



# Texas Land & Mineral Owners Association

## Official Newsletter

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### 82<sup>nd</sup> LEGISLATURE IN FULL SWING

The 82<sup>nd</sup> Legislature is now in full swing. Committees have been assigned and hearings are underway. Friday, March 11 marked the bill filing deadline. After this date, no legislation with statewide impact may be filed without suspension of the rules. This newsletter went to print a few days prior to the March 11 deadline, but there are several bills out there already that will keep us busy.

The **Railroad Commission Sunset bill** filed by Senator Glenn Hegar (R - Katy) in the Senate and is Senate Bill 655. The House version, House Bill 3586, was filed by Chair of the Energy Resources Committee, Jim Keffer (R – Granbury). As filed, these bills contain all the recommendations from the Sunset Commission. Those include:

- 1) Discontinue the practice of electing RRC commissioners and change the name. Instead, establish the Texas Oil and Gas Commission, governed by a part-time, appointed board, to assume the regulatory role currently served by the Railroad Commission.
- 2) Eliminate the use of General Revenue to support agency functions – in other words, pick up an additional \$23.4 million annually from industry. “Require the Commission’s Oil and Gas Program to be self-supporting, and authorize the Commission to levy surcharges on the program’s permits, licenses, certificates, or reports to achieve this purpose. Reconstitute the Oil Field Cleanup Fund as the Oil and Gas Fund, continued as a dedicated fund in General Revenue established to pay for the entire Oil and Gas program.”
- 3) Improve Enforcement. “Require RRC to develop, in rule, an enforcement policy to guide staff in evaluating and ranking oil and natural gas- related violations; Require RRC to formally adopt penalty guidelines in rule; transfer enforcement hearings to SOAH, direct RRC to revamp tracking of violations and related enforcement actions tied to oil and gas production, and develop a clear and consistent method for analyzing violation data and trends.
- 4) Eliminate RRC authority to promote the use of propane.
- 5) Authorize RRC to enforce damage prevention requirements for interstate pipelines (they already have it for intrastate).
- 6) Develop a succession plan to prepare for impending retirements and workforce changes (RRC is about to lose lots of institutional knowledge from retirements).
- 7) Transfer gas utility regulation from RRC to PUC; require use of SOAH in contested gas utility cases.



Senator Glenn Hegar

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**Got Internet? Be sure to check out our web site at: [www.tlma.org](http://www.tlma.org)**

**Also, be sure we have your correct e-mail address to receive updates and alerts!**

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TLMA's mission is to create a business and legal environment that is accommodating to the continued exploration for and production of oil and natural gas by ensuring that the rights of both the mineral and surface owners are protected, reduce litigation and to protect our precious groundwater resources.

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We will spend a large part of our time trying to ensure the improved enforcement provision remain in the bill. However, the big issue that will likely take up most of the debate is whether to change the name to the Texas Oil and Gas Commission and to change the governance structure from three statewide elected commissioners to one elected commissioner who would serve a four year term.

The **Eminent Domain** reform legislation, Senate Bill 18, has now passed the full Senate and had a committee hearing before the House Land and Resource Management Committee. We are highly optimistic this bill will go to the full House of Representatives for consideration very soon.

There are also a number of bills filed that have negative impacts on our private property rights. One such bill is House Bill 2087 which would take away the right of a Non Participating Royalty Owner to negotiate their royalty payment. Instead payment would be based on a formula derived from statute. Another bill we are watching closely is House Bill 3106 by State Representative Van Taylor (R - Plano) that would essentially mandate forced unitization/pooling for carbon capture. This is an extremely dangerous bill that circumvents most leases negotiated by land and royalty owners all for the benefit of one company's bottom line. We will continue to work on all these bills and will keep our membership notified as things develop.



Chairman Keffer

## **MIKE GILLEAN AWARDED TLMA 2010 OUTSTANDING MEMBER AWARD**

Congratulations to Mike Gillean of El Campo, Texas, the recipient of the 2010 TLMA Outstanding Member Award.

“Mr. Gillean has been dedicated to TLMA since the Association was formed. He has sponsored membership recruitment events, testified before the Texas Legislature, held the office of TLMA VP, and has shared his knowledge of the oil and gas industry to the benefit of the Association,” shares Dr. Kitty-Sue Quinn, TLMA Executive Director.

