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Mississippi Oil and Gas Update

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MISSISSIPPI OIL AND GAS UPDATE

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In *Douglas v. Denbury Onshore, LLC*, the court of appeals of Mississippi held, in a matter of first impression, that an abandoned wellbore belongs to the mineral owners rather than the surface owners when the mineral and surface estates are severed.[2]

The facts of *Douglas* involved circumstances that are not uncommon. In 1937, M.R. Douglas and his wife, Connie Douglas ("Lessors"), executed an oil, gas, and mineral lease covering lands that they owned in fee simple, which provided for a primary term of ten years.[3] Following execution of this lease, the Lessors executed a series of deeds over time that ultimately severed all minerals from the surface estate of the land ("Land") on which the subject well ("Well") was eventually drilled.[4] The Well was drilled by Chevron in 1947 and completed as a producing oil well in the Mallalieu Field.[5]

In 1968, after twenty years of production, Chevron plugged the Well. In plugging the Well, Chevron abandoned the tubing and casing, which it had cut below ground level, plugged the wellbore with cement, and covered the cemented wellbore with dirt. The Well remained plugged and abandoned for nearly forty years until Denbury Onshore, LLC ("Denbury") sought to re-enter the Well in 2005.[6]

1. Brunini, Grantham, Grower & Hewes, Jackson, Mississippi. J.D. 1983, University of Mississippi; B.A. 1980, University of Mississippi.
2. Douglas v. Denbury Onshore, LLC, 78 So. 3d 912, 917, 920 (Miss. Ct. App. 2011).
3. *Id.* at 913–14.
4. *Id.* at 914–17.
5. *Id.* at 915.
6. *Id.*

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By 1982, Connie Mack Douglas, grandson of the Lessors, and his wife, Charlene T. Douglas (the "Douglases") had become the owners of the Land's surface estate.[7] Although they did not own any mineral interests in the Land, the Douglases did own minerals in other tracts in the surrounding area that would eventually become a field-wide unit.[8]

Beginning in 2001, Denbury obtained leases from the mineral owners in the Land and surrounding lands.[9] On Denbury's petition, the state Oil and Gas Board ("Board") formed a compulsory field-wide unit for the East Mallalieu Field Unit ("Unit").[10] The Unit was formed for tertiary oil recovery by injection of carbon dioxide.[11] Rather than leasing their minerals, the Douglases chose to participate in the Unit as working interest owners.[12] The Douglases, as unleased mineral owners in the Unit, received notice of Denbury's petition but neither attended the hearings nor objected to the plans for the Unit.[13]

Since the Land on which the Well was located was included within the boundaries of the Unit, it was subject to the Unit Agreement and Operating Agreement.[14] The Douglases, as working interest owners subject to the plan of unitization,[15] were eventually paid working interest income of over $300,000 for Unit production.[16]

In 2005, Denbury obtained a permit from the Board to re-enter the Well and complete it as a producing well.[17] The Douglases did not object to the permit[18] but did claim that they owned the hole (subsurface wellbore) and all rights to its use. Denbury later received a permit to convert the Well to an injection well.

The Douglases filed their complaint against Denbury in chancery court, claiming ownership of the Well and the equipment cemented therein[19] and alleging re-entry of the Well without their permission. They sought damages for the use of the Well in addition to claims for nuisance and personal injury.[20] They did not, however, allege or attempt to prove that Denbury had used more of the surface than was reasonably necessary to exercise its rights in the Unit, nor did they allege that Denbury's use of the property was for an unreasonable

7. *Id.* at 913, 915.
8. *Id.* at 915.
9. *Id.*
10. *Id.*
11. *Id.* at 916, 918.
12. *Id.* at 915.
13. *Id.* at 915–16.
14. *Id.* at 916.
15. *Id.*
16. *Id.* at 919.
17. *Id.* at 916.
18. *Id.*
19. *Id.*
20. *Id.*

purpose.[21] Denbury's motion for summary judgment was granted by the lower court, and the Douglases appealed.[22]

In ruling for Denbury, the court of appeals noted that in Mississippi, the severance of all or part of the mineral estate from the surface creates separate and distinct estates in real property, with the mineral estate as dominant over the surface estate.[23] One right enjoyed by the mineral estate owner is the right to "use as much of the surface as is reasonably necessary to exercise its right to recover minerals, without liability for surface damage."[24] Another incident of mineral ownership is the exclusive right to drill a well and "the absolute right to select the location for drilling."[25] The court of appeals agreed with the lower court's finding that the plugged and abandoned Well was part of the mineral estate and that as part of the mineral estate, the dominant estate owners have the right to use the Well to access the mineral estate:

