. L. INST. § 15 (2005) (discussing a broad range of problems operators encounter as a result of production).

14. Owen L. Anderson, *Calculating Royalty: “Costs” Subsequent to Production—“Figures Don't Lie, but . . .”*, 33 WASHBURN L.J. 591, 605 (1994).

15. See John E. Jolly, *The COPAS Accounting Procedures Demystified*, 34 ROCKY MTN. MIN. L. INST. § 21, § 21.01 (1988). *But cf.* Bruce M. Kramer, *Interpreting the Royalty Obligation by Looking at the Express Language: What a Novel Idea?*, 35 TEX. TECH L. REV. 223, 223–24 (2004) (arguing that courts should place more emphasis on the actual royalty clause language in the lease). See generally Robin Forté, *COPAS: Tips for the Non-Operator in Interpreting, Negotiating, and Drafting*, 41 ROCKY MTN. MIN. L. INST. § 21 (1995) (addressing solutions to operator abuse through operating agreements).

less sophisticated in oil and gas expertise—are the sole avenue of redress for parties facing overhead calculation disputes.<sup>16</sup> Reflecting their lack of expertise, Texas courts have created contradictory lines of precedent in addressing this area of law.<sup>17</sup> The problem has become so prevalent that parties often depend on expert witness testimony to determine what the court should consider an overhead expense.<sup>18</sup> The fact that many courts rely upon judicial decisions the Texas Supreme Court set aside decades ago further compounds the problem.<sup>19</sup> In addition to unwarranted legal expenses—both in lease drafting and in litigation—the current judicial landscape also presents opportunities for, and arguably even encourages, operators to engage in abusive practices, creatively passing their overhead expenses on to mineral owners.<sup>20</sup>

This Comment focuses on issues that arise regarding overhead expense calculations.<sup>21</sup> Part V.A describes the types of situations readers want to avoid, discussing problematic precedent and developments in this area of law, identifying unresolved questions to which Texas courts have reached contradictory conclusions, and analyzing the areas of law Texas must improve upon to provide a fair playing field for both interest owners and operators.<sup>22</sup> Shifting the focus from the courts to the parties, Part V.B identifies problems that arise when parties apply different calculation methods to determine their overhead expenses.<sup>23</sup> Finally, Part V.C discusses the problematic trend wherein parties adopt form leases as their operating agreements, but neglect to include provisions that address specific elements particular to their lease or its unique attributes.<sup>24</sup>

After analyzing Texas's confusing precedent, different calculation methods, and common lease drafting inadequacies, Part VI proposes steps Texas's courts, legislature, and Attorney General can take to improve the unpredictable climate currently affecting Texas oil and gas production.<sup>25</sup> Part VI.A addresses reforms Texas courts must make to facilitate this booming industry that is quintessential to our state's economic prominence on both the national and international stage.<sup>26</sup> Similarly, Part VI.B discusses areas where the Texas Legislature can reduce confusion stemming from overhead expense calculation, ultimately decreasing the potential for litigation.<sup>27</sup> Part VI.C

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16. *Oil & Gas*, *supra* note 11; *see infra* Part III.A.

17. *See infra* Part V.A.

18. *See infra* Part V.A.3; *see, e.g.*, *Prize Energy Res., L.P. v. Cliff Hoskins, Inc.*, 345 S.W.3d 537, 564–65 (Tex. App.—San Antonio 2011, no pet.); *S & J Invs. v. Am. Star Energy & Minerals Corp.*, No. 07-07-0357-CV, 2008 WL 2669665, at \*1 (Tex. App.—Amarillo July 8, 2008, pet. denied) (mem. op.).

19. *See, e.g.*, *Skelly Oil Co. v. Archer*, 163 Tex. 336, 336 (1961) (judgment set aside Feb. 21, 1962).

20. *See infra* Part V.

21. *See infra* Part V.

22. *See infra* Part V.A.

23. *See infra* Part V.B.

24. *See infra* Part V.C.

25. *See infra* Part VI.A–B.

26. *See infra* Part VI.A.

27. *See infra* Part VI.B.

presents a number of factors parties should consider in determining which calculation method to apply to their drilling and production operations.<sup>28</sup> Finally, Part VI.C suggests preventive measures owners, operators, and attorneys can apply to minimize the risk of litigation when drafting lease agreements.<sup>29</sup>

## II. CHECKING TITLE: A HISTORY OF THE OIL AND GAS PRODUCTION PROCESS

*“O[il] lay beneath the earth’s surface for millions of years and contributed nothing to man’s way of life. Even today as it pours from the wells, it is useful only in terms of what can be taken from it.”*<sup>30</sup>

For many decades, the State of Texas has bolstered one of the strongest economies in the United States.<sup>31</sup> This record of opulence is largely due to the oil and gas industry’s overwhelming presence in Texas.<sup>32</sup> Accordingly, people around the country, and even the world, have come to associate Texas with oil.<sup>33</sup> For example, the phrase “oilboom” has appeared on the cover of *Texas Monthly* six times, whereas “oil bust” has appeared on the cover only once.<sup>34</sup> Despite the recent oilboom in Texas, oil and gas production will continue to be one of the state’s defining characteristics, as it has remained for well over a century.<sup>35</sup>

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28. See *infra* Part VI.C.

29. See *infra* Part VI.C.

30. John W. Newton, *Spindletop Fiftieth Anniversary and Beaumont Chamber of Commerce Dinner—An Introduction*, in SPINDLETOP: WHERE OIL BECAME AN INDUSTRY 21 (1951).

31. *Compare State of Texas Cash Flow—The Revenue Side*, TEX. ECON. (Jan. 22, 2013), [http://www.thetexaseconomy.org/gov-spending/state-revenue/articles/article.php?name=cashflow\\_revenue](http://www.thetexaseconomy.org/gov-spending/state-revenue/articles/article.php?name=cashflow_revenue) (“In fiscal 2012, the Texas state government’s net revenue, excluding trust funds, totaled \$94.7 billion . . .”), with Jessica Chasmar, *California in the Red by \$127.2 Billion, State Auditors Say*, WASHINGTON TIMES, Apr. 1, 2013, <http://www.washingtontimes.com/news/2013/apr/1/california-red-1272-billion-state-auditors-say/> (“A financial report issued by state auditors finds that the state of California is in the red by an unsustainable \$127.2 billion.”).

32. See *Key Economic Indicators*, TEX. ECON., <http://www.thetexaseconomy.org/economic-outlook/key-indicators/> (last updated Sept. 5, 2014) (discussing Texas’s increase from around \$19 billion in crude oil revenue to almost \$55 billion in crude oil revenue from 2006–2012). “In 1981 production from various wells around the state made up a full fifth of our total economic output. . . . [M]ore than 575,000 jobs related to the spree have been created statewide, and in the Eagle Ford alone, oil companies will spend around \$100 billion this year. . . .” *Fields of Fortune*, TEX. MONTHLY, Nov. 2013, at 113. “A study released last March found that in 2012 the oil and gas industry generated \$61 billion in economic impact across just twenty counties.” Mealer, *supra* note 1, at 122.

33. See *Cover Gallery: Boom Times*, TEX. MONTHLY, Nov. 2013, at 14.

34. *Id.*

35. See *infra* notes 51–58 and accompanying text. “By 2014, the state of Texas is expected to move ahead of the countries of Kuwait, Venezuela, Mexico, and Iraq to become the ninth-largest oil producer in the world.” Mealer, *supra* note 1, at 113.

*A. Energy Production in Texas*

“‘Water, not oil, is the lifeblood of Texas . . .’ But together, oil and gas are its muscle . . . .”<sup>36</sup>

Civilizations have used oil as a commodity for thousands of years; however, oil production did not become essential to our society’s way of life until the industrial revolution ushered in the widespread use of the combustion engine.<sup>37</sup> Even the most primitive civilizations used petroleum in a number of ways: construction, warfare, and a variety of daily tasks such as caulking boats and greasing axles.<sup>38</sup> Centuries before Europeans arrived in America, Native Americans utilized oil for its medicinal purposes.<sup>39</sup> Oil in Texas, however, remained a widely unused commodity until the mid-1800s, when a new technological innovation revolutionized the oil and gas industry.<sup>40</sup>

In 1859, George Bissell and Edwin Drake developed a new method of oil production: drilling.<sup>41</sup> Until that time, existing production methods involved either harvesting oil that seeped through the ground to the surface, or digging for it by hand.<sup>42</sup> The two men began their operation in northwestern Pennsylvania, in a small town called Titusville.<sup>43</sup> On August 27, 1859, they struck oil, becoming the first men to produce a modern oil well.<sup>44</sup> In 1866, Lyne T. Barrett drilled Texas’s first producing oil well in Nacogdoches County.<sup>45</sup> Though several well-documented oil discoveries occurred in the years following the Barrett discovery, oil production continued to be a largely underutilized resource in Texas—taking a backseat to water production.<sup>46</sup>

At the turn of the century, Captain Anthony F. Lucas, an Austrian mining engineer, arrived in Texas determined to find oil.<sup>47</sup> On the morning of January

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36. Coastal Oil & Gas Corp. v. Garza Energy Trust, 268 S.W.3d 1, 26 (Tex. 2008) (Willett, J., concurring) (quoting JAMES A. MICHENER, TEXAS v (1985)).

37. See, e.g., JUDITH WALKER LINSLEY ET AL., GIANT UNDER THE HILL: A HISTORY OF THE SPINDLETOP OIL DISCOVERY AT BEAUMONT, TEXAS, IN 1901 5–6 (2002).

38. See, e.g., *id.*

39. See, e.g., *id.*; Mary G. Ramos, *Oil and Texas: A Cultural History*, TEX. ALMANAC, <http://www.texasalmanac.com/topics/business/oil-and-texas-cultural-history> (last visited Sept. 26, 2014). Centuries before Europeans arrived in America, the Iroquois used oil medicinally as “salve, mosquito repellent, purge and tonic.” *Early Native American Oil Discoveries*, ENO PETROLEUM CORP., <http://www.enopetroleum.com/oildiscoveries.html> (last visited Sept. 26, 2014).

40. See, e.g., WALKER LINSLEY ET AL., *supra* note 37; Ramos, *supra* note 39.

41. See WALKER LINSLEY ET AL., *supra* note 37, at 1, 12 (examining the development of the drilling technique).

42. See, e.g., *id.*

43. See *id.*

44. See *id.*

45. Ramos, *supra* note 39. Nacogdoches County eventually became home to the state’s first commercial oil field and oil pipeline. *Id.* Additionally, the first efforts to refine crude oil in Texas took place in Nacogdoches County. *Id.*

46. *Id.* Considering the high prices required to produce minerals, oil production was not a profitable venture during this era, resulting in a market with low demand. *Id.*

47. WALKER LINSLEY ET AL., *supra* note 37, at 53–55.



10, 1901, just outside the small town of Beaumont, Texas, Lucas struck the nation's first big oil well: commonly referred to as "Spindletop."<sup>48</sup> During its peak production period, Spindletop's "Lucas Gusher" produced an estimated 100,000 barrels per day.<sup>49</sup> Almost overnight, Beaumont grew from a town of roughly 9,000 citizens to over 50,000—a growth that spawned the establishment of some of the biggest oil companies in the world.<sup>50</sup>

In the months following Spindletop, the petroleum industry—in Texas and around the country—experienced an incendiary period of growth.<sup>51</sup> "Texas would soon become an icon for Big Oil. By 1905, more than a quarter of the crude pumped in the country came from the Lone Star State."<sup>52</sup> By 1921, for the first time in the state's history, the manufacturing industry's overall annual value exceeded the value of agricultural production.<sup>53</sup> During this time, the United States went from producing roughly 142,000 barrels per day to almost 3.4 million.<sup>54</sup>

Today, Texas is home to two of the largest oil and gas formations in the world: the Eagle Ford formation and the Barnett Shale.<sup>55</sup> Implementing innovative technologies such as hydraulic fracturing (fracing) and horizontal drilling, mineral producers can now produce oil and gas in places where production would have otherwise been unfeasible.<sup>56</sup> In fact, these new innovations are so efficient that their introduction to the oil and gas industry puts the United States on a path towards complete energy independence within the next two decades.<sup>57</sup> Furthermore, oil and gas production in the United States is currently at an all-time high, and it appears this trend could endure for

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48. *Id.* at 1; Newton, *supra* note 30, at 21.

49. WALKER LINSLEY ET AL., *supra* note 37, at 1–2.

50. *Id.* at 1–4; Newton, *supra* note 30, at 7 ("Major oil companies, such as Gulf Oil Corporation, The Texas Company, Magnolia Petroleum Company, and Humble Oil & Refining Company, to mention but a few, either were founded as a direct result of the Spindletop discovery, or the nucleuses for their formation originated during the early Spindletop era.")

51. WALKER LINSLEY ET AL., *supra* note 37, at 211. Seven months after Spindletop, the *New York Journal* published a story on Texas's sudden oilboom, proclaiming, "Texas has found her glory. It is OIL. . . ." *Id.* (quoting a *New York Journal* article from August, 1901).

52. *Id.* at 212.

53. Richard B. McCaslin, *Science and Technology in Texas Before World War II*, in 100 YEARS OF SCIENCE AND TECHNOLOGY IN TEXAS: A SIGMA XI CENTENNIAL VOLUME 19 (Rice University Press, 1986).

54. *Id.* at 34.

55. See *Barnett Shale Information*, RAILROAD COMMISSION TEX., <http://www.rrc.state.tx.us/oil-gas/major-oil-gas-formations/barnett-shale-information/> (last updated July 29, 2014); *Eagle Ford Shale Information*, RAILROAD COMMISSION TEX., <http://www.rrc.state.tx.us/oil-gas/major-oil-gas-formations/eagle-ford-shale/> (last updated Sept. 2, 2014).

56. See David Blackmon, *Horizontal Drilling: A Technological Marvel Ignored*, FORBES (Jan. 28, 2013, 3:31 PM), <http://www.forbes.com/sites/davidblackmon/2013/01/28/horizontal-drilling-a-technological-marvel-ignored/> (discussing horizontal drilling and the lack of media coverage surrounding it).

57. Mark Thompson, *U.S. to Become Biggest Oil Producer - IEA*, CNNMONEY (Nov. 12, 2012, 9:48 AM), <http://money.cnn.com/2012/11/12/news/economy/us-oil-production-energy/index.html> ("The United States will overtake Saudi Arabia to become the world's biggest oil producer before 2020, and will be energy independent 10 years later, according to a new forecast by the International Energy Agency.")

decades to come.<sup>58</sup> To continue leading the charge towards energy independence, however, Texas needs a strong judicial system that can effectively resolve disputes that inevitably arise in the course of energy production.

### B. *The Production Process*

*“Formula for success: rise early, work hard, strike oil.”*<sup>59</sup>

Petroleum exploration is a highly complex process that is constantly evolving.<sup>60</sup> Because there are so many different expenditures involved in oil and gas production, to avoid subsequent disputes it is imperative to determine which party bears each cost before operations ever begin.<sup>61</sup> From the onset, this lengthy process involves extensive collusion between a number of different parties, each performing separate tasks.<sup>62</sup> The exploration phase can last up to ten years before the production process begins.<sup>63</sup> Moreover, an oil field’s productive life can carry on for up to fifty additional years.<sup>64</sup> Considering the lengthy duration of the production process, the numerous parties involved, the massive amounts of capital and investments, and the costly nature of litigation, the accounting process involved in mineral production is remarkably complex.<sup>65</sup> These factors make it imperative for attorneys and other parties to have a predictable system that enables them to take preventative measures to avoid disputes.<sup>66</sup> Further, parties must go to great lengths to specify the nature of their agreement and to define its parameters to reduce the likelihood of litigation.<sup>67</sup>

Generally, oil and gas production consists of three phases: acquiring the mineral property, exploration and development, and operation.<sup>68</sup> After the

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58. See Mark J. Perry, *Energy Fact of the Day: US Oil Output Surged During the First Week of September to the Highest Level in More than 24 Years*, AM. ENTERPRISE INST. (Sept. 11, 2013, 11:33 AM), <http://www.aei-ideas.org/2013/09/energy-fact-of-the-day-us-oil-output-surged-during-the-first-week-of-september-to-the-highest-level-in-more-than-24-years/>. In the week of September 6, 2013, oil production in the United States reached its highest level since May 1989. *Id.* Since September 2011, oil production in “Saudi America” has increased by over 37.3%. *Id.*

59. *‘Formula for Success: Rise Early, Work Hard, Strike Oil’*, FIN. EXPRESS (Nov. 23, 2008), <http://www.financialexpress.com/news/formula-for-success-rise-early-work-hard-strike-oil/389324> (quoting J. Paul Getty).

60. Michel T. Halbouty, *Petroleum and Petrochemical Technology*, in 100 YEARS OF SCIENCE AND TECHNOLOGY IN TEXAS: A SIGMA XI CENTENNIAL VOLUME 177 (Rice University Press 1986).

61. *Cf. infra* Part II.B (discussing the parties involved in the oil and gas production process in Texas).

62. See Halbouty, *supra* note 60, at 177.

63. *Id.*

64. *Id.*

65. See *supra* notes 60–64 and accompanying text.

66. See *infra* Parts V.A, VI.A.

67. See *infra* Parts V.B, VI.B.

68. INTERNAL REVENUE SERV., INTERNAL REVENUE MANUAL § 4.41.1.3.2 (2005) [hereinafter INTERNAL REVENUE MANUAL 2005], available at [http://www.irs.gov/irm/part4/irm\\_04-041-001-cont01.html](http://www.irs.gov/irm/part4/irm_04-041-001-cont01.html).



operator acquires the mineral property, the exploration and development process begins with in-depth geological and geophysical studies.<sup>69</sup> Once producers locate a potential mineral source, they drill confirmation and extension wells to determine whether that source contains a profitable quantity of petroleum.<sup>70</sup> If the well appears sufficient for production, the operator begins the production process by installing production facilities, drilling development wells, and arranging transportation for the minerals produced.<sup>71</sup>

During a well's productive life, operators constantly conduct repairs and make modifications to maintain productivity.<sup>72</sup> These operations include installing artificial lift devices and compressors and conducting scientific research on productivity.<sup>73</sup> After the well's productivity begins to decline, producers commence secondary and tertiary recovery procedures such as water flood or gas injection.<sup>74</sup> Once the well reaches the end of its productive life, producers use cement to plug the well, removing all salvageable surface equipment and clearing the surface area.<sup>75</sup> From start to finish, operators constantly perform maintenance on the well, accruing different types of overhead expenses during each phase of drilling and production.<sup>76</sup>

### III. DRAFTING THE LEASE: THE CAST OF CHARACTERS INVOLVED IN PRODUCTION OPERATIONS

*"Life, liberty, and property do not exist because men have made laws. On the contrary, it was the fact that life, liberty, and property existed beforehand that caused men to make laws in the first place."*<sup>77</sup>

Oil and gas law encompasses a complex set of relationships that are highly dependent upon one another.<sup>78</sup> Though the main crux of any operating agreement turns on the parties' intent as outlined in the lease, a number of other parties play significant roles in the agreement's broad scope.<sup>79</sup> Because production involves such an extensive number of entities, oil and gas producers and mineral interest owners should have a working knowledge of the hierarchy governing oil and gas production in Texas.