“My Grandfather came to El Campo, TX in 1908 to build and operate a rice mill for Beaumont Rice Mills. He also started a seed rice operation which sold seed in Texas and exported seed to Cuba. He later acquired the rice mill from his employers,” reminisced Gillean. “He began purchasing land in the early 30’s and continued until his death in 1960 becoming one of the area’s largest landowners.”

Mr. Gillean attended St. Edwards University and Southwest Texas State University. He was previously General Manager of Gillean 4-G Ranch managing the family cattle and rice farming operations. He currently manages the mineral recourses, Oil and Gas Leasing and Royalty disbursement for the R. H. Hancock Heirs.

## DENBURY GREEN PIPELINE CONTROVERSY HEADS TO TEXAS SUPREME COURT

Written by Steve Korris. Previously printed in the Southeast Texas Record on 2/16/2011. Reprinted with permission.

State Supreme Court justices will review Jefferson County District Judge Donald Floyd's grant of eminent domain power to owners of a carbon dioxide pipeline. The justices will hear oral argument April 19, on an appeal from property owner Texas Rice Land Partners and tenant Mike Latta. Floyd ruled that Denbury Green Pipeline-Texas could enter the property as a common carrier under the Texas Natural Resources Code.

According to the company website, Denbury is constructing a 24-inch pipeline from Donaldsonville, La., to Hastings Field, south of Houston. "The approximately 320-mile pipeline, estimated to cost a total of \$825 million, is designed to transport both natural and man-made CO<sub>2</sub>. The Green Pipeline will be one of the first pipelines designed to transport anthropogenic CO<sub>2</sub> in the Gulf Coast area," the site says.

The Ninth District Court of Appeals affirmed Floyd, two to one.

The Texas Railroad Commission issued a permit to Denbury Green in 2008, finding it made all necessary filings for classification as a common carrier. That didn't impress Latta and his landlord, who wouldn't let surveyors on the property. Denbury Green petitioned for a temporary restraining order, and Floyd granted it. Both sides moved for summary judgment, and Floyd granted it to Denbury Green.

He found Denbury Green proved it was a common carrier with authority to condemn and take. He permanently enjoined Texas Rice and Latta from interfering with Denbury Green's right to enter and survey the route of the pipeline it proposed. He enjoined Texas Rice from harassing Denbury Green's employees and contractors.

On appeal, Chief Justice Steve McKeithen and Justice Charles Kreger decided they must give great weight to determinations of the Texas Railroad Commission. Denbury Green submitted itself to TRC jurisdiction, Kreger wrote. He wrote that company vice president Ray Dubuisson stated in an affidavit that Denbury Green was negotiating with other entities to transport carbon dioxide. He wrote that Dubuisson stated Denbury Green might transport other entities' carbon dioxide, "from anywhere near the pipeline."

Kreger wrote that those facts supported Denbury Green's contention that it is a common carrier. He wrote, "Denbury Green's pipeline will be available for public use from the outset of its operation."

Dissenting Justice David Gaultney found evidence that Denbury Green intends to use the pipeline as an essential part of oil production operations.

Denbury's description of the pipeline's purpose indicates the CO<sub>2</sub> it transports in the pipeline will be its own," he wrote. "How then does Denbury Green have the power to take the private property of another to accomplish this purpose?"

Gaultney wrote that the Constitution does not authorize the taking of private property for regulated private use but for public use. "Is the intent to make a pipeline running from a Denbury well to a Denbury well available for use by the 'public for hire' reasonable?" he wrote, "The summary judgment record is not entirely clear on that question." Gaultney wrote that he would have remanded the case to Floyd for trial.

Anthony Brocato represents Texas Rice, and Marcus Pitre represents Latta. Thomas Buchanan, Jack Strother and Michael Baker represent Denbury Green.