> In the present case, we find that the Well is part of the mineral estate. The wellbore and casing are clearly part of the subsurface; no part of the abandoned Well is above ground, and the Well can only be used for development of the mineral estate. The Well is a passageway or entrance to the mineral estate, and the Douglases admit that they have no use for the abandoned Well, nor can they extract it from the property.[26]

As the court of appeals noted, the plan of unitization gave Denbury the right to access the Well and, as lessee of the mineral rights and Unit operator, Denbury had the right to enter the Land as was reasonably necessary for mineral exploration and to use the Well to gain access to the mineral estate. Therefore, the court of appeals upheld the lower court's decision.[27] The Douglases' request to the Mississippi Supreme Court for certiorari review was denied.[28]

In *Pursue Energy Corp. v. Abernathy*, the Mississippi Supreme Court addressed the reasonableness of deducting from royalty payments the operation and investment costs for a gas processing plant.[29]

21. *Id.* at 916–17.
22. *Id.* at 917.
23. *Id.*
24. *Id.* at 918.
25. *Id.*
26. *Id.*
27. *Id.* at 920.
28. Douglas v. Denbury Onshore, LLC, 80 So. 3d 111 (Miss. 2012).
29. Pursue Energy Corp. v. Abernathy, 77 So. 3d 1094, 1098–99 (Miss. 2001).

In the 1960s, Shell Oil Company built a sour gas processing plant.[30] To recover the costs of operation and its investment in the plant, Shell charged all royalty owners under a two-part formula comprised of (1) the actual capital investment combined with a return on investment and (2) the cost per day of operating the plant.[31] Shell used this formula to deduct processing and investment costs from its royalty owners' checks.[32]

After Shell had completed recovery of its capital investment, Pursue Energy Corp. purchased Shell's position in the field and the plant.[33] Pursue began using Shell's two-part formula to recover processing costs by charging each royalty owner a pro rata share of the capital investment previously recovered by Shell.[34]

The Mississippi Supreme Court agreed with the lower court that Pursue had been unreasonable in requiring royalty owners to continue to pay the capital investment cost after it had already been recovered.[35] The Court held that, while an oil company may "deduct reasonable processing and investment costs from the payments made to royalty owners . . . it is unreasonable for [royalty owners] to pay for their share of investment costs repetitively."[36] The lower court relied on Pursue's records to determine that the Shell plant was a "non cost item" of the purchase by Pursue, requiring no additional capital investment costs, and should have been assigned a zero value.[37] Furthermore, it held that Pursue could continue to deduct daily plant operating expenses but that the royalty owners were entitled to relief for any amount charged above and beyond operating expenses.[38] In this regard, the Mississippi Supreme Court affirmed the ruling by the lower court.[39]

The Court also addressed the applicability of the Mississippi statute requiring purchasers of oil or gas production to pay interest on delinquent royalty proceeds.[40] According to the pertinent part of the statute,

> [p]urchasers of oil or gas production from any oil or gas well shall be liable for the payment of interest on royalty proceeds which have not been disbursed to the royalty owners from and after one hundred twenty (120) days following the date of the first sale of oil or gas.

30. *Id.* at 1099.
31. *Id.*
32. *Id.*
33. *Id.*
34. *Id.*
35. *Id.*
36. *Id.*
37. *Id.*
38. *Id.*
39. *Id.*
40. *Id.* at 1101.

> The rate of interest shall be eight percent (8%) per annum and shall be computed from the date of one hundred twenty (120) days after such first sale.[41]

In the subject case, the lower court awarded the royalty owners 6% simple interest from the time Pursue began using the two-part formula to deduct costs through the time the royalty owners filed the complaint; 6% interest compounded annually from that time through the date the final judgment was entered; and 6% simple interest following the final judgment.[42] However, the Mississippi Supreme Court ruled that pursuant to section 53-3-39 of the Mississippi Code, the entire award should have accrued 8% simple interest.[43] The Court reasoned that because Pursue had actually received the revenue that the chancellor had deemed unreasonable by withholding from the royalty payments, the award of prejudgment interest was correct; however, the interest rate should have been 8% rather than 6%.[44]

41. MISS. CODE ANN. § 53-3-39 (2003).
42. *Pursue Energy Corp.*, 77 So. 3d at 1101.
43. *Id.* at 1102.
44. *Id.*