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69. Halbouty, *supra* note 60, at 177.

70. *Id.*

71. *Id.*

72. *Id.*

73. *Id.*

74. *Id.*

75. *Id.*

76. *See id.*

77. FRÉDÉRIC BASTIAT, THE LAW 2 (1850).

78. *See infra* Part III.A–C.

79. *See infra* Part III.B.

A. *Governing Bodies: The Railroad Commission and the Courts*

*“Remember that the Texas Railroad Commission is the Rebel Alliance and the [F]eds are the Empire.”*<sup>80</sup>

Established in 1891, the Texas Railroad Commission regulates a number of industries.<sup>81</sup> Widely known for its role as the sole regulatory agency with exclusive administrative jurisdiction over oil and gas enterprises, the Railroad Commission governs Texas’s petroleum industry in many areas including the environment, well spacing, production, transportation, and allocation.<sup>82</sup> The Railroad Commission does not, however, have the authority to regulate agreed upon terms within a lease agreement.<sup>83</sup> As a result, the Railroad Commission’s inability to resolve issues pertaining to expense calculation creates a massive void, which Texas courts are left to resolve.<sup>84</sup>

As a general matter, the majority of Texas oil and gas law comes from state appellate court decisions.<sup>85</sup> Because the Texas Constitution, as well as a number of other laws, address leases, no formal set of codified statutes explicitly governs leasing law.<sup>86</sup> As a result, almost all disputes involving mineral leases fall within the purview of *stare decisis*—making a case “subject to its own interpretation, often depending on the ‘eye of the beholder.’”<sup>87</sup> In many situations regarding limited facts or narrow questions of law, courts apply a rationale that can be “broadly extended and enlarged upon for want of a precedent, and interpreted to apply to situations far beyond what the court envisioned and . . . bear very fragile, if any, resemblance to the original issue.”<sup>88</sup>

When adjudicating lease disputes, Texas courts apply “the four corners rule,” which allows courts to treat the lease as a contract, interpreting the parties’ intent through the lease’s language as it is written.<sup>89</sup> In applying the

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80. E-mail from Christopher S. Kulander, Of Counsel, Haynes & Boone, LLP, to author (Mar. 21, 2013, 14:22 CST) (on file with author).

81. *History of the Railroad Commission*, RAILROAD COMMISSION TEX., <http://www.rrc.state.tx.us/about-us/history> (last updated May 14, 2014).

82. *See id.*

83. *See Railroad Commission Authority and Jurisdiction*, RAILROAD COMMISSION TEX., <http://www.rrc.state.tx.us/about-us/resource-center/faqs/railroad-commission-authority-and-jurisdiction-faq/> (last updated May 14, 2014).

84. *See infra* notes 86–91 and accompanying text.

85. *See* Ben F. McDonald, Jr., *The Anatomy of an Oil and Gas Lease*, in *OIL AND GAS LEASES A-1, A-4* (State Bar of Texas 1982).

86. *Id. See generally, e.g.*, TEX. EST. CODE ANN. (West 2014); TEX. AGRIC. CODE ANN. (West 2004); TEX. BUS. & COM. CODE ANN. (West 2009); TEX. CIV. PRAC. & REM. CODE ANN. (West 2002); TEX. INS. CODE ANN. (West 2009); TEX. NAT. RES. CODE ANN. (West 2011); TEX. PROP. CODE ANN. (West 2004); TEX. TAX CODE ANN. (West 2008); TEX. WATER CODE ANN. (West 2008) (containing provisions relating to oil and gas leasing regulations).

87. McDonald, *supra* note 85, at A-4–5.

88. *Id.* at A-5.

89. *Luckel v. White*, 819 S.W.2d 459, 461–62 (Tex. 1991); *see Tittizer v. Union Gas Corp.*, 171

four corners rule, Texas courts construe a lease as a whole, attempting to harmonize all its parts.<sup>90</sup> These courts embrace the lease's language in its plain meaning unless that meaning undermines the parties' intent.<sup>91</sup>

*B. The Lease and Its Relationship to the Accounting Process*

*"The oil and gas lease is like other documents the same as a rattlesnake is like a piece of rope."*<sup>92</sup>

An inherently unique document, the oil and gas lease simultaneously serves as a lease (a conveyance of real property) and a contract.<sup>93</sup> "Some states refer to the oil and gas lease as an easement or a license . . . or a servitude . . . or a covenant running with the land. Sometimes lawyers and judges call it unprintable names."<sup>94</sup>

Despite the well-established principle that the lease governs the scope of any production agreement, many situations arise when parties' interests become enjoined in production without their consent—dramatically limiting their ability to amend lease provisions they find unfavorable to their position.<sup>95</sup> These disputes arise primarily from pooling or unitization.<sup>96</sup> To understand the differing relationships, rights, and obligations this unique document creates, practitioners need a basic understanding of the varying roles parties play during the production, lease agreement, and accounting processes.<sup>97</sup>

*C. Parties*

*"With friends like that, who needs enemies?"*<sup>98</sup>

Regarding oil and gas production, the lease agreement exclusively governs the relationships and responsibilities between different parties.<sup>99</sup> In most cases, production involves a number of different companies combining their resources to successfully produce oil from a well, which in turn involves multiple mineral

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S.W.3d 857, 860 (Tex. 2005) (discussing the four corners rule); *Anadarko Petroleum Corp. v. Thompson*, 94 S.W.3d 550, 554 (Tex. 2002); McDonald, *supra* note 85, at A-4.

90. *Luckel*, 819 S.W.2d at 461–62.

91. *See id.*

92. McDonald, *supra* note 85, at A-1 (emphasis omitted).

93. *See, e.g., id.* at A-1–3.

94. *Id.* at A-1.

95. *See infra* notes 114–16 and accompanying text.

96. *See infra* notes 114–16 and accompanying text.

97. *See infra* Part II.C.

98. *With Friends Like That, Who Needs Enemies?*, FREE DICTIONARY, <http://idioms.thefreedictionary.com/With+friends+like+that,+who+needs+enemies%3F> (last visited Sept. 27, 2014).

99. *See, e.g.,* McDonald, *supra* note 85, at A-1–3.

owners.<sup>100</sup> Production may also involve multiple parcels of property with completely unrelated chains of title.<sup>101</sup> In that light—considering factors such as the varying size, experience, and amount of capital—accounting methods used in the oil and gas industry are not uniform.<sup>102</sup>

The premise of oil and gas production involves two basic categories of property interests: operating (working) interests and non-operating (royalty or mineral) interests.<sup>103</sup> Typically, for each parcel of land there are a number of parties with working interest rights, royalty or mineral interest rights, or sometimes both.<sup>104</sup> The main distinction between mineral interest owners and royalty interest owners is that the mineral interest owner bears the operating costs from production.<sup>105</sup> Before production begins, the working interest owners designate one party as the operator; the operator may either be a party with a working interest in the property or a designated party who otherwise has no interest in the property.<sup>106</sup> The operator is responsible for executing the oil and gas well's production activity and performs all functions to produce the minerals.<sup>107</sup> Once the well is in production, the operator proportionately allocates the expenses, including overhead, among the working interest owners.<sup>108</sup> These operating expenses are comprised of both indirect and direct expenditures.<sup>109</sup> With the working interest owners bearing all operating costs, royalty owners are only responsible for paying production taxes and ad valorem taxes.<sup>110</sup>

Because the nature of each well is substantially different—number of parties, amount of experience, amount of minerals, number of different properties involved, etc.—there is no single accepted accounting method applied to oil and gas production.<sup>111</sup> Regardless of which calculation method the parties select, the operator must send the parties and mineral owners a monthly statement that details items such as expenses, equipment, and revenue relating to the property.<sup>112</sup> In most cases, the working interest owner will pay the royalty owners directly.<sup>113</sup>

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100. See, e.g., CECIL H. MOORE & JAMES D. GRIER, ACCOUNTING STANDARDS AND REGULATIONS FOR OIL AND GAS PRODUCERS, 1401–03 (1983); INTERNAL REVENUE SERV., INTERNAL REVENUE MANUAL § 4.41.1.2.1 (2013) [hereinafter INTERNAL REVENUE MANUAL 2013], available at [http://www.irs.gov/irm/part4/irm\\_04-041-001.html](http://www.irs.gov/irm/part4/irm_04-041-001.html).

101. See, e.g., INTERNAL REVENUE MANUAL 2005, *supra* note 68, § 4.41.1.3.

102. See, e.g., *id.*

103. See *id.*

104. See *id.*

105. *Id.*

106. *Id.*

107. *Id.*

108. *Id.*

109. See *id.*

110. See, e.g., *id.*

111. See INTERNAL REVENUE MANUAL 2013, *supra* note 100, § 4.41.1.2.1.

112. INTERNAL REVENUE MANUAL 2005, *supra* note 68, § 4.41.1.3.

113. See *id.*

Though the lease exclusively governs mineral production, many individuals or entities become non-consenting parties to the agreement through pooling or unitization—the practice of joining a number of parcels together to jointly produce their minerals.<sup>114</sup> In Texas, a cotenant may produce minerals from a common tract without securing their cotenants' consent; however, the producing cotenant must account to the non-consenting mineral owners for the value of minerals taken minus the necessary and reasonable costs of producing and marketing those minerals.<sup>115</sup> Because a lease's provisions do not protect non-consenting parties, those parties have very little authority to dictate which method the operators use to calculate overhead expenses.<sup>116</sup>

#### IV. DRILLING THE WELL: CALCULATING OVERHEAD EXPENSES ACCORDING TO THE OPERATING AGREEMENT

*“Overhead will eat you alive if not constantly viewed as a parasite to be exterminated.”*<sup>117</sup>

One of the more convoluted areas affecting oil and gas production involves calculating expenses and revenues.<sup>118</sup> A particular point of confusion arises when calculating overhead expenses.<sup>119</sup> Generally speaking, overhead expenses encompass a number of different categories and line items, which vary from situation to situation; however, overhead is technically defined as: “[a]dministrative and financial overhead items includ[ing] expenses of a general nature. [Overhead costs] would include office expense[s], accounting, rent, administrative salaries, utilities, insurance, interest expense[s] not assignable to a particular lease, and other financing costs.”<sup>120</sup> Two common situations in which overhead expenses are particularly important occur when determining royalty payments, as previously discussed, and when determining whether a well is producing in paying quantities.<sup>121</sup>

Due to the multitude of acceptable accounting procedures, no single method to calculate overhead expenses exists.<sup>122</sup> Under any calculation system,

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114. SAMUEL H. GLASSMIRE, *LAW OF OIL AND GAS LEASES AND ROYALTIES* 39–42 (2d ed. 1938). “Pooling of interests is . . . simply a matter of mutual agreement between all parties concerned to operate a given area as a unit.” *Id.* at 39.

115. *Cox v. Davison*, 397 S.W.2d 200, 201 (Tex. 1965); *Stroud v. Guffey*, 3 S.W.2d 592, 594 (Tex. Civ. App.—Waco 1927), *aff'd*, 16 S.W.2d 527 (Tex. 1929); *Burnham v. Hardy Oil Co.*, 147 S.W. 330, 334 (Tex. Civ. App.—San Antonio 1912), *aff'd*, 108 Tex. 555 (1917).

116. *Cox*, 397 S.W.2d at 201–02. “Where one cotenant decides to develop a common property, the law raises no obligation binding a nonjoining cotenant . . . Cases dealing with debts or obligations implied by law are not directly applicable.” *Id.*

117. Felix Dennis, *Felix Dennis on the ‘Getting of Money’*, *ENTREPRENEUR* (Apr. 14, 2011), <http://www.entrepreneur.com/article/219480>.

118. *See supra* notes 13–19 and accompanying text.

119. *See supra* notes 13–19 and accompanying text.

120. INTERNAL REVENUE MANUAL 2005, *supra* note 68, § 4.41.1.3.2.3.

121. *See supra* notes 99–120 and accompanying text; *infra* Part IV.A–B.

122. *See, e.g.*, Karla Bower et al., *COPAS Accounting Procedures, the 2005 COPAS Accounting*

however, the underlying goal is to differentiate direct from indirect expenses, and then determine what portion of the indirect expenses to allocate as overhead.<sup>123</sup> Overhead expenses serve to compensate operators for expenditures not directly applicable to operations in a well's vicinity.<sup>124</sup> Operators typically recover these expenses from the mineral owner's share of the profits using a fixed or percentage basis rather than a direct deduction.<sup>125</sup> Considering the nature of overhead expense calculations, there are unavoidable ambiguities that will continue to arise.<sup>126</sup> Some of the most common disputes occur when reducing expenditures during a well's transition from drilling to production, when there are multiple wells operating under one lease, when the lease deals with a shut-in gas well, and when the lease involves multi-zone operations.<sup>127</sup> Working to shed light on these questions, the Council of Petroleum Accountants Societies (COPAS) provides guidance to make the oil and gas accounting process as simple and as fair as possible.<sup>128</sup>

#### A. COPAS

Emerging in 1961, many consider COPAS the leading authority on oil and gas accounting.<sup>129</sup> One of COPAS's most notable characteristics is the numerous methods of calculating values relating to oil and gas production it has developed.<sup>130</sup> These methods provide detailed instruction regarding overhead calculations—though almost all of these methods are general in nature—and provide an abundance of leeway for parties to adapt accounting procedures to each individual agreement.<sup>131</sup>

Due to the varying elements at play in different operating agreements, including “size, organization, philosophy, terminology, and even operating concepts,” distinguishing overhead costs from other expenses is quite complicated.<sup>132</sup> Generally, the first step in determining overhead costs is to differentiate direct from indirect costs.<sup>133</sup> Direct costs are defined as expenses

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*Procedure, the Audit Process, and Legal and Practical Considerations*, in 2 ROCKY MOUNTAIN MINERAL LAW FOUNDATION ET AL., OIL AND GAS AGREEMENTS: JOINT OPERATIONS, § III.A, M, P–Q (2008); Jolly, *supra* note 15, §§ 21.01, 21.04(3), 21.04(8).

123. *See, e.g.*, Bower et al., *supra* note 122, § I.A, D; Jolly, *supra* note 15, § 21.04(8).

124. Jolly, *supra* note 15, § 21.04(8).

125. *Id.* § 21.04(8)–(8)(a).

126. *See infra* Part IV.A–B. “Probably the most misunderstood and mishandled charge in the joint operation is the allowable overhead.” Jolly, *supra* note 15, § 21.04(8). “It would be virtually impossible to list each and every item or service that could be charged directly to the joint account.” Bower et al., *supra* note 122, § I.D.

127. Forté, *supra* note 15, §§ 21.05–.06.

128. *See, e.g.*, Jolly, *supra* note 15, § 21.02.

129. *Id.*

130. *See, e.g., id.* §§ 21.01, 21.04(3), 21.04(8)(a); Bower et al., *supra* note 122, § III.A, M, P–Q.

131. *See, e.g.*, Bower et al., *supra* note 122, § III.A, M, P–Q; Jolly, *supra* note 15, §§ 21.01, 21.04(3), 21.04(8)(a).

132. Jolly, *supra* note 15, § 21.04(8).

133. *See id.* § 21.04(8)–(8)(a).



accruing directly from drilling and production operations in a well's general vicinity.<sup>134</sup> These expenses generally, but not always, consist of on-site employees' salaries, maintenance fees, on-site office expenses, repair and replacement expenses for tools, and a number of other miscellaneous expenses.<sup>135</sup> Operators deduct direct expenses on a "dollar for dollar" basis.<sup>136</sup> After operators differentiate direct from indirect costs, the next step is to determine which indirect costs constitute overhead.<sup>137</sup> Though these expenses are vital to the drilling and production processes, overhead expenses are costs accruing off-site and away from the actual well.<sup>138</sup> As such, operators recover these expenses using the accounting procedures specified in the operating agreement; these procedures commonly involve either a fixed rate or percentage based calculation procedure.<sup>139</sup> Despite the numerous accounting methods COPAS has developed to calculate overhead expenses, the fixed rate and the percentage basis remain the most popular COPAS methods.<sup>140</sup> Besides calculating the amount of expenses the mineral interest owner is responsible for, overhead expenses are also crucial in determining whether a well can continue to operate under a lease agreement.<sup>141</sup>

#### B. *The Habendum Clause*

*"[I]nterior decorating is a rock-hard science compared to [this.]"*<sup>142</sup>

In addition to deducting the operator's expenses, overhead costs also affect whether a well produces "in paying quantities."<sup>143</sup> A common portion of an oil and gas lease is the habendum clause, which sets out the primary term's length and defines terms the operator must satisfy for production to continue into the secondary term.<sup>144</sup> Typically, the habendum clause provides for the lease to continue for an agreed term of years, then for so long as the well

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134. *Id.* § 21.04(6), (8)(a)–(b).

135. *Id.* § 21.04(8)(a)–(b).

136. *Id.* § 21.04(8).

137. *See id.* § 21.04(8)–(8)(a).

138. *See id.* § 21.04(6), (8)(a)–(b).

139. *See id.* § 21.04(8)(c)–(d).

140. *See id.*; *infra* Part V.B.

141. *See infra* Part IV.B.

142. *Lee v. Weisman*, 505 U.S. 577, 636 (1992) (Scalia, J., dissenting).

143. *See* George J. Person, *The Habendum Clause and Termination*, in OIL AND GAS LEASES B, B-6 (State Bar of Texas 1982). *See generally* McDonald, *supra* note 85, at A-13 (discussing a lease's duration and related costs).