## RECONCILING MINERAL RIGHTS AND CONSERVATION EASEMENTS

According to the Texas A&M *Land Trends* Study, Texas is losing its rural lands faster than any other state in the country. Mindful of this fact, leaders from the Texas Farm Bureau, Texas & Southwestern Cattle Raisers Association and Texas Wildlife Association came together in 2006 to create the Texas Agricultural Land Trust (TALT). While there are 49 land trusts in Texas, TALT is the only one whose sole mission is the protection of agricultural lands. The second largest land trust in Texas today, TALT works with landowners who *voluntarily* choose to place a perpetual agricultural conservation easement on their ranch. TALT is also unique among land trusts in that it proactively works with landowners to make conservation easements compatible with oil and gas development.

An agricultural conservation easement restricts development while allowing most other uses of the property. For landowners, this means that they can continue grazing cattle or hunting just as before. They can build fence, windmills and waterings without prior permission. Large buildings, like barns and houses, are confined to a "building envelope" that concentrates development in several areas around the ranch. Prohibitions extend to non-agricultural commercial activities, such as surface mining and wind-development. TALT and the landowner negotiate an agreement that works for that particular property and that family, making each agreement unique.

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In return for voluntarily giving up the right in perpetuity to develop the property, the landowner receives significant income tax benefits. A donation of the value of the restrictions is made to the land trust, which is then entrusted with ensuring that those restrictions are upheld. Through an appraisal, this donation--or the difference between the value of the property before the restrictions versus the value of the property with the restrictions--- is determined. The landowner can then deduct that amount against 50% of adjusted gross income and carry forward the unused portion of the donation for 15 years. (These enhanced provisions expire at the end of 2011, when it reverts to 30% of AGI and a 5-year carry-forward.) Additionally, the value of the property is reduced, thus making it possible for one's heirs to enjoy the property without having to sell all or part for estate tax purposes.



When I give presentations around the state, the first question typically asked is, "what about oil and gas development?" While lawyers much more qualified than I devote hour-long presentations to the subject, the answer can be boiled down to this: While surface mining is not allowed, the IRS permits sub-surface extraction as long as there is a " limited, localized impact... that [is] not irremediably destructive of significant conservation interests."

What does that mean? Basically, as long as extraction of the minerals has minimal-to-no permanent impact on the conservation value of the easement, the IRS will probably allow the deduction. By inference, the landowner who is granting the conservation easement must have a degree of control over surface damages, either through a surface use agreement or surface protection provisions in the lease itself. Otherwise, the deductibility of the donation may be questioned by the IRS.

There are four different scenarios that typically play out when TALT assesses this issue for landowners interested in donating a conservation easement:

- **The landowner owns the minerals, and the minerals are not leased.** This scenario poses the least risk to the deductibility of a conservation easement. A landowner who owns the mineral estate and has not previously leased the minerals can either subordinate the mineral interest to the conservation easement, or ensure adequate surface use protections when negotiating a lease. The landowner can also pursue a surface use agreement that specifically protects the conservation values as part of mineral development.
- **The landowner owns the minerals, and the minerals are leased.** The risk involved with donating a conservation easement under this scenario will depend on the terms of the lease. Unless expressly restricted in the lease, a mineral lessee's use of the surface will be governed by common law doctrine, which affords the landowner little protection from the mineral lessee's use of the surface. The landowner runs a risk of not qualifying for the tax deduction unless the mineral lessee agrees to subordinate its interest to the conservation easement or enter into a surface use agreement with surface protections.
- **The landowner does not own the minerals, and the minerals are not leased.** This scenario is a bit more complicated. The landowner must first determine who owns the oil and gas minerals. Once ownership is clarified, the deductibility of a conservation easement will depend on who controls surface mining and whether the conservation values can be protected through a surface use agreement.
- **The landowner does not own the minerals, and the minerals are leased.** As in the second scenario, here the landowner must look to the terms of the oil and gas lease to determine if there are adequate surface protections. If there are none in the lease, the mineral lessee will have the right to use the surface without restriction, in which case the landowner runs a high risk of not obtaining the deduction.

Placing a perpetual conservation easement on one's ranch is an enormous step, and should not be entered into without extensive due diligence: Is it right for the family? Is it consistent with one's goals for the ranch? Does it make financial sense? Equally important is to understand the implications of donating a conservation easement on land with a severed mineral estate. TALT encourages any landowner interested in a conservation easement to seek legal counsel. Through careful analysis and preparation, it is possible for Texas landowners to both develop their minerals and protect open space, agricultural lands and native wildlife habitats for generations to come.



