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## Produced Water Ownership in Texas: Is *Cactus Water* the Answer?

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On July 28, 2023, a divided Texas Court of Appeals in El Paso issued a long-awaited decision in *Cactus Water Services, LLC v. COG Operating, LLC*,<sup>1</sup> addressing ownership of produced water. The case pitted surface owners against mineral owners over the rights to a byproduct of hydrocarbon production that was once thought of exclusively as a nuisance but that has taken on a new importance as technological innovation has created potential stand-alone value in produced water. The majority of the court of appeals sided with the mineral owners' rights to the produced water over a dissenting opinion that favored surface owners. The case and the likely appeal to the Supreme Court of Texas represents an opening in salvo in what is likely to be an increasing number of produced-water cases.<sup>2</sup>

With that in mind, this alert (1) provides a background on produced water in Texas, (2) discusses the conclusion and reasoning of the majority opinion in *Cactus Water*, (3) discusses the dissenting opinion's contrary holding in *Cactus Water*, and (4) assesses the future of the issue as it heads towards the Texas Supreme Court.

### I. Background: *What is the Importance of Produced Water Ownership?*

"Produced water" typically refers to the slurry of non-hydrocarbon liquids generated by oil and gas production. The slurry contains water that is also entrained with inorganic materials including various mineral salts, such as sulfides, lithium chloride, and sodium chloride. In its 2022 report to the Texas Legislature, the Texas Produced Water Consortium estimated that oil and gas operations resulted in 3.9 billion barrels of produced water were generated across Texas in 2019.<sup>3</sup> Much of this large volume stems from hydraulic fracking operations.<sup>4</sup> In those operations, produced-water is typically viewed as an unused byproduct—or waste—that historically was mostly disposed of underground through injection wells.<sup>5</sup> For instance, over 2.7 billion barrels of produced water in 2019 were put to no beneficial use, accounting for almost 70% of all such volumes.<sup>6</sup> This characterization of produced water as waste historically led to indifference to its ownership between the surface and mineral estate.

Recent technology innovations have, however, created intrinsic value in produced water. For one, Texas producers have begun re-using produced water in their own operations, which has created a substantial market for third-party companies to purchase, treat, transport, and sell produced water among producers.<sup>7</sup> This itself is a lucrative market given the relative scarcity of water supply in West Texas.<sup>8</sup> Apart from re-use in oil and gas operations, treatment and recycling of produced water has unlocked other economic opportunities. Treated produced water can be used in cement and concrete for construction and as coolant in electric-power generation

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<sup>1</sup> No. 08-22-00037-CV, 2023 WL 4846861, at 1\*, 6\* (Tex. App.—El Paso July 28, 2023, no pet. h.) [hereinafter *Cactus Water*].

<sup>2</sup> See Peter McGuire, *Texas Appeals Court Rules Conoco Unit Owns Waste Water*, LAW360 (July 31, 2023, 6:38 PM), <https://www.law360.com/articles/1705621/texas-appeals-court-rules-conoco-unit-owns-waste-water->. As of the publication of this alert, *Cactus Water Services, LLC* has not filed a petition to the Texas Supreme Court.

<sup>3</sup> TEX. PRODUCED WATER CONSORTIUM, *Beneficial Use of Produced Water in Texas: Challenges, Opportunities and the Path Forward 12* (2022), <https://www.depts.ttu.edu/research/tx-water-consortium/2022-report.php> [hereinafter Tex. Consortium].

<sup>4</sup> Dylan Baddour, *To ease looming West Texas water shortage, oil companies have begun recycling fracking wastewater*, THE TEX. TRIBUNE (Dec. 19, 2022 8:00 AM), <https://www.texastribune.org/2022/12/19/texas-permian-basin-fracking-oil-wastewater-recycling/>.

<sup>5</sup> *Id.*

<sup>6</sup> Tex. Consortium, *supra* note 3, at 12.

<sup>7</sup> Baddour, *supra* note 4.

<sup>8</sup> *Id.*

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processes.<sup>9</sup> With additional treatment, produced water can be used in agriculture and livestock cultivation.<sup>10</sup> Furthermore recently, there has been increased interest in technology capable of extracting valuable constituents from the produced water, such as lithium—a prized resource for electric vehicle manufacturing and a “critical mineral” under the Inflation Reduction Act.<sup>11</sup>

Altogether, the variety of economic uses for produced water has generated significant commercial interest. However, the legal ambiguity as to who owns produced water represents an impediment to the efficient development of the produced water market. Without clear direction on whether a landowner or mineral owner has the right to produced water, many companies have been unwilling to invest substantial amounts of capital to capture, transfer, treat, and sell produced water. It is within these circumstances that *Cactus Water* was decided.