144. McDonald, *supra* note 85, at A-13. "A habendum clause is that provision which dictates the duration of the mineral lease. The lease subsists during the primary term and for so long thereafter as oil or gas is produced. The period of time after the primary term is sometimes called the secondary term." Patrick S. Ottinger, *Production in "Paying Quantities"—A Fresh Look*, 65 LA. L. REV. 635, 636 (2005) (footnote omitted) (internal quotation marks omitted) (citing HOWARD R. WILLIAMS & CHARLES J. MEYERS, MANUAL OF OIL AND GAS TERMS 800 (6th ed. 1984)).

produces in paying quantities.<sup>145</sup> To produce in paying quantities, the amount of oil or gas a well produces must be adequate to pay the lessee a profit after the operator deducts operating and marketing expenses from the calculation.<sup>146</sup> This calculation includes royalty payments but does not take drilling or reworking costs into consideration.<sup>147</sup> In addressing whether a well produces in paying quantities, courts ask whether the well will realize a reasonable expectation of profitable returns.<sup>148</sup> When parties do not satisfy the provisions of the habendum clause, production ceases and parties lose their interest in the operating agreement; therefore, the habendum clause is a vital factor in any operating agreement.<sup>149</sup> Moreover, the application of overhead expenses to the in paying quantities calculation is particularly important because the amount of overhead accrued can affect whether a well produces in paying quantities during a production lag.<sup>150</sup>

Despite countless statutes, regulations, and judicial decisions addressing the habendum clause, mineral owners, operators, attorneys, and even courts continually experience great confusion when applying overhead expenses to the clause.<sup>151</sup> Similarly, overhead expenses create disputes in calculating a well's production expenses; however, these situations leave parties in an even more precarious situation considering the sparse amount of guidance addressing these issues.<sup>152</sup> Even with the considerable amount of guidance COPAS provides, overhead expenses remain one of the more ambiguous and problematic factors in an oil and gas operating agreement.<sup>153</sup>

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145. McDonald, *supra* note 85, at A-13. "If a well pays a profit, even small, over operating expenses, it produces in paying quantities, though it may never repay its costs, and the enterprise as a whole may prove unprofitable." Clifton v. Koontz, 160 Tex. 82, 89 (1959) (quoting Garcia v. King, 139 Tex. 578, 583 (1942)).

146. Morgan v. Fox, 536 S.W.2d 644, 650 (Tex. Civ. App.—Corpus Christi 1976, writ ref'd n.r.e.); see Pshigoda v. Texaco, Inc., 703 S.W.2d 416, 418 (Tex. App.—Amarillo 1986, writ ref'd n.r.e.).

147. Morgan, 536 S.W.2d at 650; see Pshigoda, 703 S.W.2d at 418. Such expenses are considered "speculative" in nature. Cox v. Davison, 397 S.W.2d 200, 202 (Tex. 1965).

148. Clifton, 160 Tex. at 89.

149. See McDonald, *supra* note 85, at A-13.

150. See, e.g., Patton v. Rogers, 417 S.W.2d 470, 472, 474–76 (Tex. Civ. App.—San Antonio 1967, writ ref'd n.r.e.).

151. See *supra* text accompanying notes 143–50; *infra* Part V.

152. See *supra* Part IV; *infra* Part V.

153. See *supra* Part IV.A; *infra* Part V.

V. DEVELOPING THE WELL SITE: ANALYZING THE TEXAS JUDICIAL SYSTEM'S FLAWS IN ADJUDICATING OVERHEAD DISPUTES AND IDENTIFYING THE MANNER IN WHICH SUCH DISPUTES ARISE

*"These things only seem to happen when we have the oxygen of money to fuel the fire of litigation."*<sup>154</sup>

Typically, legal issues regarding expense calculations in the oil and gas industry are questions of fact.<sup>155</sup> Because courts present such questions to juries in different areas of the state, a lack of uniformity in the outcomes of such cases is implicitly guaranteed.<sup>156</sup> This lack of uniformity is due, in large part, to the following: (1) the complex nature of not only oil and gas accounting, but also oil and gas production in general; (2) the massive amount of assets and parties involved; and (3) the fact that many jurors have little to no understanding of energy production.<sup>157</sup>

One similar factor influencing the confusion in this area of Texas law is the diversity amongst judges.<sup>158</sup> In addition to disparity in political ideology, judges differ in their experience and knowledge of oil and gas production in the same way as juries.<sup>159</sup> Many judges have relatively limited knowledge of the intricacies of oil and gas production.<sup>160</sup> On the other hand, some judges are moderately—even intimately—familiar with oil and gas production.<sup>161</sup>

In addition to the inherent uncertainty arising from presenting complex issues to diverse judges and juries, another factor contributing to the lack of certainty in this area of law involves the varying precedent courts apply to these adjudicated cases.<sup>162</sup> For example, after its final judgment in 1961, the Texas Supreme Court set aside *Skelly Oil Co. v. Archer* in 1962.<sup>163</sup> While some Texas courts have adopted persuasive authority from jurisdictions where courts

154. Christopher S. Kulander, Of Counsel, Haynes & Boone, LLP, Remarks at Oil and Gas II Class Lecture, Texas Tech University School of Law (Jan. 21, 2014).

155. See *Prize Energy Res., L.P. v. Cliff Hoskins, Inc.*, 345 S.W.3d 537, 565 (Tex. App.—San Antonio 2011, no pet.). The court in *Wagner & Brown* found “overhead expenses on a lapsed lease were properly charged as long as they were reasonable and necessary.” *Id.* (citing *Wagner & Brown, Ltd. v. Sheppard*, 282 S.W.3d 419, 425 (Tex. 2008)).

156. See generally Laura Gaston Dooley, *Our Juries, Our Selves: The Power, Perception, and Politics of the Civil Jury*, 80 CORNELL L. REV. 325 (1995) (discussing political factors affecting the manner in which American juries perceive and resolve conflicts).

157. See, e.g., David E. Pierce, *The Missing Link in Royalty Analysis: An Essay on Resolving Value-Based Royalty Disputes*, 5 TEX. WESLEYAN L. REV. 185, 186 (1999).

158. See Anderson, *supra* note 14, at 638.

159. See *id.*

160. See *id.*

161. See, e.g., *Coastal Oil & Gas Corp. v. Garza Energy Trust*, 268 S.W.3d 1, 26–50 (Tex. 2008) (Willett, J., concurring).

162. See *infra* Part V.A.1.

163. See *Skelly Oil Co. v. Archer*, 163 Tex. 336, 347–48 (1961) (judgment set aside Feb. 21, 1962).

have developed more concrete principals regarding overhead expenses, a number of Texas courts continue to cite *Archer* to this day.<sup>164</sup>

One popularly held solution, as Professor Bruce Kramer presents, suggests courts should use the lease's express language to adjudicate these issues.<sup>165</sup> Though Professor Kramer's solution—that analyzing the four corners of a lease agreement is the cure—is incredibly effective as it relates to royalty ownership, there is an inherent sense of uncertainty for which no amount of lease provisions can compensate when courts expand upon this principle and apply it to more complex situations.<sup>166</sup> Ultimately, the solution to this rampant problem revolves around proactive lease agreements; however, parties cannot avoid potential conflicts without a judicial system that can effectively adjudicate these disputes when the lease is ineffective to answer questions at hand.<sup>167</sup>

In Texas, the inherent uncertainty in adjudicating disputes involving overhead expenses makes it all the more important for parties to take steps to avoid litigation.<sup>168</sup> Unfortunately, many parties simply draft form leases that contain no provisions addressing factors specific to their individual needs.<sup>169</sup> These leases often contain general accounting procedures that bear little relevance to the individual well in question.<sup>170</sup>

In addition to adopting leases that incorporate accounting procedures that are not well-suited for the agreement to which they apply, parties typically neglect to take further steps to define the manner in which they will designate and account for specific line items.<sup>171</sup> This lack of due diligence results in a generally avoidable vicious circle, leaving parties at the court's doorstep with little guidance to protect their interests.<sup>172</sup>

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164. See, e.g., *Abraxas Petroleum Corp. v. Hornburg*, 20 S.W.3d 741, 756 (Tex. App.—El Paso 2000, no pet.); *Peacock v. Schroeder*, 846 S.W.2d 905, 908–09 (Tex. App.—San Antonio 1993, no writ); *Pshigoda v. Texaco, Inc.*, 703 S.W.2d 416, 418 (Tex. App.—Amarillo 1986, writ ref'd n.r.e.); *Patton v. Rogers*, 417 S.W.2d 470, 474 (Tex. Civ. App.—San Antonio 1967, writ ref'd n.r.e.). But see, e.g., *BoMar Oil & Gas, Inc. v. Loyd*, No. 10-08-00016-CV, 2009 WL 2136404, at \*6–7 (Tex. App.—Waco July 15, 2009, pet. denied) (mem. op.), modified, 298 S.W.3d 832 (Tex. App.—Waco 2009, pet. denied); *Ladd Petroleum Corp. v. Eagle Oil & Gas Co.*, 695 S.W.2d 99, 108 (Tex. App.—Fort Worth 1985, writ ref'd n.r.e.).

165. See generally Kramer, *supra* note 15 (explaining courts should use a lease's express language to adjudicate disputes relating to royalty clauses).

166. See Bower et al., *supra* note 122, § III.E; *infra* Part V.A–B.

167. See *infra* Part V.B.

168. See *infra* Parts V.B, VI.B.

169. See Bower et al., *supra* note 122, § III.A; *infra* Part V.B.

170. See *infra* Part V.B.1–3; cf. Bower et al., *supra* note 122, § III.A (noting that choices often vary based on different situations).

171. See *infra* Part V.B.4; cf. Bower et al., *supra* note 122, § III.A (advising users of the 2005 COPAS procedure to account for their specific needs).

172. See *infra* Part V.B.

*A. Problems Within the Texas Judicial System*

*“Contrary to popular belief, little in the law is black and white. Shades of gray latently course between and within the words written by legislators and judges. Those shades may spark hardy discussion among members of the legal community, or simply supply reason for the day’s headache.”*<sup>173</sup>

Due to the oil and gas industry’s constantly evolving nature, ever-present ambiguities in the law require extra scrutiny.<sup>174</sup> For a multitude of reasons, however, overhead expense calculation is an area of oil and gas law that Texas’s statutes and legal precedent have yet to adequately address.<sup>175</sup> One of the most prevalent reasons overhead calculations are so perplexing is the remarkable lack of case law addressing such questions.<sup>176</sup> Following that lack of precedent, to resolve disputes in this area, Texas established a trend wherein courts rely on cases that higher courts previously set aside.<sup>177</sup> The fact that appellate courts review trial records under a standard that allows a wide variance in the already sparse case law in existence only exacerbates the problem.<sup>178</sup>

Moreover, Texas courts developed a trend of misconstruing, or broadening, existing case law as it relates to narrow sets of facts or questions of law.<sup>179</sup> This proverbial “playground of precedent” resulted in lines of authority that directly contradict one another, allowing any given court to reach whatever conclusion it desires, then cherry pick cases to support its conclusion.<sup>180</sup>

Similarly, the standard of review appellate courts apply to these disputes gives trial courts tremendous discretion.<sup>181</sup> Using these broad standards of review, Texas courts have developed a dangerous trend that encourages operators to engage in speculative ventures, then pass their overhead expenses on to non-operators by coaching their expert witnesses to portray these expenses in a manner that makes them seem necessary and reasonable.<sup>182</sup> As a result, the Texas judicial system has become an operator-friendly institution that allows large oil companies to use expensive and risky operating techniques, leaving non-operating interest owners holding the bag.<sup>183</sup>

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173. *Am. Star Energy & Minerals Corp. v. Stowers*, 405 S.W.3d 905, 906 (Tex. App.—Amarillo 2013, pet. granted).

174. Christopher S. Kulander, *Shale Oil and Gas State Regulatory Issues and Trends*, 63 CASE W. RES. L. REV. 1101, 1101–02 (2013).

175. *See* Anderson, *supra* note 14, at 605.

176. *See infra* Part V.A.1–3.

177. *See infra* notes 185–89 and accompanying text.

178. *See supra* Part V.A.3; *see, e.g.*, *Prize Energy Res., L.P. v. Cliff Hoskins, Inc.*, 345 S.W.3d 537, 562–65 (Tex. App.—San Antonio 2011, no pet.).

179. *See infra* Part V.A.2.

180. *See infra* Part V.A.2.

181. *See infra* Part V.A.3.

182. *See infra* Part V.A.3.

183. *See infra* Part V.A.3.

### I. Skelly Oil Co. v. Archer

“*Similar to a Star Wars bar scene, the procedural history in this action is bizarre.*”<sup>184</sup>

The Texas Supreme Court’s 1961 *Archer* decision is a heavily cited case addressing overhead expense calculation.<sup>185</sup> In *Archer*, a mineral lessor brought suit against the mineral lessee to determine whether the lease expired because the well ceased to produce in paying quantities.<sup>186</sup> Skelly Oil, the lessee, contended the court should not allow Archer’s overhead expense deduction in determining whether the wells produced in paying quantities.<sup>187</sup> The court—relying heavily on Edwin M. Cage’s lecture *Production in Paying Quantities: Technical Problems Involved*—noted “those items of overhead charges which can be traceable to the actual expense of production of the well’s product for marketing should be considered in determining whether or not the well is producing in paying quantities.”<sup>188</sup> Though the court seemingly based its conclusions on valid information, arriving at a reasonable conclusion, this case presents a major problem.<sup>189</sup>

Roughly four months after the court handed down the *Archer* decision, the Texas Supreme Court set the holding aside.<sup>190</sup> Despite the fact that *Archer*’s direct negative history would preclude the case’s use in almost any other setting, many of the remarkably few Texas cases evaluating overhead expenses rely heavily on the case.<sup>191</sup> There are, however, two outliers in Texas case law where courts declined to adopt *Archer*.<sup>192</sup>

In the first case, *Ladd Petroleum Corp. v. Eagle Oil & Gas, Co.*, the Fort Worth Court of Appeals sought to determine whether a lease terminated when

184. *Quinonez v. Empire Today, LLC*, No. C 10–02049 WHA, 2010 WL 5211501, at \*1 (N.D. Cal. Dec. 16, 2010).

185. *Skelly Oil Co. v. Archer*, 163 Tex. 336, 336 (1961) (judgment set aside Feb. 21, 1962); *see, e.g.*, *Abraxas Petroleum Corp. v. Hornburg*, 20 S.W.3d 741, 756 (Tex. App.—El Paso 2000, no pet.); *Peacock v. Schroeder*, 846 S.W.2d 905, 908–09 (Tex. App.—San Antonio 1993, no writ); *Pshigoda v. Texaco, Inc.*, 703 S.W.2d 416, 418 (Tex. App.—Amarillo 1986, writ ref’d n.r.e.); *Patton v. Rogers*, 417 S.W.2d 470, 474 (Tex. Civ. App.—San Antonio 1967, writ ref’d n.r.e.).

186. *Archer*, 163 Tex. at 337–40.

187. *Id.* at 344.

188. *Id.* at 344–46 (citing *Whitaker v. Texaco, Inc.*, 283 F.2d 169, 176 (10th Cir. 1960)) (referencing Edwin M. Cage, *Production in Paying Quantities: Technical Problems Involved*, 10 INST. ON OIL & GAS L. & TAX’N 61 (1959)).

189. *See infra* notes 190–91 and accompanying text.

190. *See Archer*, 163 Tex. at 336.

191. *Id.*; *see, e.g.*, *Abraxas Petroleum Corp. v. Hornburg*, 20 S.W.3d 741, 756 (Tex. App.—El Paso 2000, no pet.); *Peacock v. Schroeder*, 846 S.W.2d 905, 908–09 (Tex. App.—San Antonio 1993, no writ); *Pshigoda v. Texaco, Inc.*, 703 S.W.2d 416, 418 (Tex. App.—Amarillo 1986, writ ref’d n.r.e.); *Patton v. Rogers*, 417 S.W.2d 470, 474 (Tex. Civ. App.—San Antonio 1967, writ ref’d n.r.e.).

192. *See BoMar Oil & Gas, Inc. v. Loyd*, No. 10-08-00016-CV, 2009 WL 2136404, at \*6–7 (Tex. App.—Waco July 15, 2009, pet. denied) (mem. op.), *modified*, 298 S.W.3d 832 (Tex. App.—Waco 2009, pet. denied); *Ladd Petroleum Corp. v. Eagle Oil & Gas Co.*, 695 S.W.2d 99, 108 (Tex. App.—Fort Worth 1985, writ ref’d n.r.e.).



several wells ceased to produce in paying quantities.<sup>193</sup> One of the forty-five issues raised in the case involved the application of certain types of overhead expenses to the producing in paying quantities calculation.<sup>194</sup> At trial, Ladd's expert witness stated the expenses would continue to accrue regardless of whether the wells ceased operation.<sup>195</sup> The trial court, however, "defined overhead expenses as those charges which can be traceable to the actual expenses of production of the well's product for marketing," finding the operator appropriately deducted overhead in its calculation.<sup>196</sup> On appeal, the court declined to follow *Archer*, finding the issue at hand was not directly on point in that case.<sup>197</sup> Finding no controlling Texas cases addressing the prorated application of administrative and district expenses to the producing in paying quantities formula, the court adopted an Oklahoma case, *Mason v. Ladd Petroleum Corp.*<sup>198</sup> In *Mason*, the Oklahoma Supreme Court held "[o]rdinary business experience would indicate that as the elimination of a single well would not materially reduce such expense, it should not be included as overhead."<sup>199</sup> Taking a slightly narrower view than that in *Archer*, the court distinguished administrative overhead fees from overhead charges relating directly to production, thus reversing the trial court's holding, and remanded the case to allow a trier of fact to evaluate the different expenses accordingly.<sup>200</sup>

In the second case, *BoMar Oil & Gas, Inc. v. Loyd*—an unreported 2009 case from the Waco Court of Appeals—the court adopted *Ladd*'s distinction between types of overhead expenses.<sup>201</sup> In *BoMar*, Loyd (the mineral owner) sued BoMar (the operator), claiming it charged improper and disproportionate expenses against his share of the mineral interest.<sup>202</sup> *BoMar* involved a joint operating agreement where, because of pooling, Loyd became an unleased mineral owner.<sup>203</sup> At trial, each side presented expert witnesses to testify as to whether the expenses were reasonable and necessary, as set forth in *Byrom v. Pendley* and *Cox v. Davison*.<sup>204</sup> Loyd's witness testified that the charges were unreasonable because they were administrative overhead expenses that would

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193. *Ladd*, 695 S.W.2d at 100–08.

194. *Id.* at 100.

195. *Id.* at 108.

196. *Id.* (internal quotation marks omitted).

197. *Id.* (distinguishing the case from *Skelly Oil Co. v. Archer*, 163 Tex. 336 (1961) (judgment set aside Feb. 21, 1962); *Patton v. Rogers*, 417 S.W.2d 470 (Tex. Civ. App.—San Antonio 1967, writ ref'd n.r.e.); *Sullivan & Garnett v. James*, 308 S.W.2d 891 (Tex. Civ. App.—San Antonio 1957, writ ref'd n.r.e.)).