*Article by Blair Fitzsimons, Executive Director, Texas Agricultural Land Trust. Nothing in this article constitutes legal, financial or tax advice. TALT wishes to thank Joseph Fitzsimons and Trace Burton, of Uhl, Fitzsimons & Jewett, for their contributions to this article. For more information on TALT, please check their website at [www.txaglandtrust.org](http://www.txaglandtrust.org) or call 210-826-0074.*

## RICK WALKER AWARDED TLMA 2010 MEMBERSHIP RECRUITMENT AWARD

Congratulations to James P. "Rick" Walker Sr. of Aguilares, Texas, the recipient of the 2010 TLMA Membership Recruitment Award. Mr. Walker has spent most of his life managing cattle, oil, gas, and wildlife. He is an avid sportsman. Mr. Walker utilizes helicopters to patrol for wildlife violations, oil field and ranch theft and to gather cattle, and to observe any activity of surface oil & gas leases. He is active in the negotiation of contracts and oversees oil and gas field operations for Vaquillas LLC and Huisache Cattle Co., Ltd. He is married with two children and enjoys flying and donating his time to several of his favorite charities.



"We are happy to have Mr. Walker working on behalf of TLMA to recruit new members. He is a much respected man and his endorsement of the Association holds a lot of weight," states Dr. Kitty-Sue Quinn, TLMA Executive Director.

## CLASS ACTION TO FORCE COMPANIES TO REIMBURSE ROYALTY OWNERS FOR SEVERANCE TAX REFUNDS – COLL V ABACO

Recently some of my clients have received notices of class action settlements in *Coll v. Abaco Operating, LLC, et al.*, in the U.S. District Court for the Eastern District of Texas, Marshall Division, C.A. No. 2:08-CV-345 TJW. The case reveals a little-known aspect of royalty payments: many companies never reimburse their royalty owners for refunds of severance taxes.

Most royalty owners know little about severance taxes except that they are a deduction that regularly appears on their royalty check stubs. Texas imposes a tax on the value of all oil and gas produced in the state: 7.5% for gas and 4.6% for oil. Most producing states impose similar severance taxes. Pennsylvania has been debating whether to pass a severance tax in light of its budget problems and recent development of the Marcellus Shale in that state. Texas' severance taxes are paid into its "rainy day fund" that has been much in the news of late.

Over the past several years, the Texas Legislature, at the behest of producers, has passed various exemptions from the severance tax intended to encourage further exploration and production and avoid abandonment of low-producing wells:

- The Enhanced Oil Recovery Incentive (Tex. Tax Code Sections 202.052, 202.054)
- The High-Cost Gas Incentive (Tex. Tax Code Section 201.057)
- The Two- and Three-year Inactive Well Incentives (Tex. Tax Code Sections 201.053, 301.058, 202.056)
- The Incentive for Marginal Gas and Oil Wells (Tex. Tax Code Sections 201.059, 202.058)
- The Enhanced Efficiency Equipment Severance Tax Credit (Tex. Tax Code Section 202.061)
- The Orphaned Well Reduction Program (Tex. Tax Code Section 202.060)
- The Advanced Clean Energy Enhanced Oil Recovery Reduction (Tex. Tax Code Section 202.0545)
- The Incremental Production Incentive (Tex. Tax Code Sections 201.058, 202.057)



One of the most lucrative tax exemptions is the Texas High-Cost Gas Incentive. It reduces the severance tax on natural gas produced from a well that produces from a formation designated by the Texas Railroad Commission as a "tight formation." This exemption has become much more important with the increase in drilling of horizontal shale wells in the Barnett, Haynesville and Eagle Ford formations. The exemption was originally passed in 1991 and provided an exemption from all gas severance tax for qualified gas wells. In 1997 the Legislature amended the statute to provide for a reduced tax rate for a limited time, applicable for wells spudded after August 31, 1996. The reduced tax rate is based on a formula and depends on the drilling and completion costs for the well compared to the median cost of all high-cost gas wells drilled in the previous fiscal year. Using the comptroller's formula, if I completed a high-cost gas well in 2009 for \$3 million, my severance tax would be reduced from 7.5% to 2.6%. The reduced tax rate applies for ten years or until the well accumulates tax savings of 50 percent of the actual drilling and completion costs for the well, whichever is first. The savings for companies (and the loss of severance tax revenue to the State) are huge.