## II. *Cactus Water* Majority Opinion: *Mineral Owner Owns the Produced Water*

The dispute in *Cactus Water* centered on a mineral lessor’s claims to produced-water rights pursuant to oil and gas leases in opposition to competing claims from a water lessor claiming similar rights under its water leases. COG Operating, LLC (“COG”) was the mineral lessee under four mineral leases executed from 2005 to 2014 (before produced water was seen as a valuable resource) in the Delaware Basin of the Permian.<sup>12</sup> The leases contained typical granting clause language: the mineral lessee was granted rights to the production of “oil and gas and other hydrocarbons” or slight variations thereof.<sup>13</sup> The granting language in the leases did not mention “water,” “produced water” or “other minerals.”<sup>14</sup> COG used hydraulic fracturing to complete its wells and generated significant amounts of produced water for which it was responsible for disposing pursuant to various surface use compensation agreements (“SUCAs”) and right-of-way agreements (“ROWs”) with the surface owners.<sup>15</sup> Separately, the surface owners executed water leases with Cactus Water, LLC (“Cactus”) in 2019 and 2020 purporting to grant “all water ‘produced from oil and gas wells and formations on or under the [covered properties].’”<sup>16</sup>

In the trial court, the parties presented opposing claims of ownership over the produced water and argued both their positions on summary judgment. The trial court granted summary judgment in COG’s favor, holding that COG owned the produced water as mineral lessee.<sup>17</sup> Cactus appealed, but the majority of the panel from the El Paso Court of Appeals affirmed. The majority opinion’s conclusion largely hinged on the question of whether produced water “is, as a matter of law, water or if it is waste.”<sup>18</sup> To reach the conclusion that produced water is, by law, “waste,” the court relied on three arguments:

1. **Texas statutes and regulations:** Relying on precedent stating that mineral leases are contracts that should be construed according to their legal and regulatory contexts, the majority looked to the Texas

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<sup>9</sup> Tex. Consortium, *supra* note 3, at 76–77.

<sup>10</sup> *Id.* at 80–81.

<sup>11</sup> See Caroline Evans, *E&Ps Explore Potential of Lithium Extraction*, ENERGY INTELLIGENCE (Mar. 8, 2023), <https://www.energyintel.com/00000186-c80a-d1ee-a5e7-fe9ff9250000>; Mella McEwen, *Study finds potential in extracting lithium from produced water*, MIDLAND REPORTER TELEGRAM (Jan. 8, 2023), <https://www.mrt.com/business/oil/article/Study-finds-potential-in-extracting-lithium-from-17696841.php>; U.S. Dept. of the Treasury, *Treasury Releases Proposed Guidance on New Clean Vehicle Credit to Lower Costs for Consumers, Build U.S. Industrial Base, Strengthen Supply Chains* (Mar. 31, 2023), <https://home.treasury.gov/news/press-releases/jy1379>.

<sup>12</sup> *Cactus Water*, No. 08-22-00037-CV, 2023 WL 4846861, at 1\*.

<sup>13</sup> *Id.*

<sup>14</sup> *Id.*

<sup>15</sup> *Id.* at 1\*–2\*.

<sup>16</sup> *Id.*

<sup>17</sup> *Id.* at 3\*.

<sup>18</sup> *Id.*

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Natural Resources Code, Texas Water Code, and Railroad Commission Rules for their definitions of “oil and gas waste.”<sup>19</sup> These sources uniformly included “brine,” “other mineralized water,” and other variations of “produced water” within their definitions of “oil and gas waste.”<sup>20</sup> Additionally, these sources did not include produced water, or variations thereof, in their definitions for “fresh water,” “groundwater,” or “surface or subsurface water.”<sup>21</sup> Based on these definitions, the court concluded that “[t]he relevant legal definitions of oil and gas waste include produced water,” and as a result, “produced water is more accurately classified as a waste byproduct of oil and gas production.”<sup>22</sup> Furthermore, regulations on proper produced water disposal “underscore[] the understanding of produced water as oil and gas waste . . . rather than water.”<sup>23</sup>

2. **Industry practice.** Informed by the historical assumption that producers are responsible for the processing, transporting, and disposing of produced water as waste, the majority observed that “produced water has long been treated as a liability,” and thus, the parties to the mineral leases did not contemplate produced water as something of value that the surface owner would have reserved in the leases.<sup>24</sup> Moreover, the majority reasoned that to conclude that produced water was reserved with the surface owner “would give the surface estate (and thus Cactus) ‘the benefit of costs and risks [COG] voluntarily undertook.’”<sup>25</sup>
3. **Lease language.** The majority further focused on the lack of an express reservation of produced water to the surface estate in COG’s oil and gas leases and refused to assume one because “[c]ourts do not favor reservation by implication.”<sup>26</sup>

Bases on these three rationales, the majority held that produced water is within the mineral lessee’s grant of “oil, gas and other hydrocarbons.”<sup>27</sup> Therefore, COG had the exclusive right to the produced water under the mineral leases, meaning Cactus’s purported water leases from the surface owners were void as a matter of law.<sup>28</sup>