198. *Id.* (adopting *Mason v. Ladd Petroleum Corp.*, 630 P.2d 1283, 1285 (Okla. 1981)).

199. *Id.* (citing *Mason*, 630 P.2d at 1285).

200. *Id.* at 108–09 (distinguishing the case from *Archer*).

201. *BoMar Oil & Gas, Inc. v. Loyd*, No. 10-08-00016-CV, 2009 WL 2136404, at \*6–7 (Tex. App.—Waco July 15, 2009, pet. denied) (mem. op.), *modified*, 298 S.W.3d 832 (Tex. App.—Waco 2009, pet. denied).

202. *Id.* at \*5.

203. *See supra* notes 114–15 and accompanying text.

204. *BoMar*, 2009 WL 2136404, at \*5 (citing *Byrom v. Pendley*, 717 S.W.2d 602, 605 (Tex. 1986); *Cox v. Davison*, 397 S.W.2d 200, 201, 203 (Tex. 1965)).

continue to accrue whether the well ceased production.<sup>205</sup> BoMar's witness, on the other hand, testified that the expenses were not only necessary and reasonable, but they were also consistent with industry practice.<sup>206</sup> The witness further testified that BoMar charged the expenses only against profitable wells in an effort to help its investors.<sup>207</sup> Evaluating the application of overhead expenses, the court adopted the *Abraxas Petroleum Corp. v. Hornburg* rule, which states:

In the context of an oil and gas lease, the term "production" has been construed to mean a well which pays a profit, however small, over operating and marketing expenses, even though it may never repay its costs and the enterprise as a whole may prove unprofitable. This definition should apply equally to the phrase "producing in paying quantit[ies]." Operating and marketing expenses include taxes, *overhead charges*, labor, repairs, and depreciation on salvable equipment, but not costs or expenses in connection with the original drilling of the well or reworking expenses. Periodic cash expenditures incurred in the daily operation of a well (sometimes called out-of-pocket lifting expenses) are classified as operating expenses, while one-time investment expenses, such as drilling and equipping costs, are to be treated as capital expenditures. Reworking expenses are part of the capital investment.<sup>208</sup>

Adopting *Ladd*, the court found the distinction between administrative overhead and overhead expenses relating to production was appropriate.<sup>209</sup> Finding no material questions of fact remaining, the court held all expenses at issue were unnecessary and unreasonable because the expenses were administrative, bearing no relation to the well's production.<sup>210</sup>

Despite *Ladd's* lack of negative treatment, Texas courts continue to apply *Archer* to adjudications involving overhead calculations.<sup>211</sup> Regardless of *Archer's* notably thoughtful analysis and subsequent holding, the fact that Texas courts still rely on *Archer* as a staple case regarding the classification of overhead expenses raises substantial concerns when one considers the fact that

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205. *Id.*

206. *Id.*

207. *Id.*

208. *Id.* at \*6 (alteration in original) (quoting *Abraxas Petroleum Corp. v. Hornburg*, 20 S.W.3d 741, 756 (Tex. App.—El Paso 2000, no pet.)).

209. *Id.* at \*7; see *supra* notes 193–99 and accompanying text.

210. *BoMar*, 2009 WL 2136404, at \*7.

211. See *Skelly Oil Co. v. Archer*, 163 Tex. 336, 336 (1961) (judgment set aside Feb. 21, 1962); see, e.g., *Abraxas*, 20 S.W.3d at 756; *Peacock v. Schroeder*, 846 S.W.2d 905, 908–09 (Tex. App.—San Antonio 1993, no writ); *Pshigoda v. Texaco, Inc.*, 703 S.W.2d 416, 418 (Tex. App.—Amarillo 1986, writ ref'd n.r.e.); *Patton v. Rogers*, 417 S.W.2d 470, 474 (Tex. Civ. App.—San Antonio 1976, writ ref'd n.r.e.). But see *BoMar*, 2009 WL 2136404, at \*6–7; *Ladd Petroleum Corp. v. Eagle Oil & Gas Co.*, 695 S.W.2d 99, 108 (Tex. App.—Fort Worth 1985, writ ref'd n.r.e.).

the Texas Supreme Court set the case aside decades ago.<sup>212</sup> The relationship between *Ladd* and *Archer* has created a fork in the road regarding overhead expense calculations.<sup>213</sup> Down the first road lies *Archer*, which courts are hesitant to depart from considering it has become a building block in case law addressing overhead expenses.<sup>214</sup> Down the other road lies *Ladd*, which despite its lack of negative treatment, some courts are hesitant to adopt due to its basis in Oklahoma law.<sup>215</sup> Unfortunately, rather than providing operators and interest owners with a clear direction in case law, Texas courts have simply elected to keep both paths available when they reach this fork in the road.<sup>216</sup> As a result, Texas now has two lines of precedent courts may choose from, leaving operators and interest owners without a map to navigate overhead expenses.<sup>217</sup>

## 2. Prize Energy Resources, L.P. v. Cliff Hoskins, Inc.

*“Change brings opportunities. On the other hand, change can be confusing.”*<sup>218</sup>

Another perplexing development in Texas oil and gas law comes as a result of the San Antonio Court of Appeals' interpretation of *Wagner & Brown, Ltd. v. Sheppard* in *Prize Energy Resources, L.P. v. Cliff Hoskins, Inc.*<sup>219</sup> In *Prize*, Cliff Hoskins, who had no previous connection to the leased parties, discovered the joint operating agreement in question expired years before due to cessation in production.<sup>220</sup> After purchasing a portion of the mineral rights, Hoskins brought suit to quiet title and recover unpaid proceeds, among other complaints.<sup>221</sup> The trial court found Hoskins properly acquired title to the

212. *Archer*, 163 Tex. at 336; see, e.g., *Abraxas*, 20 S.W.3d at 756; *Peacock*, 846 S.W.2d at 908–09; *Pshigoda*, 703 S.W.2d at 418; *Patton*, 417 S.W.2d at 474.

213. Compare *Archer*, 163 Tex. at 336 (holding that courts can consider certain overhead expenses in determining whether a well is producing in paying quantities), with *Ladd*, 695 S.W.2d at 108 (distinguishing *Ladd* from *Archer*).

214. See generally *Archer*, 163 Tex. 336 (creating a distinction between different types of overhead expenses).

215. See *Ladd*, 695 S.W.2d at 108 (adopting *Mason v. Ladd Petroleum Corp.*, 630 P.2d 1283, 1285 (Okla. 1981)); see also *BoMar*, 2009 WL 2136404, at \*6–7 (adopting *Ladd*'s distinction between types of overhead expenses).

216. See, e.g., *Ladd*, 695 S.W.2d at 108; see also *BoMar*, 2009 WL 2136404, at \*6–7 (adopting *Ladd*'s distinction between types of overhead expenses).

217. See, e.g., *Ladd*, 695 S.W.2d at 108; *BoMar*, 2009 WL 2136404, at \*6–7.

218. Michael Porter, *Business Strategist Thought Leader*, BILL RINGLE, <http://www.billringle.com/blog/michael-porter/> (last visited Sept. 27, 2013).

219. See generally *Prize Energy Res., L.P. v. Cliff Hoskins, Inc.*, 345 S.W.3d 537 (Tex. App.—San Antonio 2011, no pet.) (applying its interpretation of *Wagner & Brown, Ltd. v. Sheppard*, 198 S.W.3d 369, 380–81 (Tex. App.—Texarkana 2006), *rev'd*, 282 S.W.3d 419, 421–29 (Tex. 2008)).

220. *Id.* at 547. The lease's cessation clause provided that the lease would “remain in force so long as drilling, mining or reworking operations are prosecuted (whether on the same or different wells) with no cessation of more than sixty (60) consecutive days, and if they result in production, so long thereafter as oil or gas is produced from said land or land pooled therewith.” *Id.* at 546.

221. *Id.* at 547.

portion of the lease in question, the previous operator was a good faith trespasser while conducting operations after termination, and Hoskins was entitled to recover damages.<sup>222</sup> One particularly contentious issue in the case involved the amount of operator's expenses Prize was entitled to recover from Hoskins.<sup>223</sup> Specifically, the issue addressed whether the operator was entitled to deduct expenses from all wells drilled under the lease or only from the producing wells.<sup>224</sup> Arguing that the court should apply a "well-by-well" calculation—only deducting expenses from producing wells—Hoskins relied heavily upon *Wagner & Brown*.<sup>225</sup> Noting the lease was silent regarding an accounting method, the court rejected Hoskins' well-by-well approach, instead holding that Hoskins was responsible for his share of all of the operator's necessary and reasonable expenses accrued on each well, regardless of whether that well was producing.<sup>226</sup>

After upholding the trial court's findings regarding the lease's title and good faith trespass, the San Antonio Court of Appeals turned to the trial court's findings regarding the expense calculation.<sup>227</sup> Addressing the amount Hoskins was entitled to recover, the court first cited *Wagner & Brown* as "the only case on point found by either party directly considering how damages should be calculated when an unleased cotenant drills both profitable and unprofitable wells."<sup>228</sup> In *Wagner & Brown*, the Texas Supreme Court emphasized the longstanding Texas rule that "a cotenant has the right to extract minerals from common property without first obtaining the consent of his cotenants; however, he must account to them on the basis of the value of any minerals taken, less the necessary and reasonable costs of production and marketing."<sup>229</sup> Though the Texas Supreme Court reversed the Texarkana Court of Appeals' holding, it declined to address the well-by-well calculation since neither party raised the issue before the court, making the San Antonio court's analysis in *Prize* regarding the well-by-well method an extension—rather than an interpretation—of the precedent *Wagner & Brown* established.<sup>230</sup>

Despite the host of decisions Hoskins cited supporting his position—including *Wagner & Brown*—the court adopted Prize's contention that the supreme court would not have adopted the well-by-well approach had that issue

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222. *Id.* at 547–48.

223. *See id.* at 562–67.

224. *See id.*

225. *See id.* (relying on *Wagner & Brown, Ltd. v. Sheppard*, 198 S.W.3d 369, 380–81 (Tex. App.—Texarkana 2006), *rev'd*, 282 S.W.3d 419, 421–29 (Tex. 2008)).

226. *See id.* at 562–66.

227. *See id.*

228. *Id.* at 563 (quoting *Wagner & Brown*, 198 S.W.3d at 369).

229. *Id.* (quoting *Wagner & Brown*, 282 S.W.3d at 426) (internal quotation marks omitted); *see* *Byrom v. Pendley*, 717 S.W.2d 602, 605 (Tex. 1986) (upholding the cotenant's right to produce oil and gas from the land so long as the cotenant accounts for his share of minerals less his share of drilling and operating expenses).

230. *See Wagner & Brown*, 282 S.W.3d at 422–23, 426–27.

been raised.<sup>231</sup> The San Antonio court put particular emphasis on the Texarkana court's statement:

Given the equitable nature of a reimbursement-for-improvements claim, we decline to read Texas law as establishing that drilling costs are *always* or *never* recoverable when a lease expires. Instead, we believe the equitable nature of such claims must turn on the equities in each case. . . . As with other equitable actions, a jury may have to settle disputed issues about what happened, but "the expediency, necessity, or propriety of equitable relief" is for the trial court, and its ruling is reviewed for an abuse of discretion.<sup>232</sup>

Declining to address the other cases Hoskins presented supporting his position, the San Antonio court applied its presumptive interpretation of *Wagner & Brown* in holding that the well-by-well approach is meritless and the trial court's findings regarding expenses were proper.<sup>233</sup> Despite the San Antonio court's conclusion that there were no cases directly on point addressing whether an operator may deduct overhead expenses from non-producing wells, *Neeley v. Intercity Management Corp.*, a 1987 Texas case, directly addresses this issue.<sup>234</sup> Disregarding Hoskins raising *Neeley* in support of his position, the court chose to exclude the case from its analysis, ultimately reaching a conclusion that directly contradicts *Neeley*.<sup>235</sup>

In *Neeley*, Intercity, the operator, brought suit to recover expenses from Neeley.<sup>236</sup> Similar to *Prize*, there was no contractual agreement between the parties and, thus, no predetermination as to whether the non-operator was liable for expenses accruing on non-producing wells.<sup>237</sup> At trial, the jury found Neeley was liable to Intercity for the expenses in question, including overhead.<sup>238</sup> On appeal, however, the Corpus Christi Court of Appeals analyzed the expenses, examining Intercity's calculation method as well as the

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231. *Prize*, 345 S.W.3d at 562–66; see *Wagner & Brown*, 198 S.W.3d at 373; see also *Neeley v. Intercity Mgmt. Corp.*, 732 S.W.2d 644, 646 (Tex. App.—Corpus Christi 1987, no writ) (holding that a party who drills a dry hole bears any costs associated with that well); *Shaw & Estes v. Tex. Consol. Oils*, 299 S.W.2d 307, 313 (Tex. Civ. App.—Galveston 1957, writ ref'd n.r.e.) (stating the operator should be reimbursed when his expenditures are necessary and beneficial, but not when he drills a dry hole or engages in speculative ventures or failed reworking operations); *Willson v. Superior Oil Co.*, 274 S.W.2d 947, 950 (Tex. Civ. App.—Texarkana 1954, writ ref'd n.r.e.) (stating that a party is not entitled to reimbursement from a cotenant if that party drills a dry hole); *Burnham v. Hardy Oil Co.*, 147 S.W. 330, 335 (Tex. Civ. App.—San Antonio 1912), *aff'd*, 108 Tex. 555 (1917) (finding that the party who drills a non-producing well should bear expenses accrued on that well).

232. *Prize*, 345 S.W.3d at 564 (quoting *Wagner & Brown*, 282 S.W.3d at 428–29).

233. *Id.* at 564–66.

234. See *id.* at 563. But see *Neeley*, 732 S.W.2d at 645–48.

235. See *Prize*, 345 S.W.3d at 563. But see *Neeley*, 732 S.W.2d at 645–48.

236. *Neeley*, 732 S.W.2d at 645.

237. Compare *id.* (adjudicating a dispute involving a lease that did not specify whether the operator could deduct overhead expenses from non-producing wells), with *Prize*, 345 S.W.3d at 562–66 (adjudicating a dispute where the lease contains similar ambiguities).

238. *Neeley*, 732 S.W.2d at 646.

instructions submitted to the jury.<sup>239</sup> Finding that Intercity's calculation method made no distinction between producing and non-producing wells, the court held that the overhead expenses, among others, were improper and reversed the trial court's decision.<sup>240</sup>

Whatever the San Antonio Court of Appeals' reasoning for excluding *Neeley* from its analysis in *Prize*—whether it be overlooking the case or disagreeing with it—the court should have, at the very least, addressed the case in its analysis.<sup>241</sup> Had the court properly considered *Neeley*, its holding likely would have been considerably different.<sup>242</sup> Notwithstanding *Prize* correctly noting that courts evaluate “reimbursement-for-improvements” claims on a case-by-case basis rather than applying an inflexible rule, the San Antonio court misapplied the case law leading to its holding.<sup>243</sup> Rather than applying *Wagner & Brown* within the parameters the supreme court set forth in that case—or instead, applying *Neeley*, which is directly on point—the San Antonio court based its overly expansive holding on what it perceived the court would have done in *Wagner & Brown* under slightly different circumstances.<sup>244</sup> As a result, Texas mineral owners and operators currently have little guidance—outside of their operating agreements—as to whether an operator may deduct overhead expenses from non-producing wells when its overall operation is profitable.<sup>245</sup>

### 3. Deference to Trial Court/Standard of Review

“[T]he Taj Mahal of the Doctrine of Unanticipated Consequences, the Sistine Chapel of Cost-Benefit Analysis Ignored.”<sup>246</sup>

One of the more unavoidable difficulties litigants face in adjudicating oil and gas disputes results from the overwhelmingly broad discretion Texas appellate courts give to trial courts.<sup>247</sup> Though it is a well-established principle in American jurisprudence that the trial court is the sole finder of fact, Texas appellate courts have become increasingly reluctant to question the manner in which trial courts reach their conclusions of fact.<sup>248</sup> In *Fossil Fuels, Inc. v.*

239. *Id.* at 646–47.

240. *Id.* at 646–48.

241. *See Prize*, 345 S.W.3d at 563. *But see Neeley*, 732 S.W.2d at 645–48.

242. *See Prize*, 345 S.W.3d at 564. *But see Neeley*, 732 S.W.2d at 645–48.

243. *See Prize*, 345 S.W.3d at 564.

244. *See id.* at 562–66 (relying on *Wagner & Brown, Ltd. v. Sheppard* 282 S.W.3d 419, 428–29 (Tex. 2008)). *But see Neeley*, 732 S.W.2d at 646–48 (holding that a party who drills a dry hole bears any costs associated with that well).

245. *See supra* Part IV.B.

246. Antonin Scalia, *The Freedom of Information Has No Clothes*, AEI J. ON GOV'T & SOC'Y, Mar.–Apr. 1982, at 15.

247. *See infra* note 248 and accompanying text.

248. *See* FED. R. EVID. 404; *see, e.g.*, *Jackson v. Virginia*, 443 U.S. 307, 318 (1979); *Blackburn v. Alabama*, 361 U.S. 199, 205–10 (1960). *See generally* David P. Leonard, *Power and Responsibility in Evidence Law*, 63 S. CAL. L. REV. 937 (1990) (providing an in-depth analysis of federal evidence law).