In Texas, the severance tax is a tax on the production and it is borne by all owners of the well, including royalty owners. The law requires the operator or first purchaser to collect the tax and remit payment to the comptroller. Thus, royalty owners see the deduction for severance tax on their royalty check stubs.

The severance tax exemptions require an application process, and it can sometimes be months or years between the first production from a well and the well's qualification for the exemption. Until the exemption is granted, the producer or first purchaser collects and remits the full amount of the severance tax to the comptroller. Once the exemption has been granted, the comptroller reimburses the operator or first purchaser, either in the form of an actual payment or a credit against future severance taxes owed.

The plaintiffs' attorneys who filed *Coll v. Abaco* discovered that, when producers and first purchasers receive a severance tax refund, they do not always pass it on to the royalty owner (and sometimes do not pass it on to other working interest owners in the well). As a result, the operator receives a windfall equal to the amount of the refund that is attributable to the severance tax previously paid on behalf of the royalty owner. According to the plaintiffs' complaint in *Coll v. Abaco*, over the four years 2004-2008 Texas has paid refunds totaling approximately \$1.1 billion. If the royalty on those refunds was only 1/8th, there would be \$137,500,000 in refunds owed to Texas royalty owners. Apparently, much of that money has never been paid back to the royalty owners.

Suppose that a high-cost gas well is drilled for \$5 million and produces \$3 million of gas in its first year of production. In year two, the operator applies for and receives a high-cost gas exemption reducing its severance tax on the first \$2,500,000 of production equal to 50% of the severance tax paid, or \$112,500. If the royalty on that production is 25%, then 25% of that refund, or \$28,125 belongs to the royalty owner. If the operator simply pockets this money, then in effect the net reduction in severance tax paid by the operator is 62.5% instead of 50%!

The plaintiffs in *Coll v. Abaco* sued 117 producers and first purchasers on behalf of all royalty owners who received royalties from those 117 defendants from 2000 to 2008, alleging that the defendants had failed to pay their royalty owners their share of severance tax refunds received by those companies. Since the suit was filed in 2008, many of the defendants have settled, and only about 25 defendants remain. The court has not yet ruled on whether the case can proceed as a class action, but the settling defendants have agreed to refund to their royalty owners a portion of the severance taxes they received. The amounts of the settlements differ for each company, but generally the companies have agreed to pay all or substantially all of the severance tax refunds attributable to production from wells during the four years prior to filing suit and a percentage (40% in one instance) of the severance tax refunds attributable to production from wells from 2000 to 2004.

All of the defendants, including big producers like Exxon Mobil, Anadarko, Apache, Shell, Newfield, Pioneer, Samson, Devon, BP, EOG, and Forest, and smaller producers like Abaco, Cimarex, Enervest, Noble Energy, and Vintage Petroleum, have vigorously denied that they have any obligation to pay royalty owners any refund. They have also denied that the case can proceed as a class action. (Practically, if the case cannot be brought as a class action, the companies have won, because very few royalty owners have a large enough claim standing alone to justify suing for their refund.) One of the arguments made by the companies is that their leases do not require them to pay the royalty owners any severance tax refund. Certainly, most oil and gas leases do not deal with refunds for severance tax exemptions -- many of the leases were written before there were any severance tax exemptions. The companies also insist that they owe no royalties attributable to refunds more than four years prior to the suit, because of the four-year statute of limitations on bringing claims.

In order to protect royalty owners from being denied their share of severance tax refunds, an express provision should be included in their leases, something like the following:

The royalty paid under this lease shall bear its proportionate part of all severance taxes actually paid on production from the leased premises or lands pooled therewith. If Lessee applies for and obtains an exemption from or reduction of severance tax on such production, Lessor shall be entitled to its proportionate part of such exemption or reduction. If as a result of any such exemption or reduction of severance tax, Lessee receives a refund (either in the form of a payment or credit against future taxes) for severance taxes previously paid on such production, then Lessee shall reimburse Lessor for its proportionate share of such refund, including any interest.