### III. *Cactus Water* Dissenting Opinion: *Surface Owner Owns the Produced Water*

Unsurprisingly, the dissent framed the ownership issue very differently. As a threshold point, the dissent took issue with the majority opinion’s reliance on statutes, regulations, and industry practice to define “produced water” as “waste,” stating that such interpretive tools are unnecessary and even contrary to precedent warning against interpreting mineral leases to “say what [they] unambiguously do [ ] not say.”<sup>29</sup> Instead, the dissent leaned heavily into the terms of COG’s oil and gas leases to point out that the words “water,” in any form, and “oil and gas waste” were nowhere in the leases, except for cursory limitations on water contamination and use.<sup>30</sup> Without express language transferring the surface estate’s water rights, the dissent posited that Texas law dictates that water

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<sup>19</sup> *Id.*

<sup>20</sup> *Id.*

<sup>21</sup> *Id.*

<sup>22</sup> *Id.* at 5\*.

<sup>23</sup> *Id.*

<sup>24</sup> *Id.*

<sup>25</sup> *Id.* (internal citations omitted).

<sup>26</sup> *Id.*

<sup>27</sup> *Id.* at 6\*.

<sup>28</sup> *Id.*

<sup>29</sup> *Id.* at 11\* (quoting *URI, Inc. v. Kleberg County*, 543 S.W.3d 755, 757 (Tex. 2018)).

<sup>30</sup> *Id.* at 8\*.

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remains a part of the unsevered surface estate.<sup>31</sup> Therefore, the dissent reasoned, the entire oil and gas “product stream” is not impliedly conveyed when a mineral lease only grants “oil and gas.”<sup>32</sup>

To bolster its position, the dissent also referenced limitations in COG’s leases on the use of water to drilling a water well.<sup>33</sup> The dissent contended that “[i]f all of the subsurface water had been granted to COG, there would be no need to include such limiting provision.”<sup>34</sup> Also, the dissent focused on the language of the SUCAs and ROWs, which also purported to address COG’s use of water, and specifically the transportation of produced water.<sup>35</sup> The dissent reasoned that these agreements and restrictions would not be necessary if COG’s oil and gas leases granted COG the right to the produced water.<sup>36</sup>

An obvious challenge to the dissent’s reasoning above is that it casts produced water as actual water, rather than something else. To this, the dissent countered that water—regardless of form or entrained contents—belongs to the surface estate unless expressly severed.<sup>37</sup> In *Robinson v. Robbins Petroleum Corp.*, the Texas Supreme Court held that saltwater produced by a mineral lessee remained with the surface owner since “the water itself is an incident of surface ownership in the absence of specific conveyancing language to the contrary.”<sup>38</sup> The *Robinson* court made no distinction between freshwater and saltwater, stating “[w]e are not attracted to a rule that would classify water according to a mineral contained in solution.”<sup>39</sup> Based on its reading of *Robinson*, the dissent opined that since “water by any name, even when mixed with other substances, still remains as water,” produced water must be an incident of surface ownership.<sup>40</sup>

## **IV. Looking Ahead: An Issue Ripe for Texas Supreme Court Input and Future Issues in Produced Water**

With growing commercial interest around the value of produced water, the legal ownership question of produced water has taken on increased importance. The decision in *Cactus Water* is a necessary first step to clarity, but this single court of appeals’ decision within the specific lease language and facts of that dispute are not likely to provide the ultimate answer on Texas’s position on produced water ownership. As demonstrated by the strident dissent in *Cactus Water*, arguments can be made—depending on context—for ownership by both the surface or the mineral estate. If the Texas Supreme Court grants Cactus’s position, the state of the law could become clearer, but is unlikely to be determined for all situations.

Moreover, *Cactus Water* does not address several issues tied to produced water ownership that may be important to both surface and mineral estate owners in the future. For instance, the decision does not address whether remuneration may be owed to a surface owner by a mineral-estate owner for the value of captured and monetized produced water or the costs of surface damages. Nor does the opinion address several tax questions that necessarily follow placing ownership of produced water in one estate or the other. These are, of course, just examples of the questions that may bubble to the surface on this issue in the near term as a result—or in spite of—the decision in *Cactus Water*. Regardless, both surface owners and mineral owners alike undoubtedly and eagerly await the next chapter of produced-water ownership in Texas.

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<sup>31</sup> *Id.* (citing *Sun Oil Co. v. Whitaker*, 483 S.W.2d 808, 811 (Tex. 1972)).

<sup>32</sup> *Id.* (citing *Moser v. U.S. Steel Corp.*, 676 S.W.2d 99, 101 (Tex. 1984)).

<sup>33</sup> *Id.*

<sup>34</sup> *Id.*

<sup>35</sup> *Id.* at 9\*.

<sup>36</sup> *Id.*

<sup>37</sup> *Id.* at 10\*.

<sup>38</sup> *Id.* (quoting *Robinson v. Robbins Petroleum Corp.*, 501 S.W.2d 865, 867 (Tex. 1973)).

<sup>39</sup> *Id.* (quoting *Robinson*, 501 S.W.2d at 867).

<sup>40</sup> *Id.*