*Hyde-Bower, Inc.*, the Dallas Court of Appeals reiterated this point, stating: “If there is more than a scintilla of evidence to support the finding, the evidence is legally sufficient to support the finding.”<sup>249</sup> Regarding oil and gas accounting principles, this standard of review provides trial courts with broad discretion under which any combination of reasoning and conclusions may be upheld so long as there is “more than a scintilla” of evidence supporting the finding.<sup>250</sup> This is a major contributing factor regarding the lack of uncertainty involving overhead expenses in Texas oil and gas law.<sup>251</sup>

Returning to the cataclysmic befuddlement commonly referred to as *Prize*, it is not difficult to identify several inconsistencies between existing case law, the evidence, and the San Antonio Court of Appeals’ holding.<sup>252</sup> Addressing the standard of review, the court provided a very brief excerpt from *City of Keller v. Wilson*.<sup>253</sup>

On appeal, Hoskins attempted to rebut Prize’s contention that the non-producing wells did, in fact, serve a beneficial purpose because they prevented drainage, provided geological information, and afforded opportunities for future exploration.<sup>254</sup> Though Hoskins presented witness testimony that the wells did not prevent drainage and would likely never be put to additional use, the court refused to give the testimony merit, noting that the trial court is the finder of fact.<sup>255</sup> By unequivocally accepting Prize’s contention that the wells served a beneficial purpose, the court established a concerning precedent wherein an operator can deduct expenses from non-producing wells so long as that operator makes some showing, regardless of contradiction, that the wells serve some beneficial purpose.<sup>256</sup> This precedent is particularly vexing for non-participating mineral owners who, by and large, are not as sophisticated in their knowledge of mineral production as are the operators with whom they engage in production agreements.<sup>257</sup>

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249. *Fossil Fuels, Inc. v. Hyde-Bower, Inc.*, No. 05-92-01461-CV, 1993 WL 189817, at \*2 (Tex. App.—Dallas June 3, 1993, no writ) (citing *Stafford v. Stafford*, 726 S.W.2d 14, 16 (Tex. 1987); *Aerospatiale Helicopter Corp. v. Universal Health Servs., Inc.*, 778 S.W.2d 492, 496 (Tex. App.—Dallas 1989, writ denied)).

250. *See, e.g., id.*

251. *See infra* note 256 and accompanying text.

252. *See Prize Energy Res., L.P. v. Cliff Hoskins, Inc.*, 345 S.W.3d 537, 562–67 (Tex. App.—San Antonio 2011, no pet.).

253. *Id.* at 565 (citing *City of Keller v. Wilson*, 168 S.W.3d 802, 819 (Tex. 2005)) (“[I]t is the sole province of fact finder to determine credibility of the witnesses and weight to be given their testimony.”).

254. *Id.* at 564–65.

255. *See* Brief of the Prize Appellants at 33–38, *Prize*, 345 S.W.3d 537 (No. 04-09-00603-CV), 2010 WL 1984040, at \*33–38. The only first-hand witness testified that there had been no drainage on the property. *Id.* at \*33–34. Moreover, Prize’s expert witness testified that there were no immediate plans to utilize the wells in question for secondary operations and that they only “potentially” provided useful geologic information. *Id.* at \*33.

256. *See generally Prize*, 345 S.W.3d 537 (discounting strong evidence contradicting the court’s holding).

257. *See, e.g., id.*

Another troubling Texas case involving the standard of review appellate courts apply, *S & J Investments v. American Star Energy & Minerals Corp.*, presents a situation where an appellate court upheld the trial court's finding despite notable evidence reflecting an abuse of discretion.<sup>258</sup> Unlike *Prize*, the operating agreement in *S & J Invs.* provided that the operator would not deduct overhead expenses from non-producing wells at S & J's expense.<sup>259</sup> Following a disagreement regarding the amount of overhead they were entitled to, American Star Energy brought suit to collect \$34,241.32 in unpaid overhead that accrued between 1990 and 1998.<sup>260</sup> At trial, S & J presented testimony from a Texas Railroad Commission field inspector who visited the wells in 1998.<sup>261</sup> Though the inspection took place after American Star Energy filed suit, the field inspector testified that some of the leased wells were not in production during *at least* part of the time period in question due to rust build up he observed on parts of the wellhead.<sup>262</sup> The trial court discounted the field inspector's testimony, holding for American Star Energy.<sup>263</sup> On appeal, the Amarillo Court of Appeals cited several cases discussing the deference it gives to trial courts.<sup>264</sup> Despite the fact that S & J presented clear expert testimony contradicting the factual findings, the Amarillo court upheld the trial court's holding, neglecting to find the court abused its discretion.<sup>265</sup>

Though a seemingly daunting task, there are steps Texas courts, as well as the state's Attorney General and legislature, can and should take to protect individuals and companies who engage in oil and gas production.<sup>266</sup> More importantly, however, there are steps parties can take in drafting production agreements—and throughout the drilling and production process—to protect their interests in the event of subsequent litigation.<sup>267</sup>

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258. See generally *S & J Invs. v. Am. Star Energy & Minerals Corp.*, No. 07-07-0357-CV, 2008 WL 2669665 (Tex. App.—Amarillo July 8, 2008, pet. denied) (mem. op.) (discounting testimony that clearly demonstrated a number of wells were not producing).

259. Compare *id.* at \*1 (addressing a lease agreement that did not allow overhead from non-producing wells to be charged to the non-operator), with *Prize*, 345 S.W.3d at 565 (addressing a lease that was silent as to who was responsible for expenses from non-producing wells).

260. *S & J Invs.*, 2008 WL 2669665, at \*1–2.

261. *Id.* at \*2.

262. *Id.*

263. *Id.*

264. *Id.* at \*2–3. “The decision to exclude evidence at trial is committed to the trial court’s sound discretion.” *Id.* at \*2 (citing *Tex. Dep’t of Transp. v. Able*, 35 S.W.3d 608, 617 (Tex. 2000); *City of Brownsville v. Alvarado*, 897 S.W.2d 750, 753 (Tex. 1995)). “A trial court does not abuse its discretion in excluding evidence unless it acts without reference to guiding rules or principles or acts arbitrarily or unreasonably.” *Id.* (citing *Cire v. Cummings*, 134 S.W.3d 835, 838–39 (Tex. 2004)).

265. *Id.* at \*2.

266. See *infra* Part VI.A–B.

267. See *infra* Part VI.C.

*B. Problems Parties Face with Different Calculation Methods in Texas*

Similar to the lack of controlling case law addressing overhead expenses in Texas, case law addressing COPAS procedures shares the same scarcity.<sup>268</sup> As a result, courts face various problems relating to the different calculation methods parties use to account for a well's expenses.<sup>269</sup> Even in situations applying fixed rate or percentage basis calculation methods, which are relatively uniform, courts encounter difficulties adjudicating disputes.<sup>270</sup>

One factor parties often overlook is that the operating agreement and the accounting procedure are separate documents.<sup>271</sup> Typically, parties include the accounting procedure as an exhibit to the operating agreement.<sup>272</sup> Considering the operating agreement addresses *who* pays certain costs, the accounting procedure is a vital addition to the operating agreement because it specifies *how* parties classify the costs.<sup>273</sup> Because these are separate agreements, standard industry practice provides deference to the operating agreement when the two documents conflict.<sup>274</sup>

As discussed above, COPAS has developed a number of methods to calculate expenses accrued during drilling and production.<sup>275</sup> Though the COPAS methods themselves are relatively straight forward, confusion often arises as a result of the sheer number of COPAS accounting procedures.<sup>276</sup> Many of these methods go into great depth detailing calculation instructions; however, none of these COPAS methods are absolute, and they all give parties to an agreement considerable latitude to draft provisions conducive to their particular needs.<sup>277</sup> The main reason for the abundance of calculation methods is the oil and gas industry's constant state of evolution.<sup>278</sup> Because technology in the oil and gas industry continues to evolve at a rapid pace, the nature of an operator's expenses is in a constant flux; this is particularly relevant when determining which classification certain workers fall under and the varying sizes of many operators and parties.<sup>279</sup> Despite the large number of acceptable calculation methods, considering their common underlying goals, it logically

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268. See *supra* Part V.A.; cf. Bower et al., *supra* note 122, § V.C (explaining how relatively few reported cases involving COPAS exist).

269. See *infra* Part V.B.1–3.

270. See *infra* Part V.B.2–3.

271. See Bower et al., *supra* note 122, § I.C; Jolly, *supra* note 15, § 21.04(6).

272. See Bower et al., *supra* note 122, § I.C; Jolly, *supra* note 15, § 21.04(6).

273. See Bower et al., *supra* note 122, § I.A.

274. See *id.* § I.C; Jolly, *supra* note 15, § 21.04(6).

275. See, e.g., Bower et al., *supra* note 122, § III.A, M, P–Q; Jolly, *supra* note 15, § 21.04(6).

276. See Jolly, *supra* note 15, § 21.04(6).

277. *Id.* § 21.01; see also Bower et al., *supra* note 122, §§ I.G, III.A. (explaining that accounting procedures are designed to be flexible).

278. Bower et al., *supra* note 122, § I.G.

279. See *id.* §§ III.M, IV.G; Jolly, *supra* note 15, § 21.04(6) (describing the many reasons large and small operators accrue overhead over the duration of an operating agreement).

follows that a number of the same techniques, as well as problems, overlap between the different accounting methods.<sup>280</sup>

### 1. Allocation Method

Albeit a method COPAS no longer endorses, because almost all oil and gas accounting procedures derive from its principals, the allocation method is a logical starting point in analyzing different oil and gas accounting methods.<sup>281</sup> The allocation method first differentiates direct expenses—accrued in direct relation to a well—from indirect expenses.<sup>282</sup> These indirect expenses—including overhead—are necessary to operate the well but do not accrue in the well's general vicinity.<sup>283</sup> After differentiating between these items, the operator either deducts district expenses and applies a fixed rate deduction to recover administrative overhead and warehousing expenses, or combines the district, administrative, and warehouse expenses under a single rate.<sup>284</sup> Again, noting the expense categorization varies from lease to lease, courts encounter difficulties in determining whether operators can deduct expenses from their production and drilling costs when their lease is silent regarding such costs.<sup>285</sup>

Though a limited number of cases address the allocation method, *Patton v. Rogers* illustrates difficulties that arise when parties use an allocation method to calculate expenses.<sup>286</sup> In that case, Patton, the operator, entered into a production agreement with Rogers in 1962.<sup>287</sup> In 1965, Rogers brought suit against Patton, seeking to terminate their lease due to a lack of production in paying quantities on a particular well.<sup>288</sup> After Patton asserted the well in question realized a roughly \$40 per-month profit, Rogers testified the well's production was not in paying quantities because Patton's calculations excluded a number of direct expenses (including telephone bills) and overhead expenses (including road lease expenses, employee expenses, among others), which

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280. See Bower et al., *supra* note 122, §§ III.M–R, IV.G; Jolly, *supra* note 15, § 21.04(8). See generally Forté, *supra* note 15, § 21.05 (detailing problematic areas where operating agreements present the potential for operators to abuse non-operators).

281. Jolly, *supra* note 15, § 21.04(8)(b).

282. *Id.*

283. *Id.*

284. *Id.* District overhead expenses are costs of a general nature relating to drilling and production; these costs often relate to salaries for employees located in the district where the well is located. *Id.* Administrative overhead expenses are executive and administrative costs accruing at the operator's home, regional, or central office that have an indirect relationship to production. *Id.* Warehouse overhead compensates the operator for storage and handling costs. *Id.*

285. See *id.* § 21.01.

286. See *Patton v. Rogers*, 417 S.W.2d 470, 472 (Tex. Civ. App.—San Antonio 1967, writ ref'd n.r.e.). See generally *Texas v. Lone Star Gas Co.*, 129 S.W.2d 1164 (Tex. Civ. App.—Austin 1939), *modified*, 137 Tex. 279 (1941) (illustrating difficulties in retroactively determining overhead's application to an operating agreement's base rate).

287. *Patton*, 417 S.W.2d at 472.

288. *Id.*

indicated the wells were operating at a net loss.<sup>289</sup> In a non-jury trial, the lower court concluded the lease terminated due to provisions in the shut-in royalty clause.<sup>290</sup> In a brief analysis addressing expense calculation, the San Antonio Court of Appeals upheld the lower court's ruling, stating that when the additional direct and overhead expenses were properly deducted, the well was not producing in paying quantities.<sup>291</sup>

Despite the allocation method's status as the most accurate accounting method, today parties rarely incorporate it into their agreements due to its complex nature and the inherent ambiguities it entails.<sup>292</sup> Even if parties are less likely to encounter the allocation method, interest owners and operators continue to create needless disputes because they fail to understand that the allocation method's principles are still at play in other accounting procedures.<sup>293</sup> Though a seemingly common sense measure, many operators and interest owners continue to thoughtlessly adopt accounting procedures without analyzing what those procedures entail.<sup>294</sup> As a result, cases like *Patton* will likely not only continue to occur, but will also become more frequent as production in Texas continues to increase.<sup>295</sup>

## 2. Fixed Rate Basis

Currently the most common accounting method in the oil and gas industry, the fixed rate basis allows operators to combine district, administrative, and warehousing overhead under a single fixed rate; operators then deduct the resulting figure proportionately.<sup>296</sup> Under the fixed rate basis method, operators only recover expenses when a well is producing.<sup>297</sup> Because it relies on predetermined deduction rates, the fixed rate basis—unlike the allocation method—results in an unexact figure, which the operator deducts from its expenses.<sup>298</sup> Even with COPAS's widely applicable set of rules regarding the fixed method's application, issues still arise when courts adjudicate such disputes.<sup>299</sup> The most common type of dispute regarding fixed rate calculations involves adjusting a well's overall deduction rate on a yearly basis.<sup>300</sup> In 2012,

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289. *Id.* at 472, 475.

290. *Id.* at 472.

291. *Id.* at 475.

292. Jolly, *supra* note 15, § 21.04(8)(b).

293. *See infra* Part V.B.2–3.

294. *See infra* Part V.B.2–4.

295. *See Patton*, 417 S.W.2d at 472–75; *infra* Part V.B.2–4.

296. Jolly, *supra* note 15, § 21.04(8)(c).

297. Bower et al., *supra* note 122, § III.M.

298. *See Jolly*, *supra* note 15, § 21.04(8)(c).

299. *See infra* notes 300–21 and accompanying text.

300. *See infra* notes 301–22 and accompanying text.

the Fort Worth Court of Appeals addressed such a dispute in *Paint Rock Operating, LLC v. Chisholm Exploration, Inc.*<sup>301</sup>

In *Paint Rock*, Chisholm entered a joint operating agreement as the operator in 1998.<sup>302</sup> The agreement provided that the operator could charge non-operators for overhead expenses by deducting a predetermined sum—subject to annual readjustment—from each well in production.<sup>303</sup> Chisholm operated the wells, charging \$400 per month per well until 2005 when Chisholm transferred its position as operator to Paint Rock.<sup>304</sup> From 1998 to 2005, Chisholm never sought to adjust the \$400 rate.<sup>305</sup> After a short period where Paint Rock acted as the operator, Chisholm evaluated the joint interest billings it received from Paint Rock, finding several overhead expenses and attorney’s fees it believed Paint Rock improperly charged.<sup>306</sup> Rather than using the 2005 overhead figure to readjust the rate, Paint Rock adjusted the rate using figures based on an adjustment each year since 1998.<sup>307</sup> Relying heavily on COPAS, the court found Paint Rock erred in its calculation.<sup>308</sup> Under COPAS, an operator may adjust the overhead deduction every year on the first day of April.<sup>309</sup> Accordingly, the court held Paint Rock should have based its adjustment on the “increase or decrease in the average weekly earnings of Crude Petroleum and Gas Production Workers for the last calendar year.”<sup>310</sup> The court further held Paint Rock was only allowed to base its adjustment on the rate currently in effect.<sup>311</sup>

Another case revolving around a fixed rate’s validity is *Fossil Fuels, Inc. v. Hyde-Bower, Inc.*<sup>312</sup> This case is somewhat unique because the parties sought to determine whether a contract between their predecessors still governed production operations.<sup>313</sup> In 1977, Hyde-Bower’s predecessor entered an operating agreement in which his predecessor agreed to pay a \$150 per-month administrative overhead fee.<sup>314</sup> In 1986, Fossil Fuels took over as

301. See *Paint Rock Operating, LLC v. Chisholm Exploration, Inc.*, 339 S.W.3d 771, 773 (Tex. App.—Eastland 2011, no pet.).

302. *Id.*

303. *Id.*

304. *Id.* at 775.

305. *Id.* at 775–76.

306. *Id.*

307. *Id.*

308. *Id.* at 776.

309. See, e.g., *id.*

310. *Id.*

311. *Id.* “[T]he operator . . . may recalculate the rates as if they had been adjusted each year since the effective date. However, retroactive adjustments to the joint account for the revised overhead rates are limited to the current year plus the two prior years.” Bower et al., *supra* note 122, § II.D; see also *Hi-Mountain Energy Corp. v. Avra Oil Co.*, No. 08-00-00243-CV, 2002 WL 660891, at \*1, 7 (Tex. App.—El Paso Apr. 23, 2002, pet. denied) (holding an operator improperly applied COPAS standards when it increased monthly overhead charges from \$100 to \$300 per well).

312. See *Fossil Fuels, Inc. v. Hyde-Bower, Inc.*, No. 05-92-01461-CV, 1993 WL 189817, at \*1 (Tex. App.—Dallas June 3, 1993, no writ).

313. See *id.*

314. *Id.*



operator and began charging a \$450 per-month administrative overhead fee without disclosing the \$150 rate in effect up to that point.<sup>315</sup> In 1989, Hyde-Bower took over the mineral interest and began paying the \$450 per-month overhead charge.<sup>316</sup> When Hyde-Bower discovered the original agreement months later, it refused to pay the \$450 per-month fee.<sup>317</sup> Fossil Fuels appealed the trial court's finding that the original \$150 per-month rate was still in effect, arguing that the trial court relied on legally and factually insufficient findings to conclude the parties never modified the agreement.<sup>318</sup>

Before the Dallas Court of Appeals, Fossil Fuels first argued that Hyde-Bower validated the \$450 per-month rate through waiver and estoppel.<sup>319</sup> Disregarding Fossil Fuels raising these questions, the trial court never addressed the issue.<sup>320</sup> Reviewing the trial record, the court found Hyde-Bower did not validate the new rate because Fossil Fuels presented no evidence suggesting Hyde-Bower was aware of the lower rate when it entered the contract.<sup>321</sup> Rather, as soon as it learned of the previous contract, Hyde-Bower immediately refuted the \$450 rate in favor of the rate listed in the original contract.<sup>322</sup> The court went further in analyzing the agreement's contract component, finding that because it was undisputed that there was no consideration for the rise in the overhead rate, the new agreement was invalid.<sup>323</sup>

Unlike the allocation method—where the operator attempts to calculate and deduct the expenses exactly—the fixed rate basis yields an unexact, predetermined amount; there is an inherent guarantee that the non-operator will either overpay or be undercompensated.<sup>324</sup> Because operators only recover their expenses once a well begins production, non-operators often view the fixed rate basis as a cost-saving approach, neglecting to consider the opportunities this method provides operators to abuse the system.<sup>325</sup> Considering the wide potential for operator abuse, as demonstrated above, non-operators must take proper care to enter into agreements that protect their interests using the fixed rate basis.<sup>326</sup>

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315. *Id.*

316. *Id.*

317. *Id.* at \*1–2.

318. *Id.* at \*3–4.

