

Oil and Gas Lease: Texas Supreme Court Addresses Offset Provision



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The Texas Supreme Court (“Court”) recently ruled in favor of Murphy Exploration & Production Company—USA (“Murphy”) in a dispute arising from the location of an offset well on the properties of Shirley Mae Herbst Adams and William Albert Herbst (collectively, “Herbst”).

The Court found a proximity requirement was not necessary to comply with the leases. See *Murphy Exploration & Prod. Co.—USA v. Adams*, No. 16-0505, 2018 WL 244913 (Tex. June 1, 2018).

The dispute involved contractual agreements for oil and gases leases between Herbst and Murphy. The leases covered a 302-acre tract in Atascosa County, Texas. Each contained a provision obligating Murphy to either drill an offset well, pay royalties, or release acreage in the event a producing well was completed on an adjacent tract within 467 feet of the leased tracks.

Comstock Oil & Gas, LP drilled a producing horizontal well (the “Lucas well”) on the tract adjacent to the land covered by the leases. The Lucas well, which was in the Eagle Ford Shale formation (“Eagle Ford”), was 350 feet from the lease boundary, triggering the contract’s offset provision.

Rather than pay royalties based on the Lucas well’s production or release acreage, Murphy instead chose to drill an offset well. Within the required 120 days of the Lucas well’s completion, Murphy commenced drilling a horizontal well (the “Herbst well”) on the leased land.

The Herbst well was also located in the Eagle Ford and drilled to a depth adequate to test the formation from which the Lucas well was producing. However, the Herbst well was approximately 1,800 feet from the lease line. Further, the horizontal laterals of both wells ran parallel to the lease line.

Murphy completed the Herbst well in November 2012 and paid royalties to Herbst for its production. Six months later, Herbst sued Murphy for breach of contract. They alleged that Murphy failed to comply with the contract’s offset provision. Herbst argued that the Herbst well was too far from the lease boundary to qualify as an offset well, in light of both the common meaning and the oil and gas industry’s understanding of the term.

In response, Murphy asserted that the provision imposed no location or spacing requirement for the offset well, and that it only required the well to be drilled “on the leased acreage” and “to a depth adequate to test the same formation” from which the competing producing well was drilled. Therefore, Murphy argued that the offset provision, in light of the horizontal nature of the drilling in the Eagle Ford, could not be used as a drainage well. As a result, the company contended there was no reason for it to be located near the lease line.

In addressing the alleged breach of contract the Court looked to ascertain the true intentions of the parties in the contract itself. The contract's words are given their plain meaning, unless the contract used the terms in a technically different way. In oil and gas leases, a court reviews the contract in a manner that foregoes imposing more stringent obligations unless it is clear that the parties intended for the conditions to exist.

The pertinent lease provision stated that if "a well is completed as a producer of oil and/or gas on land adjacent and contiguous to the leased premises, and within 467 feet of the premises covered by the lease," then within 120 days of the well's completion Murphy was required to drill on the leased land to the same depth as the competing producing well. While the trial court found that Murphy complied with these terms, which placed no restrictions on the offset well's location in feet from the lease line, the Court of Appeals disagreed. It held that Murphy did not conclusively establish the Herbst well satisfied the commonly understood meaning of an offset well.

Herbst argued that the provision at issue, which was triggered by a producing well within 467 feet of the lease boundary, protected against the risk of drainage while eliminating any dispute over whether drainage occurred. In addition, they contended that an offset well must be in close proximity to the lease line where the competing well is producing and that the Herbst well, which was drilled 1,800 feet away from the lease line and 2,100 feet from the Lucas well, did not offset the Lucas well.

The case turned on the Court's definition of an offset well.

The Court had recognized that drilling an offset well can be a method of protecting against drainage. This is stated to occur when a well produces oil or gas that migrates from another owner's property. However, in this case, the Court found that the contract only required the offset well to be located on the leased acreage and to a depth adequate to test the same formation of the producing well. The clause did not reference draining, nor did it place a restriction on the well Murphy must drill in response. Therefore, the Court found that "offset" meant to "counterbalance" or "compensate" for the Lucas well's production and that the Herbst interpretation of offset well was not reasonable.

The Court's described differences between vertical and horizontal wells supported its conclusion. It noted that, while vertical wells drain an entire reservoir of minerals that have seeped out and sit on top of shale, horizontal drilling, in conjunction with hydraulic fracturing—the type of drilling Murphy used here—allows developers to extract oil and gas directly from the less permeable shale, typically found in formations that are horizontally wide but vertically narrow.

In horizontal drilling, points along the horizontal wellbore are perforated and fractured to access the surrounding oil and gas. Further, horizontal drilling does not involve shared reservoirs in the same sense as vertical drilling because, although the same strata of shale may underlie two separate tracts, little or no drainage between the tracts occur.

In addition to the plain reading of the contract, Texas courts can use the facts and circumstances surrounding the contract's execution to inform its construction of the lease language. Based on the formation of the Eagle Ford and the prevalence of the horizontal drilling, Murphy argued that offset well should be interpreted as applied to a horizontal, not a vertical well.

The Court agreed.

It faulted Herbst's conflation of the purpose of an offset well in horizontal and vertical drilling. This was based on a finding that the only locations that matter in the horizontal drilling are those of the perforated and fractured portions of the horizontal wellbore. Further, the Court found that a well may be drilled in close proximity to the lease boundary, but have no chance of preventing (or causing) draining depending on the direction of the horizontal wellbore and the placement of the perforations. Therefore, it found that a proximity requirement for the Herbst well, as Herbst argued, would be ineffective as applied in a horizontal drilling scenario.

Similar to the ineffectiveness of a proximity, the Court also found that the absence of a significant possibility of drainage occurring in this context supported Murphy's definition of offset. Based on the Eagle Ford formation and the use of the drilling and hydraulic fracturing, little or no drainage would occur. Therefore, the Court found that the close proximity of an offset well in a formation like the Eagle Ford would not prevent draining, but it could compensate Herbst by counterbalancing against production on the adjacent land. Since the drilling of the offset well itself, not its location mattered, the Court found no implied reading of a physical location was the only reasonable interpretation of the contract.

The Court limited its holding, however, to the specific circumstances in this case, which involved unconventional production in tight shale formations.

A [copy of the opinion](#) can be downloaded here.