THE CURIOUS CASE OF THE MODERN NON-PARTICIPATING LEASEHOLD CO-TENANT

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I. INTRODUCTION

Historically, the specter of unleased mineral co-tenants or non-participating leasehold co-tenants created uncertainty and discouraged mineral development. Unleased mineral co-tenants or non-participating leasehold co-tenants have long been thorns in the side of operators. These co-tenancies often create problems or situations that make mineral development difficult or economically challenging.

While some of the challenges with unleased or non-participating co-tenants are operational, the biggest problem is often economic. An unleased mineral co-tenant or non-participating leasehold co-tenant bears no risk associated with the development of the mineral estate. If the drilling operations result in a dry hole or unproductive well, the drilling party bears all the financial risk. Development expenses are recoverable from the non-participating co-tenant only if production is obtained. It has long been the rule in Texas that a drilling party is entitled to recoup its reasonable and necessary costs of production, resulting in traditional accounting between co-tenants.

Historically, if a significant portion of the mineral estate was unleased or other leasehold owners did not participate, the risk of development was too great and operated to discourage drilling. Even after "payout" occurred, the negative effect on the drilling party's net revenue interest discouraged development with less than all parties.

However, with the advent of proven horizontal development in some areas, the calculation of economic risk may be changing. In areas of the state where horizontal development has skyrocketed, operators appear to be setting aside the economic risk of drilling wells with participation from less than all parties. The certainty of success of horizontal wells and rapid payout may mitigate the financial risk sufficiently to make it advantageous for operators to develop land even when less than the full mineral or working interest participates. Because a drilling party is entitled to recover its development expenses before it must account to an unleased mineral co-tenant or non-participating leasehold co-tenant, when drilling with less than all parties, the drilling party might be able to recover their expenses faster. In areas of proven development, quicker recovery of drilling expenses may be worth the risk of drilling with less than parties. As a result, the drilling party retains all of the unleased mineral co-tenant's or non-participating leasehold co-tenant's share of revenue until payout occurs. In areas where there may be an accelerated decline curve, the recovery of development expenses is faster during the early "boom" production and may offset a lower long term net revenue interest. In cases involving non-participating leasehold co-tenants, this also means a drilling party may retain the non-participating leasehold co-tenant's lessor's share of royalty, potentially to the detriment of the non-participating co-tenant's mineral owners.

Essentially, the drilling party retains the non-participating co-tenant's lessor's share of royalty to recover their development costs faster. Oddly, it seems that the smaller the ownership of the operating co-tenant, the harsher the economic penalty may be on the non-participating co-tenant. If the operating co-tenant keeps all royalty during the flush production of the well, when payout occurs and the non-participating co-tenant is required to pay its lessor's royalty back to the date of first production, the non-participating co-tenant is left to make this payment when its

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