319. *Id.*

320. *Id.*

321. *Id.*

322. *Id.*

323. *Id.* at \*4.

324. Jolly, *supra* note 15, § 21.04(8)(c).

325. *Id.* § 21.04(8)(c)–(d).

326. *See generally* Forté, *supra* note 15 (describing common situations in which operators abuse their governing accounting system to pass overhead costs on the non-operator).

### 3. Percentage Basis

Similar to the fixed rate basis, another method of accounting for production expenses is the percentage basis.<sup>327</sup> As previously noted, the fixed rate basis is the most widely accepted accounting procedure in the oil and gas industry; however, the percentage basis is the exclusive accounting method for offshore production; is the preferred method on the West Coast, Alaska, and Canada; and is becoming more popular in other areas around the country.<sup>328</sup> With the percentage basis method, the operator deducts expenses based upon a percentage of the value of the minerals produced.<sup>329</sup> This method allows for classification of different types of expenses and then provides for a deduction of a predetermined percentage of the value of the minerals produced to compensate the operator for each expense category.<sup>330</sup> Like other accounting methods, the most important function these provisions provide—and thus the basis of many disputes—is to classify costs as either direct expenses or overhead.<sup>331</sup> Considering that the percentage method is much more difficult to calculate than the fixed rate basis, calculating administrative, supervisory, and district overhead expenses can become a particularly contentious process.<sup>332</sup> Because some administrative expenses are inherent in executing an operating agreement, disputes tend to arise when these expenses appear to overlap between categories.<sup>333</sup>

Despite predating COPAS's existence, *Luling Oil & Gas Co. v. Humble Oil & Refining Co.* presents an analogous situation to common disputes that arise under the percentage method, wherein categories of administrative overhead expenses appear to overlap.<sup>334</sup> In that case, Luling entered into an operating agreement with Humble in 1928, designating Humble as the operator.<sup>335</sup> The agreement specified that Humble would provide Luling with a monthly accounting, which detailed the production costs and included a provision for overhead expenses:

No home office or overhead charge shall be made to the joint account in connection with the operation of said premises; but to cover bookkeeping, accounting and office expenses generally a charge on each well, while

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327. See Jolly, *supra* note 15, § 21.04(8)(c)–(d).

328. See *id.* § 21.04(8)(d); *supra* note 296.

329. See Jolly, *supra* note 15, § 21.04(8)(d).

330. *Id.*

331. *Id.* § 21.04(8)(b)–(d).

332. See, e.g., Lee Jones, Jr., *Problems Presented by Joint Ownership of Oil, Gas and Other Minerals*, 32 TEX. L. REV. 697, 725 (1954); see also Bower et al., *supra* note 122, § III.B (distinguishing different accounting procedure provisions). See generally *Luling Oil & Gas Co. v. Humble Oil & Ref. Co.*, 144 Tex. 475 (1945) (distinguishing overlapping expense categories).

333. See *Luling*, 144 Tex. at 475 (distinguishing overlapping expense categories); Bower et al., *supra* note 122, § III.B.

334. See *Luling*, 144 Tex. at 475.

335. *Id.* at 477.

actually drilling, of \$50.00 per month and a charge of \$25.00 per month on each producing well shall be made to the joint account, and to cover supervision and all other general and division overhead expenses a charge of \$25.00 per well on each producing well and \$50.00 per month on each drilling well shall also be made to the joint account.<sup>336</sup>

By 1942, Humble had completed over sixty wells under the agreement, some of which were not producing.<sup>337</sup> Luling brought suit, seeking to recover large sums of expenses for which Humble had not properly accounted.<sup>338</sup> The sums in question included \$345,567.86 and \$196,135.88, under the respective aforementioned clauses.<sup>339</sup> Luling claimed Humble double charged the \$196,135.88 figure under the contract's second clause because it also deducted the same expenses under the first clause, arguing it was, therefore, not liable to Humble for expenses accrued under the second clause.<sup>340</sup> After the trial court rendered a judgment favoring Luling, the Galveston Court of Civil Appeals reversed the decision in favor of Humble.<sup>341</sup> Reviewing the record, the Texas Supreme Court affirmed the court of appeals, finding Luling failed to show that the district expenses included overhead and that Humble properly applied its overhead to the contract's second clause.<sup>342</sup>

Like the fixed rate basis, because the percentage basis does not result in the exact amount of overhead expenses accrued during operations, using this method almost guarantees that either the non-operator will overpay or the operator will not recover a portion of its overhead expenses.<sup>343</sup> This problem is even more relevant with the percentage basis method because the calculation is based on the amount produced, creating a situation where operators stand to lose a significantly larger amount of their investment on non-producing wells.<sup>344</sup>

Because the relationship between operators and non-operators is, by nature, a contentious one, COPAS accounting procedures provide a top-notch resource for parties to reduce the risk of conflict by outlining a method to calculate expenses using a relatively straightforward set of formulas.<sup>345</sup> Considering the wide variance in different accounting procedures, it is essential for parties to adopt a procedure that is conducive to different factors present in their particular operating agreement.<sup>346</sup>

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336. *Id.* at 488.

337. *Id.* at 478–79.

338. *Id.* at 479.

339. *Id.* at 488.

340. *Id.* at 488–89.

341. *Id.* at 479.

342. *Id.* at 488–90.

343. See Bower et al., *supra* note 122, § III.B; Jolly, *supra* note 15, § 21.04(8)(d).

344. See Bower et al., *supra* note 122, § III.B; Jolly, *supra* note 15, § 21.04(8)(c)–(d).

345. See Bower et al., *supra* note 122, § I.G.

346. See Jolly, *supra* note 15, § 21.04(8)(c)–(d); see also Bower et al., *supra* note 122, §§ I.F–G, III (discussing various approaches to different factors present in operating agreements).

#### 4. Lease Provisions

An equally important step in negotiating the accounting process's parameters is drafting thorough lease agreements.<sup>347</sup> Selecting an accounting process that accommodates the parties' needs is essential to avoiding conflict; however, the accounting method provides little assistance in a situation where parties draft key lease provisions in an ambiguous or insufficient manner.<sup>348</sup> In fact, one could conclude that faulty lease provisions proximately caused the conflicts in many, if not all, of the aforementioned cases.<sup>349</sup> Because applying due diligence in drafting lease provisions is a seemingly common-sense prerequisite, the continued trend wherein parties adopt form lease agreements that provide no guidance as to specific elements at play in their endeavors is quite concerning.<sup>350</sup>

As mentioned above, one of the most contentious areas where lease provisions provide inadequate guidance appears in the habendum clause, which is often silent regarding overhead's application to the paying quantities formula.<sup>351</sup> Another common area of dispute involves provisions that do not adequately address which party is responsible for paying overhead on non-producing wells.<sup>352</sup> The risk of dispute in this situation is twofold.<sup>353</sup> First, conflicts can arise in determining which party bears the overhead costs for non-producing wells.<sup>354</sup> This raises questions as to whether the non-producing wells are speculative in nature or serve a beneficial purpose on the lease, which would negate the operator's responsibility to absorb those costs.<sup>355</sup> In some instances where there is no governing agreement, such disputes are unavoidable.<sup>356</sup>

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347. See Bower et al., *supra* note 122, § I.C.

348. See *id.*

349. See *supra* Part V.A-B.1-3.

350. See *supra* Part V.A-B.1-3.

351. See, e.g., *Skelly Oil Co. v. Archer*, 163 Tex. 336, 344-45 (1961) (judgment set aside Feb. 21, 1962); *Ladd Petroleum Corp. v. Eagle Oil & Gas Co.*, 695 S.W.2d 99, 107-08 (Tex. App.—Fort Worth 1985, writ ref'd n.r.e.); *Patton v. Rogers*, 417 S.W.2d 470, 475 (Tex. Civ. App.—San Antonio 1967, writ ref'd n.r.e.).

352. See, e.g., *Wagner & Brown, Ltd. v. Sheppard*, 282 S.W.3d 419, 424-25 (Tex. 2008); *Prize Energy Res., L.P. v. Cliff Hoskins, Inc.*, 345 S.W.3d 537, 562-67 (Tex. App.—San Antonio 2011, no pet.); *S & J Invs. v. Am. Star Energy & Minerals Corp.*, No. 07-07-0357-CV, 2008 WL 2669665, at \*1 (Tex. App.—Amarillo July 8, 2008, pet. denied) (mem. op.); *Neeley v. Intercity Mgmt. Corp.*, 732 S.W.2d 644, 645-47 (Tex. App.—Corpus Christi 1987, no writ).

353. See, e.g., *Wagner & Brown*, 282 S.W.3d at 424-25; *Prize*, 345 S.W.3d at 562-67; *S & J Invs.*, 2008 WL 2669665, at \*1; *Neeley*, 732 S.W.2d at 645; cases cited *infra* note 357.

354. See, e.g., *Wagner & Brown*, 282 S.W.3d at 424-25; *Prize*, 345 S.W.3d at 562-67; *S & J Invs.*, 2008 WL 2669665, at \*1; *Neeley*, 732 S.W.2d at 645.

355. See, e.g., *Wagner & Brown*, 282 S.W.3d at 424-25; *Prize*, 345 S.W.3d at 562-67; *Neeley*, 732 S.W.2d at 645.

356. See, e.g., *Wagner & Brown*, 282 S.W.3d at 424-25; *Prize*, 345 S.W.3d at 562-67; *Neeley*, 732 S.W.2d at 645.

Additionally, leases often fail to address situations where parties transfer or lose their interests.<sup>357</sup> In many cases, these disputes arise in a manner that is altogether unnecessary, considering that a meager amount of due diligence applied to a title search could have completely circumvented the dispute.<sup>358</sup> Relatedly, leases often cause disputes when they provide little guidance regarding rate adjustment throughout the lease's duration.<sup>359</sup> These situations are especially prevalent when a well progresses from the drilling phase into the production phase.<sup>360</sup> Finally, as a general matter, parties tend to adopt leases and accounting procedures that are silent as to classifying expenses.<sup>361</sup> These situations are notably rampant where the lease classifies different types of employees.<sup>362</sup>

Attempting to address every potential ambiguity that could arise over the course of an operating agreement is not only impractical, but is next to impossible; however, there is no reason parties should overlook areas where disputes have become prevalent.<sup>363</sup> In the same manner that a driver is highly unlikely to be involved in a life-threatening collision on any given day, the majority of operating agreements also start and end without facing a major controversy.<sup>364</sup> In the event of a dispute, however, incorporating the correct accounting process, coupled with thorough lease provisions, can substantially reduce a party's losses in the same way wearing a seatbelt during a serious collision can save a driver's life.<sup>365</sup>

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357. *Fasken Land & Minerals, Ltd. v. Occidental Permian Ltd.*, 225 S.W.3d 577, 581–82 (Tex. App.—El Paso 2005, pet. denied); *Fossil Fuels, Inc. v. Hyde-Bower, Inc.*, No. 05-92-01461-CV, 1993 WL 189817, at \*1 (Tex. App.—Dallas June 3, 1993, no writ).

358. See JOSEPH SHADE & RONNIE BLACKWELL, *PRIMER ON THE TEXAS LAW OF OIL & GAS* 100–04 (LexisNexis, 5th ed. 2013).

359. See, e.g., *Paint Rock Operating, LLC v. Chisholm Exploration, Inc.*, 339 S.W.3d 771, 775–77 (Tex. App.—Eastland 2011, no pet.); *Hi-Mountain Energy Corp. v. Avra Oil Co.*, No. 08-00-00243-CV, 2002 WL 660891, at \*1–3 (Tex. App.—El Paso Apr. 23, 2002, pet. denied).

360. See, e.g., *Luling Oil & Gas Co. v. Humble Oil & Ref. Co.*, 144 Tex. 475, 488–89 (1945).

361. See *supra* Part V.B.

362. See *BoMar Oil & Gas, Inc. v. Loyd*, No. 10-08-00016-CV, 2009 WL 2136404, at \*5–7 (Tex. App.—Waco July 15) (mem. op.), *modified*, 298 S.W.3d 832 (Tex. App.—Waco 2009, pet. denied); *Poynor Corp. v. McFarlin*, No. 01-91-00091-CV, 1992 WL 69225, at \*4 (Tex. App.—Houston [1st Dist.] Apr. 9, 1992, no writ); *Texas v. Lone Star Gas Co.*, 129 S.W.2d 1164, 1180–81 (Tex. Civ. App.—Austin 1939), *modified*, 137 Tex. 279 (1941).

363. See Bower et al., *supra* note 122, § I.A–D.

364. See *Exxon Mobil Corp (XOM US Equity)*, BLOOMBERG L., <http://www.bloomberglaw.com/company/ticker/XOM%20US%20Equity?toYear=2014&circuitCourts=false&subsidiaries=true&frequency=annual&caseType=> (last visited Sept. 26, 2014) [hereinafter BLOOMBERG]; *Comparison of Motor Vehicle Traffic Deaths, Vehicle Miles, Death Rates, and Economic Loss 2003–2012*, TEX. DEPARTMENT TRANSP. (2013) [hereinafter TEX. DEPARTMENT TRANSP.], available at [http://ftp.dot.state.tx.us/pub/txdot-info/trf/crash\\_statistics/2012/comparisons.pdf](http://ftp.dot.state.tx.us/pub/txdot-info/trf/crash_statistics/2012/comparisons.pdf). Between 2003 and 2012, there was an average of 1.41 fatalities per every 100,000,000 miles traveled on Texas roads. TEX. DEP'T TRANSP., *supra*. Just as rare, in 2011, Exxon Mobil—number two on the Fortune 500 list—and its subsidiaries only engaged in federal litigation on 324 occasions. BLOOMBERG, *supra*; *Fortune 500 2011*, FORTUNE, [fortune.com/fortune500/2011/exxon-mobile-corporation-2/](http://fortune.com/fortune500/2011/exxon-mobile-corporation-2/) (last visited Sept. 20, 2014). Even more remarkable, however, is the fact that of those 324 cases, 256 were brought on the basis of asbestos exposure, not operating disputes. BLOOMBERG, *supra*.

365. See sources cited *supra* note 364.

VI. PRODUCING THE MINERALS: CLEANING UP THE MESS TEXAS COURTS,  
MINERAL OWNERS, AND OPERATORS HAVE MADE

Considering the ambiguities within Texas's judicial system regarding overhead expenses, there are a number of steps state officials can take to aid Texas courts.<sup>366</sup> In addition to intervention and clarification from the Texas Supreme Court, the Texas Legislature, Attorney General, and Railroad Commission can also play important roles in helping Texas become an even stronger player in the global energy market.<sup>367</sup> If owners and operators want to see actual improvements, however, Austin, Texas, is not the only place where changes have to occur.<sup>368</sup>

In addition to governmental improvements, individual parties must begin approaching pre-production negotiations in a much more proactive manner by attempting to clarify potential ambiguities and address potential issues in areas where conflict is known to arise.<sup>369</sup> Parties should also analyze the nature and scope of their agreements by adopting lease provisions and accounting procedures that reflect the unique elements at play in their particular operation.<sup>370</sup> Considering Texas has traditionally been a leader in oil and gas production, to continue leading the way towards energy independence in the United States, everyone involved in the energy sector—from mineral owners, to operators, to the legislature—must do their part in addressing problems within our judicial system.<sup>371</sup>

A. Courts

*“It is the highest form of self-respect to admit our errors and mistakes and make amends for them. To make a mistake is only an error in judgment, but to adhere to it when it is discovered shows infirmity of character.”*<sup>372</sup>

Because the ambiguities parties face in litigating overhead disputes are judicial in nature, any solution should logically start within the courts; however, solving these problems extends to other entities as well.<sup>373</sup> In addition to courts revising their litigation procedures, the Texas Supreme Court, Attorney General, legislature, and Railroad Commission should all take notice of the

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366. See *infra* Part VI.A.

367. See *infra* Part VI.A.

368. See *infra* Part VI.B.

369. See *infra* Part VI.B.

370. See *infra* Part VI.B.

371. See *supra* Part II.A.

372. Dale Turner Quotes, BRAINYQUOTE, [http://www.brainyquote.com/quotes/authors/d/dale\\_turner.html](http://www.brainyquote.com/quotes/authors/d/dale_turner.html) (last visited Sept. 20, 2014).

373. See *infra* Part VI.A–C.



problems existing within the realm of overhead expenses and take action to provide solutions that will aid one of our state's most important industries.<sup>374</sup>

First, Texas courts should abandon their existing trend of giving more deference to trial court holdings than they give to binding precedent from higher courts.<sup>375</sup> Courts, however, must take great care in this undertaking to apply precedent in a manner where they do not expand upon, broaden, or interpret precedent in a presumptive or hypothetical manner.<sup>376</sup> Accordingly, when courts encounter issues where the only available precedent is either outdated or does not directly address the questions at hand, Texas courts should be receptive to applying precedent from other states, federal courts, and secondary sources that provide guidance to the issues they are adjudicating.<sup>377</sup> Conversely, when courts encounter an issue where there is ample precedent, they must apply more due diligence in reviewing each case cited by the parties before reaching a conclusion, rather than reaching a conclusion and selectively applying precedent that fits their holding.<sup>378</sup> In that regard, parties to operating agreements should incorporate proactive measures into their agreements to reduce factual ambiguities in the event of subsequent litigation.<sup>379</sup>

In addition to lower courts' efforts to improve the culture within our judicial system, the Texas Supreme Court and Attorney General should also take action to modify the standard of review in cases involving overhead expenses.<sup>380</sup> Moreover, the Texas Legislature should enact statutes that provide judges and attorneys with resources to assist them in applying complicated accounting principles to overhead disputes.<sup>381</sup> Together, these steps can make Texas a state that is even more conducive to oil and gas production.

### I. Archer and Ladd

Under a broad view of the American judicial system, a unique pattern emerges wherein our laws evolve through an unwavering precept called the

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374. See *supra* Part VI.A.

375. See *infra* Part VI.A.1–3. See generally, e.g., *Prize Energy Res., L.P. v. Cliff Hoskins, Inc.*, 345 S.W.3d 537 (Tex. App.—San Antonio 2011, no pet.) (discounting strong evidence contradicting the court's holding); *S & J Invs. v. Am. Star Energy & Minerals Corp.*, No. 07-07-0357-CV, 2008 WL 2669665 (Tex. App.—Amarillo July 8, 2008, pet. denied) (mem. op.) (discounting testimony that clearly demonstrated a number of wells were not producing).

376. See *infra* Part VI.A.1–3; e.g., *Prize*, 345 S.W.3d at 562–67 (expanding *Wagner & Brown*'s holding in a hypothetical manner).