*This article was provided by John B. McFarland an attorney with Graves, Dougherty Hearon & Moody, P.C. in Austin, TX. It was previously published on his blog [www.oilandgaslawyerblog.com](http://www.oilandgaslawyerblog.com) on February 22, 2011. In the last twenty years, Mr. McFarland has negotiated oil and gas leases and lease options covering more than 235,000 acres of land in Texas. His practice also includes negotiation of seismic survey permits, data use licenses, purchase and sales agreements, pipeline easements, and financing agreements covering leasehold, mineral and royalty interests. He obtained Board Certification as a Specialist in Oil, Gas and Mineral Law in December 1986. Mr. McFarland is the author of the Texas Land & Mineral Owners Association oil and gas lease form.*

## LANDOWNERS OWN GROUNDWATER BENEATH THEIR LAND

As associations representing more than 400,000 Texans who own millions of acres of private property, we would like to stress the importance of Senate Bill (SB) 332 and House Bill (HB) 1730 and why it must become law in order to protect landowners' groundwater from being taken by government.

Landowners own the groundwater beneath their land. In the 1904 Texas Supreme Court case of *Houston & TC Railway Company v. East*, the court said, "[T]he owner of land is the absolute owner of the soil and of percolating water, which is a part of, and not different from, the soil." For over a century, groundwater ownership in Texas has appeared clear.

Unfortunately, some groundwater conservation districts (GCDs) are trying to muddy the water by making the argument that landowners do not have a property right to the groundwater below their land. They've taken this argument to court, and if they succeed there is nothing stopping government from taking the groundwater beneath your land. This is troubling to most landowners because they voted to create their local GCD to protect their rights to groundwater, not take them away.

SB 332, introduced by Senator Fraser, and HB 1730, introduced by Representative Ritter, would clarify that landowners have an ownership interest in groundwater beneath their land and a right to capture it. SB 332 and HB 1730 would provide consistency in regulating this private property right and in no way would take authority away from GCDs to protect the aquifer. Simply speaking, SB 332 and HB 1730 would legislatively reaffirm the right landowners have had for over a century. Private landowners and their productive open land are keys to an effectively functioning water cycle. Their active and informed stewardship of land and water resources benefits all Texans.



The issue of groundwater ownership beneath the land doesn't just affect Texas landowners. It has a direct effect on the water supply for some of Texas' major cities and urban areas. For example, many cities use tax payer dollars to purchase groundwater rights from landowners to supply water to their residents. If the courts rule that those landowners don't own the water beneath their land, then taxpayer dollars have been spent on rights worth nothing. Some cities' entire water supply is dependent upon the fact that they have purchased the right to the groundwater below the land. If the courts rule in favor of the GCDs, where will cities turn to in order to provide Texans with this basic necessity?

Some GCDs argue that these bills will lead to more lawsuits from landowners and bankrupt GCDs. This is false. The fact is that there will always be some lawsuits regarding private property rights; however, Texas law is well developed to protect the interests of GCDs and landowners. The burden of proof is on the landowners, not the GCDs. Most landowners are not able to meet the difficult legal standards and rarely win these suits. What's more, if a landowner sues a GCD and loses, the landowner can be required to pay the attorney fees of the GCD. This is not required of the GCD if the landowner wins. All of these factors serve as deterrents to landowners to sue a GCD. SB 332 and HB 1730 do not change that.

Opponents to SB 332 and HB 1730 say that it would strip away authority from the GCDs. The reality is that every property right can be extensively regulated and groundwater is no different. Can you name a property right that cannot be regulated? These bills don't change that, nor do they undo the fact that the Texas Constitution specifically requires groundwater to be protected. SB 332 and HB 1730 do however require GCDs to justify the public's interest in limiting or denying the right to capture groundwater. All other government regulation of private property must be justified, why shouldn't groundwater regulation?

Let's be very clear, landowners aren't opposed to reasonable regulation. Their property rights have always been regulated in the public's interest. And, landowners support GCDs' ability to protect groundwater resources for the future. But, we must continue to recognize that groundwater is a private property right in order to maintain the balance between landowners' ownership interest in groundwater below the surface and the protection of this precious natural resource. That means clarifying the law by passing SB 332 and HB 1730.

Landowners across Texas need to send a clear message to government that we want our property rights in groundwater below our land reaffirmed and recognized.



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