377. See *Skelly Oil Co. v. Archer*, 163 Tex. 336, 344–46 (1961) (judgment set aside Feb. 21, 1962) (quoting *Cage*, *supra* note 188, at 61); *Ladd Petroleum Corp. v. Eagle Oil & Gas Co.*, 695 S.W.2d 99, 108 (Tex. App.—Fort Worth 1985, writ ref'd n.r.e.) (adopting *Mason v. Ladd Petroleum Corp.*, 630 P.2d 1283, 1285 (Okla. 1981)); *infra* Part VI.A.1.

378. See *infra* Part VI.A.2–3. But see *Prize*, 345 S.W.3d at 563–64 (declining to sufficiently address *Neeley v. Intercity Mgmt. Corp.*, 732 S.W.2d 644, 645–48 (Tex. App.—Corpus Christi 1987, no writ), despite the fact that *Neeley* directly addressed the issues *Prize* sought to adjudicate).

379. See *infra* notes 421–30 and accompanying text.

380. See *infra* Part VI.A.3.

381. See *infra* Part VI.B.

doctrine of stare decisis.<sup>382</sup> This doctrine simultaneously binds our courts to established precedent, while also allowing courts to modify existing authority that is not founded on sound principles or that has become outdated.<sup>383</sup> One of the fundamentals in maintaining the American judicial system's integrity through this doctrine is the concept that a court yields its authority to higher courts.<sup>384</sup> In addition to their obligation to apply higher courts' precedent in an accurate manner, courts also have an obligation to abandon precedent higher courts have set aside, overturned, or abrogated.<sup>385</sup> This principle provides a crucial mechanism, allowing our laws to evolve in a manner that does not create contradiction, and thus, confusion.<sup>386</sup>

In that light, *Archer's* ongoing application in Texas courts represents a travesty that undermines the very principles upon which our judicial system was established.<sup>387</sup> The most problematic (and puzzling) element in *Archer's* ongoing application is the contradictory line of cases that—rather than replace *Archer*—coexist with *Archer*, creating conflicting strings of precedent that attorneys and courts apply and adopt at will.<sup>388</sup> Because many Texas courts have shown no hesitancy in applying *Archer*, any solution to this problem must likely originate outside the state's judicial system.<sup>389</sup> For this reason, the Texas Railroad Commissioner should request an Attorney General's Opinion on the subject, encouraging courts to dissociate *Archer* from their adjudications, and instead begin applying *Ladd's* precedent to cases dealing with overhead expense calculations.<sup>390</sup>

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382. See generally Caleb Nelson, *Stare Decisis and Demonstrably Erroneous Precedents*, 87 VA. L. REV. 1 (2001) (describing trends where courts fail to correctly apply the doctrine of stare decisis).

383. See *id.* at 2–4.

384. See *id.*

385. See *id.*

386. See *id.*

387. See *Skelly Oil Co. v. Archer*, 163 Tex. 336, 336 (1961) (judgment set aside Feb. 21, 1962); see also *Abraxas Petroleum Corp. v. Hornburg*, 20 S.W.3d 741, 756 (Tex. App.—El Paso 2000, no pet.) (applying *Archer* to determine the extent of a well's production); *Peacock v. Schroeder*, 846 S.W.2d 905, 908–09 (Tex. App.—San Antonio 1993, no writ) (applying *Archer* to support the appellant's failure to prove that wells were not producing in paying quantities); *Pshigoda v. Texaco, Inc.*, 703 S.W.2d 416, 418 (Tex. App.—Amarillo 1986, writ ref'd n.r.e.) (holding that an analysis under *Archer's* framework can resolve the issue); *Patton v. Rogers*, 417 S.W.2d 470, 474 (Tex. Civ. App.—San Antonio 1976, writ ref'd n.r.e.) (applying *Archer* to determine the amount of production in paying quantities); Nelson, *supra* note 382, at 2–4 (criticizing conventional wisdom that finding factual error is insufficient to ignore an underlying court's decision).

388. Compare *BoMar Oil & Gas, Inc. v. Loyd*, No. 10-08-00016-CV, 2009 WL 2136404, at \*6–7 (Tex. App.—Waco July 15) (mem. op.), *modified*, 298 S.W.3d 832 (Tex. App.—Waco 2009, pet. denied) (declining to follow *Archer*), *Ladd Petroleum Corp. v. Eagle Oil & Gas Co.*, 695 S.W.2d 99, 108 (Tex. App.—Fort Worth 1985, writ ref'd n.r.e.) (declining to follow *Archer*), *with Archer*, 163 Tex. at 336, *Abraxas*, 20 S.W.3d at 756 (following *Archer*), *Peacock*, 846 S.W.2d at 908–09 (following *Archer*), *Pshigoda*, 703 S.W.2d at 418 (following *Archer*), and *Patton*, 417 S.W.2d at 474 (following *Archer*).

389. See *supra* Part V.A.I; *supra* notes 387–81.

390. *About Attorney General Opinions*, ATT'Y GEN. TEX.: GREG ABBOTT, <https://www.oag.state.tx.us/opin/> (last revised Oct. 2, 2013) [hereinafter *Attorney General Opinions*]. The Texas Constitution allows the state's Attorney General to issue Attorney General Opinions addressing questions of law. *Id.*; see also TEX. GOV'T CODE ANN. §§ 402.042–.043 (West 2013 & Supp. 2014) (declaring the Attorney General's authority to issue opinions and outlining the parameters of requesting an opinion). Attorney General Opinions

Although this Comment presents *Archer* in a largely negative light, *Archer* does contribute one positive principle the Attorney General Opinion should not only commend, but also encourage Texas courts to expand upon.<sup>391</sup> Notwithstanding the Texas Supreme Court setting *Archer* aside in 1962, the court's analysis in the case was notably thorough.<sup>392</sup> In addressing how overhead expenses should be applied to the producing in paying quantities calculation, rather than adhering exclusively to Texas's sparse case law on the subject, the court relied heavily upon persuasive authority to reach its conclusion.<sup>393</sup> Because such persuasive authority can be immensely helpful in analogous situations, any Attorney General Opinion on this subject should encourage courts to adopt persuasive authority from federal courts, other states, and secondary sources.<sup>394</sup>

Because each state's laws often address oil and gas law differently, Texas courts should adopt case law from states with similar laws to its own.<sup>395</sup> Despite Oklahoma's wealth of case law addressing oil and gas disputes, Texas's and Oklahoma's laws diverge on many issues.<sup>396</sup> For that reason, Texas courts should first look to states like Kansas and New Mexico for persuasive authority, applying Oklahoma, California, and Louisiana precedent as an alternative.<sup>397</sup>

## 2. Prize Energy Resources, L.P. v. Cliff Hoskins, Inc.

In addition to adopting case law that is no longer applicable, Texas courts have also developed a dangerous trend in misapplying, or erroneously expanding upon, case law when addressing overhead calculations.<sup>398</sup> The

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address the manner in which courts interpret existing laws; however, they cannot create new provisions or effects of the law, resolve questions of fact, or address pending litigation. *Attorney General Opinions, supra*. Though Attorney General Opinions ultimately fall within a court's purview, these opinions are "highly persuasive and are entitled to great weight." *Id.* Because the Attorney General is not permitted to unilaterally issue these opinions, a designated state official must request that the Attorney General issue an opinion on the legal question in dispute. *Id.* During the course of drafting the opinion, the Attorney General and his staff review briefs from the requesting party and any other party who may submit briefs on the subject. *Id.*

391. *See Archer*, 163 Tex. at 344–45.

392. *See id.*

393. *See id.* at 344–46 (citing *Whitaker v. Texaco, Inc.*, 283 F.2d 169, 176 (10th Cir. 1960)) (referencing *Cage, supra* note 188, at 61).

394. *See, e.g., id.*; *Ladd Petroleum Corp. v. Eagle Oil & Gas Co.*, 695 S.W.2d 99, 108 (Tex. App.—Fort Worth 1985, writ ref'd n.r.e.) (citing *Mason v. Ladd Petroleum Corp.*, 630 P.2d 1283, 1285 (Okla. 1981)); *see also United Cent. Oil Corp. v. Helm*, 11 F.2d 760, 760 (5th Cir. 1926) (adjudicating a Texas dispute involving overhead expense calculations in federal court). *See generally Hondo Oil & Gas Co. v. Tex. Crude Operator, Inc.*, 970 F.2d 1433 (5th Cir. 1992) (adjudicating a Texas dispute involving overhead expense calculations in federal court).

395. *Cf. JOHN S. LOWE ET AL., CASES AND MATERIALS ON OIL AND GAS LAW* 54–56 (6th ed. 2013) (citing EUGENE KUNTZ, A TREATISE ON THE LAW OF OIL AND GAS § 2.4 (1987)) (describing different theories of oil and gas ownership).

396. *See id.*

397. *See id.*

398. *See supra* Part V.A.2.

aforementioned *Prize* case provides a notable example of this troubling tendency.<sup>399</sup> In *Prize*, rather than applying *Wagner & Brown* in light of the principles that case presented, the San Antonio Court of Appeals expanded *Wagner & Brown*'s holding and applied the case in the context it presumed the Texarkana Court of Appeals, and later the Texas Supreme Court, intended.<sup>400</sup> Moreover, despite the fact that Hoskins raised the case on appeal, the San Antonio court neglected to sufficiently address *Neeley*, a case where the well-by-well approach was directly on point.<sup>401</sup> Viewing the case objectively, it appears the San Antonio court first reached its conclusion, then selectively applied case law to justify its holding.<sup>402</sup> This trend is particularly problematic considering the meager amount of case law addressing overhead calculations in Texas.<sup>403</sup>

Due to the controversial nature in which the San Antonio Court of Appeals applied *Wagner & Brown*—neglecting to adopt *Neeley*—the Texas Supreme Court should take action in clarifying the principles *Prize* established.<sup>404</sup> There are two manners in which the court could address the issue.<sup>405</sup> First, the Texas Supreme Court should thoroughly review its holding in *Wagner & Brown* when adjudicating future cases where parties raise *Wagner & Brown*, *Neeley*, or *Prize*.<sup>406</sup> Under such a review, the court should address not only the extent to which *Wagner & Brown* is applicable, but also *Prize*'s interpretation of *Wagner & Brown*.<sup>407</sup> Accordingly, the court should make a determination as to whether it should modify, or completely set aside, the San Antonio court's opinion in *Prize*.<sup>408</sup>

Considering the hypothetical nature of a situation where the Supreme Court could review *Prize*'s application of *Wagner & Brown*, the court could also take a more pragmatic approach in evaluating *Wagner & Brown*'s application in *Prize*.<sup>409</sup> Under this solution, the court should use the same analysis suggested above to issue an advisory opinion addressing the manner in which *Prize*'s application should proceed in Texas courts.<sup>410</sup>

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399. See generally *Prize Energy Res., L.P. v. Cliff Hoskins, Inc.*, 345 S.W.3d 537 (Tex. App.—San Antonio 2011, no pet.) (relying on *Wagner & Brown, Ltd. v. Sheppard*, 198 S.W.3d 369, 421–29 (Tex. App.—Texarkana 2006), *rev'd*, 282 S.W.3d 419 (Tex. 2008)).

400. See *id.* at 562–67.

401. See *id.* at 563 (declining to address *Neeley v. Intercity Mgmt. Corp.*, 732 S.W.2d 644, 645–48 (Tex. App.—Corpus Christi 1987, no writ)).

402. See *id.* at 562–67.

403. See *supra* notes 174–78.

404. See *Prize*, 345 S.W.3d at 562–67 (relying on *Wagner & Brown*, 198 S.W.3d at 421–29, but declining to address *Neeley*, 732 S.W.2d at 645–48); *infra* notes 407–10.

405. See *infra* notes 407–10 and accompanying text.

406. See *Prize*, 345 S.W.3d at 562–67 (relying on *Wagner & Brown*, 198 S.W.3d at 421–29, but declining to address *Neeley*, 732 S.W.2d at 645–48).

407. See *id.*

408. See generally *id.* (relying on *Wagner & Brown*, 198 S.W.3d at 421–29).

409. See *id.*; *supra* notes 404–08 and accompanying text.

410. See *Prize*, 345 S.W.3d at 562–67; *supra* notes 404–08.

### 3. Standard of Review

Similar to the conflicting lines of precedent established in *Archer* and *Ladd*, Texas courts have shown no indication that they will address problems that the standard of review presents in cases involving overhead calculations.<sup>411</sup> Though Texas appellate courts properly defer to trial courts' findings of fact, they should not always extend this deference to the manner in which trial courts reach their determinations of fact.<sup>412</sup> Courts often cite *Fossil Fuels, Inc. v. Hyde-Bower, Inc.*, for example, in regards to the standard of review courts apply to oil and gas cases.<sup>413</sup> That case illustrates the rule that an appellate court should treat a trial court's findings with deference when there is "more than a scintilla" of evidence supporting those findings.<sup>414</sup> This standard establishes a system that is friendly to parties who have more assets and resources to apply to litigation—most often the operator.<sup>415</sup> The potential for abuse under this standard of review is particularly prevalent in cases involving expert witness testimony.<sup>416</sup>

Due to the relative uniformity in the standards of review Texas courts apply to these situations, the potential for abuse these standards present is another subject warranting an Attorney General Opinion.<sup>417</sup> This Opinion should first place emphasis on the trial court's role as the sole finder of fact, proposing changes to the manner in which appellate courts evaluate the analysis trial courts apply in arriving at their conclusions.<sup>418</sup> Specifically, this Attorney General Opinion should promote a requirement that appellate courts evaluate cases where material facts clearly establish a conclusion contradictory to the trial court's holding, as was the case in *S & J Invs.*<sup>419</sup> Additionally, an Attorney

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411. See *supra* Part V.A.1.

412. See *Fossil Fuels, Inc. v. Hyde-Bower, Inc.*, No. 05-92-01461-CV, 1993 WL 189817, at \*2 (Tex. App.—Dallas June 3, 1993, no writ) (citing *Stafford v. Stafford*, 726 S.W.2d 14, 16 (Tex. 1987); *Aerospatiale Helicopter Corp. v. Universal Health Servs., Inc.*, 778 S.W.2d 492, 496 (Tex. App.—Dallas 1989, writ denied)).

413. *Id.*

414. *Id.* (emphasis omitted).

415. See Forté, *supra* note 15, § 21.06 (addressing solutions to operator abuse through operating agreements).

416. See, e.g., *Prize Energy Res., L.P. v. Cliff Hoskins, Inc.*, 345 S.W.3d 537, 564–65 (Tex. App.—San Antonio 2011, no pet.) (allowing the operator to deduct overhead expenses accruing on nonproducing wells because the operator's expert witness testified that the wells served a beneficial purpose despite strong contradictory evidence presented in the opposing witness's testimony); *S & J Invs. v. Am. Star Energy & Minerals Corp.*, No. 07-07-0357-CV, 2008 WL 2669665, at \*2–3 (Tex. App.—Amarillo July 8, 2008, pet. denied) (mem. op.) (finding that wells were producing in paying quantities despite expert testimony from a Texas Railroad Commission inspector who stated it was impossible for some of these wells to have been in production during at least part of the time period in question due to rust build-up on the wellheads).

417. See *supra* note 390.

418. See, e.g., *Fossil Fuels*, 1993 WL 189817, at \*2 (citing *Stafford v. Stafford*, 726 S.W.2d 14, 16 (Tex. 1987); *Aerospatiale Helicopter Corp. v. Universal Health Servs., Inc.*, 778 S.W.2d 492, 496 (Tex. App.—Dallas 1989, writ denied)).

419. See *S & J Invs.*, 2008 WL 2669665, at \*2–3.

General Opinion should encourage courts to give great deference to Texas Railroad Commission witnesses testifying in cases like *S & J Invs.*<sup>420</sup>

An additional solution lies within the purview of the parties to an operating agreement.<sup>421</sup> Despite the fact that the chances of litigating operating agreement disputes are relatively small, if parties take steps to ease the manner in which disputes will eventually be resolved, it could potentially pay massive dividends.<sup>422</sup> A common-sense approach parties can take to reduce uncertainty in adjudicating disputes involving overhead expenses is to proactively draft a lease provision designating an unbiased inspector whom the parties find mutually agreeable.<sup>423</sup> Such inspectors would begin conducting inspections before drilling ever begins, periodically returning to inspect the leased property throughout the operating agreement's duration.<sup>424</sup> In the event of litigation, the inspectors would act as expert witnesses, testifying to their findings during inspections.<sup>425</sup> Adopting such a lease provision in an agreement could substantially reduce questions of fact and conflicting testimony between experts in the event of subsequent litigation.<sup>426</sup> Though courts would ideally view such testimony with great deference, the scope of the witness's area of expertise should be clearly defined in the operating agreement.<sup>427</sup> Moreover, such a provision should not act to preempt testimony from other witnesses addressing questions in areas the lease does not designate to fall within the inspector's findings.<sup>428</sup> Additionally, such a lease provision would not bar other expert witnesses from testifying at trial, so long as their testimony has a reasonable basis.<sup>429</sup>

Reviewing *S & J Invs.* and *Prize*, it is easy to see how the aforementioned Attorney General Opinion, coupled with the proposed lease provision, would have greatly reduced the substantial ambiguities these cases have created.<sup>430</sup>

### B. Legislative Action

One of the Texas Legislature's main functions is to "achieve fairness . . . by functioning in ways that do not systematically provide unfair advantages

420. *See id.*

421. *See infra* notes 422–29 and accompanying text.

422. *See supra* note 364.

423. *But see S & J Invs.*, 2008 WL 2669665, at \*2–3 (discounting testimony from a Texas Railroad Commission official who inspected the leased premises after litigation commenced).

424. *But see id.*

425. *But see id.*

426. *See Prize Energy Res., L.P. v. Cliff Hoskins, Inc.*, 345 S.W.3d 537, 564–65 (Tex. App.—San Antonio 2011, no pet.) (allowing the operator to deduct overhead expenses accruing on nonproducing wells because the operator's expert witness testified that the wells served a beneficial purpose despite strong contradictory evidence presented in the opposing witness's testimony). *But see S & J Invs.*, 2008 WL 2669665, at \*2–3.

427. *But see S & J*, 2008 WL 2669665, at \*2–3.

428. *But see id.*

429. *But see id.*

430. *See Prize*, 345 S.W.3d at 564–65; *S & J Invs.*, 2008 WL 2669665, at \*2–3.



to particular interests.”<sup>431</sup> Considering the complicated nature of COPAS procedures, and the resulting difficulties courts have in applying these principles in litigation, the Texas Legislature should act to provide clarification on COPAS’s application to litigation.<sup>432</sup> The legislature could achieve such clarification in one of two ways.<sup>433</sup> First, the State of Texas could reach out to COPAS, requesting that it draft a guidebook to help courts and attorneys navigate litigation in applying COPAS formulas.<sup>434</sup> If reaching out to COPAS to draft such a guide is for some reason infeasible, Texas could request that the Texas Railroad Commission form a taskforce to draft its own guide.<sup>435</sup> In addition to providing step-by-step instructions for applying each COPAS formula, a Texas COPAS litigation guide would also designate default formulas and rules for leases that are ambiguous or silent on certain provisions.<sup>436</sup> Though a seemingly daunting task, because our current judicial system does not sufficiently protect the interests of parties to an operating agreement, the State of Texas must begin taking steps to improve this issue within the oil and gas industry.<sup>437</sup>

### C. Avoiding Disputes Through Pre-Operating Negotiations

*“The non-operator reads the COPAS, which Abe Lincoln would say is of the operator, by the operator, and for the operator.”*<sup>438</sup>

It is a well-established principle in Texas oil and gas law that “an operator should neither gain nor lose just because he is the operator.”<sup>439</sup> Because the operator is the party who physically executes all phases of production—making them the party accruing all the overhead expenses—any abuse would logically come as a result of their actions.<sup>440</sup> When faced with allegations of abuse, operators typically defend their actions by claiming the lease authorizes such behavior.<sup>441</sup> It is typically the operator’s use of these provisions, however, which allows COPAS to become “the operator’s license to steal.”<sup>442</sup>

Considering this inherent potential for abuse, parties to operating agreements should engage in pre-production negotiations to reduce the

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431. The Univ. of Tex. at Austin, Liberal Arts Instructional Tech. Servis., *The Legislative Branch*, TEX. POL. (3d ed., Jan. 9, 2014), available at [www.laits.utexas.edu/txp\\_media/html/leg/0205.html](http://www.laits.utexas.edu/txp_media/html/leg/0205.html).

432. See *supra* Parts IV.A, V.B.

433. See *infra* notes 434–37 and accompanying text.

434. See *supra* Part IV.A (explaining the various accounting procedures used to calculate overhead expenses).

435. See *supra* Part IV.A.

436. See *supra* Part IV.A.

437. See *supra* Part VI.A.1–3.

438. Forté, *supra* note 15, § 21.02.

439. Jolly, *supra* note 15, § 21.05(1).

440. See Forté, *supra* note 15, § 21.01.

441. *Id.*

442. *Id.*

likelihood of a dispute.<sup>443</sup> Because negotiations are intended to reduce ambiguity and clearly define the agreement's parameters, "the goal in any negotiation should be equity."<sup>444</sup> Non-operators, however, must also closely monitor operations under their agreement during all stages of production to ensure the operator adheres to the operating agreement's terms.<sup>445</sup> By proactively approaching pre-production negotiations, and subsequently ensuring that parties abide by the operating agreement's terms throughout production, parties can greatly reduce the likelihood of litigation.<sup>446</sup>

### *1. Analyze and Select the Ideal Calculation Method*

The first step parties should take during negotiations is to select the accounting method that best suits their particular needs.<sup>447</sup> Currently, COPAS procedures are a model form in which parties fill in the blanks to select provisions that will govern the operating agreement.<sup>448</sup> Because some provisions rarely come into play, and because it is difficult to predict every question that could arise, there are a number of procedures COPAS forms do not address.<sup>449</sup> Parties should also be cognizant of the COPAS default rules.<sup>450</sup> Under these rules, any provision the parties leave blank automatically adopts the first option on the form.<sup>451</sup> Considering the areas COPAS forms do not address, coupled with COPAS's default rules, parties should take great care when selecting the manner in which they draft their COPAS agreements to ensure that the selected provisions accommodate any unique circumstances at play in the operating agreement.<sup>452</sup>

Perhaps the most important decision parties make in drafting their accounting procedure is determining whether the fixed rate basis or the percentage basis will govern the agreement.<sup>453</sup> The first question operators should ask before addressing this decision is whether their accountants are familiar with the calculation method they plan to implement.<sup>454</sup> The parties should then evaluate the advantages and drawbacks the two methods present.<sup>455</sup>

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443. *See id.* § 20.05.

444. *Id.* § 21.05.

445. *See infra* Part VI.C.3.

446. *See infra* Part VI.C.1–3.

447. *See supra* Part V.B.1–3.

448. *See* Bower et al., *supra* note 122, § III.A.

449. *Id.*

450. *See id.*

451. *Id.* § III.B.

452. *Cf. id.* § III.A (recommending users take their operational needs into account when filling out accounting forms).

453. *See supra* Part V.B.2–3.

454. *See* Jolly, *supra* note 15, §§ 21.01, 21.04(3).

455. *See infra* notes 456–60.

As noted above, the fixed rate basis is the most popular accounting procedure for onshore drilling.<sup>456</sup> Under this method, the operator may only charge overhead on producing wells.<sup>457</sup> Many operators prefer this method, however, because it is easier to administer.<sup>458</sup> The fixed rate method is also popular amongst many non-operators because, in many cases, it reduces the overall amount of overhead expenses.<sup>459</sup> In applying a ratio to deduct overhead expenses under the fixed rate basis, parties should keep in mind that a gas well will typically incur more overhead expenses than an oil well.<sup>460</sup> Similarly, parties should consider the potential well's depth, taking into account that overhead expenses proportionately increase as the well extends deeper.<sup>461</sup> Parties should also clearly define the manner in which the operator deducts expenses for on-site and off-site employees, as the fixed rate basis form does not address such expenses without additional provisions.<sup>462</sup> In that light, the non-operator should have several goals in negotiating the rate base the operator uses to deduct overhead expenses under the fixed rate basis.<sup>463</sup> These goals should include the following: trying to negotiate a lower rate than the national average, including a provision requiring the operator to re-evaluate the rate base each year according to the changing economic environment, and applying a lower rate to gas wells than the rate applied to oil wells.<sup>464</sup>

Unlike the fixed rate basis, where the operator can only deduct overhead expenses on producing wells, the percentage basis allows operators to deduct overhead expenses as soon as they begin accruing costs related to operations.<sup>465</sup> This method is particularly appealing to operators in situations where drilling and production operations will not commence immediately.<sup>466</sup> This method also allows the operator to deduct overhead expenses on shut-in wells, unlike the fixed rate basis.<sup>467</sup> Additionally, the percentage basis can be beneficial to both parties as it is more likely to accurately reflect inflation and deflation.<sup>468</sup> One drawback to using the percentage basis, however, is that it is considerably more complex than calculating expenses using the fixed rate basis.<sup>469</sup> Additionally, the percentage basis has been subject to criticism because many

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456. Bower et al., *supra* note 122, § III.M; Jolly, *supra* note 15, § 21.04(8); *see supra* Part V.B.2.

457. *See* Bower et al., *supra* note 122, § III.M.

458. *Id.*

459. *Id.*

460. *Id.* § III.P. COPAS strongly discourages implementing commercially published survey rates into its agreements because these rates do not take a party's organizational structure into consideration. Jolly, *supra* note 15, § 21.04(8)(c)–(d). These commercially published survey rates typically provide unjust benefits to the operator. Forté, *supra* note 15, § 21.05.

461. *See* Bower et al., *supra* note 122, § III.P.

462. *Id.*

463. Forté, *supra* note 15, § 21.05.

464. *Id.*

465. *See* Bower et al., *supra* note 122, § III.M; *supra* Part V.B.3.

466. Bower et al., *supra* note 122, § III.M.

467. *Id.*

468. *Id.* § III.Q.

469. *Id.*

believe it discourages productivity by allowing an expensive operator to recover more overhead than an operator using more efficient techniques.<sup>470</sup>

Another key function the accounting procedure facilitates, both under the fixed and percentage rate basis, is rate adjustment, which is an extremely important task the operator is required to complete each year.<sup>471</sup> Rate adjustment is particularly relevant when operations move from drilling to production considering that overhead expenses are naturally higher during the drilling phase than they are during production.<sup>472</sup> Similarly, overhead rates naturally decrease as production moves into its later phases due to the decreasing labor requirements and administrative decisions that are necessary to continue operating a well in the late production phases.<sup>473</sup> Despite this natural reduction in overhead expenses, parties must also take into account additional warehousing expenses that begin to accrue during the production phase.<sup>474</sup> For these reasons, it is important to incorporate provisions that simultaneously decrease overhead deductions as a well progresses through the different phases of production, while also bearing in mind expenses occurring in the intermediate and late phases of production.<sup>475</sup>

## 2. Include Adequate Lease Provisions

As previously noted, it is not only impractical, but also infeasible for parties to address each potential expense that could accrue during the course of production.<sup>476</sup> It is well advised, however, that parties include adequate provisions addressing problematic trends that commonly occur during production.<sup>477</sup> One particular area parties should focus on during negotiations is the habendum clause, ensuring the operating agreement addresses whether the operator or the non-operator bears responsibility for overhead accruing from non-producing wells or shut-in wells.<sup>478</sup> Another essential provision should address complex operations involving multiple wells or multi-zone completion.<sup>479</sup> In these cases, non-operators should attempt to include provisions setting forth an initial deduction rate, applying a reduced rate to additional wells drilled on the lease.<sup>480</sup> These provisions are particularly important regarding administrative expenses.<sup>481</sup> Parties should also ensure the

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470. Jolly, *supra* note 15, § 21.04(8)(c)–(d).

471. *Id.* § 21.04(8)(e). *See generally id.* § 21.01 (explaining the importance of updated accounting methods).

472. *Id.* §§ 21.01, 21.04(8)(b).

473. Forté, *supra* note 15, § 21.05.

474. *See* Jolly, *supra* note 15, § 21.04(8)(b).

475. *See supra* notes 471–74 and accompanying text.

476. *See* Bower et al., *supra* note 122, § I.D; *supra* note 449 and accompanying text.

477. *See* Bower et al., *supra* note 122, § I.D.

478. *See supra* Part IV.B.

479. Forté, *supra* note 15, § 21.06.

480. *Id.* §§ 21.05–.06.

481. *See id.*

lease adequately addresses other problematic areas where disputes commonly arise such as who bears post termination costs when parties become disassociated with the operating agreement, when new parties become part of the agreement, where a party transfers their rights, and determining the manner in which the operator deducts expenses relating to on-site versus off-site employees.<sup>482</sup>

Finally, a helpful tool parties can utilize to avoid costly litigation is a mediation provision.<sup>483</sup> Parties, however, should take particular care in clearly distinguishing alternative dispute resolution (ADR) provisions from mediation provisions.<sup>484</sup> Although current COPAS agreements incorporate mediation provisions, the majority of operating agreements contain provisions that make ADR the default avenue to solve disputes.<sup>485</sup> Because the operating agreement prevails when the accounting procedure and operating agreement contradict, parties should ensure the lease provides for the mediation provision to govern disputes regarding accounting procedures.<sup>486</sup> Incorporating adequate mediation provisions and drafting thorough operating provisions can potentially save parties substantial amounts of time and money and, therefore, should be drafted with great care and deliberation.<sup>487</sup>

### 3. *Keep the Operator Honest During Operations*

Though selecting an appropriate accounting procedure and drafting thorough lease provisions are effective methods of protecting parties' rights, neglecting to take steps to enforce these agreements can render the efforts parties make during pre-production negotiations useless.<sup>488</sup> First, before negotiations ever begin, parties should undertake due diligence in determining the manner by which previous parties and their transferred interests affect the agreement, ensuring previously executed leases do not still govern subsequent

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482. See, e.g., *Paint Rock Operating, LLC v. Chisholm Exploration, Inc.*, 339 S.W.3d 771, 773–76 (Tex. App.—Eastland 2011, no pet.) (calculating a new operator's allowable overhead expense deduction); *Prize Energy Res., L.P. v. Cliff Hoskins, Inc.*, 345 S.W.3d 537, 562–67 (Tex. App.—San Antonio 2011, no pet.) (determining how expenses accruing during a post-termination period should be calculated when a party forfeits their rights to an outside party); *Fasken Land & Minerals, Ltd. v. Occidental Permian Ltd.*, 225 S.W.3d 577, 580–81, 594–96 (Tex. App.—El Paso 2005, pet denied) (calculating a removed operator's allowable overhead deductions); *Fossil Fuels, Inc. v. Hyde-Bower, Inc.*, No. 05-92-01461-CV, 1993 WL 189817, at \*1, 3–4 (Tex. App.—Dallas June 3, 1993, no writ) (calculating expenses after parties discovered an agreement between their predecessors still governed their operations).

483. See *Bower et al.*, *supra* note 122, § II.D.

484. See *id.*

485. See *id.*

486. See *id.* §§ I.C, II.D.

487. See *id.* § II.D. See generally Forté, *supra* note 15 (addressing solutions to operator abuse through operating agreements).

488. See *infra* notes 489–92 and accompanying text.

operating agreements.<sup>489</sup> Once negotiations conclude and drilling operations begin, non-operators should attempt to stay in periodic contact with the operator and make sure to raise questions and concerns as they arise.<sup>490</sup> Moreover, non-operators should periodically visit the leased tract to inspect the premises and note any activities with which they are concerned.<sup>491</sup> The non-operator should also carefully review billing and accounting statements, paying particular attention to line items involving additional contracted labor or other services.<sup>492</sup>

The best principle operators and non-operators can incorporate into their agreements, however, is morality.<sup>493</sup> “Phil Lear, recently gave an ethics presentation . . . saying that all you need to know about ethics you learned in Sunday school: ‘Do unto others as you would have them do unto you.’ Follow the Golden Rule and you will pass the ethics test.”<sup>494</sup>

#### VII. PLUGGING THE WELL: ENSURING TEXAS REMAINS AN INTERNATIONAL LEADER IN OIL AND GAS PRODUCTION

Due to the oil and gas industry’s constantly evolving nature, a predictable judicial system that adheres to steadfast principles is a vital necessity if Texas is to remain an international leader in oil and gas production.<sup>495</sup> Oil is one of Texas’s most precious resources and will become increasingly important as developing technologies such as fracing and horizontal drilling continue to evolve and become more efficient.<sup>496</sup>

Considering the great potential for abuse regarding overhead expense calculations, Texas courts should make efforts to provide mineral owners and operators with a clear sense of the outcomes they can expect when they seek to adjudicate such disputes.<sup>497</sup> Specifically, courts should immediately curtail *Archer*’s application as a bedrock overhead case.<sup>498</sup> In this same manner, Texas courts should also address the problems *Wagner & Brown*’s hypothetical and

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489. *But see* Fossil Fuels, Inc. v. Hyde-Bower, Inc., No. 05-92-01461-CV, 1993 WL 189817, at \*1, 3–4 (Tex. App.—Dallas June 3, 1993, no writ) (calculating expenses after parties discovered that an agreement between their predecessors still governed their operations).

490. Forté, *supra* note 15, § 21.04.

491. *See id.* § 21.06.

492. *See id.*

493. *See infra* notes 497–501 and accompanying text.

494. Forté, *supra* note 15, § 21.09.

495. *See supra* Part I.

496. *See supra* Part I.

497. *See infra* notes 498–501.

498. *See* Skelly Oil Co. v. Archer, 163 Tex. 336, 336 (1961) (judgment set aside Feb. 21, 1962); *Abraxas Petroleum Corp. v. Hornburg*, 20 S.W.3d 741, 756 (Tex. App.—El Paso 2000, no pet.); *Peacock v. Schroeder*, 846 S.W.2d 905, 908–09 (Tex. App.—San Antonio 1993, no writ); *Pshigoda v. Texaco, Inc.*, 703 S.W.2d 416, 418 (Tex. App.—Amarillo 1986, writ ref’d n.r.e.); *Patton v. Rogers*, 417 S.W.2d 470, 474 (Tex. Civ. App.—San Antonio 1976, writ ref’d n.r.e.); *supra* Part V.A.1.



overly broad application in *Prize*'s have created.<sup>499</sup> Similarly, *Prize* and *S & J Invs.*, illustrate how the standard of review Texas courts apply to overhead disputes provides trial courts with astoundingly broad discretion, which in turn provides operators broad potential to abuse the system.<sup>500</sup> Finally, Texas can improve litigation addressing overhead expenses by drafting a guide to help courts and litigants in applying COPAS formulas.<sup>501</sup>

Moreover, considering the aforementioned challenges parties to oil and gas operating agreements face—and the massive amount of assets at stake in such disputes—parties themselves should take proactive steps to avoid disputes in the first place.<sup>502</sup> Ultimately, these proactive steps start and end with well-drafted lease agreements that address some of the more problematic areas owners and operators encounter during drilling and production, as well as any elements specific to their own agreements.<sup>503</sup> Furthermore, mineral owners should not approach their relationship with the operator passively.<sup>504</sup> Owners should thoroughly review their billing statements, stay in constant contact with operators, and visit the well site periodically.<sup>505</sup>

Despite the numerous challenges mineral owners and operators face regarding overhead expense calculations, these measures will put the Lone Star State on a road to continue leading the charge towards energy independence and economic security in the United States for decades to come.<sup>506</sup> By implementing these changes, Texas can ensure its landowners have a similar experience to Jed Clampett's—receiving fair compensation for their minerals.<sup>507</sup>

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499. See *supra* Part V.A.2. See generally *Prize Energy Res., L.P. v. Cliff Hoskins, Inc.*, 345 S.W.3d 537 (Tex. App.—San Antonio 2011, no pet.) (applying its interpretation of *Wagner & Brown, Ltd. v. Sheppard*, 198 S.W.3d 369, 380–81 (Tex. App.—Texarkana 2006), *rev'd*, 282 S.W.3d 419, 421–29 (Tex. 2008)).

500. See generally *Prize*, 345 S.W.3d 537 (discounting strong evidence contradicting the court's holding); *S & J Invs. v. Am. Star Energy & Minerals Corp.*, No. 07-07-0357-CV, 2008 WL 2669665 (Tex. App.—Amarillo July 8, 2008, pet. denied) (mem. op.) (discounting testimony that clearly demonstrated a number of wells were not producing); *supra* Part V.A.3; *supra* note 390.

501. See *supra* note 431 and accompanying text.

502. See *supra* Part VI.C.

503. See *supra* Part VI.C.2.

504. See *supra* Part VI.C.2.

505. See *supra* Part VI.C.2.

506. See *supra* notes 497–505 and accompanying text.

507. See *The Beverly Hillbillies*, *supra* note 2.

