PICKING UP THE TAB: TEXAS' OIL & GAS POSTPRODUCTION BATTLE

I. INTRODUCTION

Within the last year, Texas courts have addressed a series of issues related to oil and gas postproduction costs and the effect of contractual language that seems to prohibit their deduction from oil and gas royalties.[1] In the oil and gas industry, a royalty is understood to be an "expense-free share" of oil and gas proceeds that are distributed throughout the existence of a lease.[2] Postproduction costs are defined as expenses incurred by the lessee that "add value" to the oil or gas when it is in its "raw state at the location of the wellhead prior to a final sale."[3] Some of the costs incurred may derive from the need for "compression, treatment, processing, transportation, and dehydration" of the oil and or gas.[4] In 1996, the Supreme Court of Texas delivered an opinion in *Heritage Resource, Inc. v. Nationsbank*[5] that has led to years of confusion in determining how contractual language can prohibit postproduction costs from being applied to royalties.[6] In June of 2015, the Supreme Court of Texas again faced the task of determining whether or not contractual language was sufficient enough to prohibit postproduction costs from being applied to an overriding

1. Robert Theriot & Josh Downer, *Our Texas Heritages: The Summer of the No Deductions Clause*, HOUS. LAW., Nov.–Dec. 2014, at 26, 26.

2. Edward B. Poitevent, II, *Post-Production Deductions from Royalty*, 44 S. TEX. L. REV. 709, 715 (2003).

3. *Id.* at 714.

4. *Id.*

5. Heritage Res., Inc. v. Nationsbank, 939 S.W.2d 118 (Tex. 1996).

6. Theriot & Downer, *supra* note 1, at 27.

royalty.[7] In *Chesapeake Explorations, L.L.C. v. Hyder*, the court, in a 5-4 decision, determined that the contractual language used by a lessor was sufficient in prohibiting the lessee from deducting postproduction costs from an overriding royalty.[8] The dissent contended that the majority failed to use established Texas oil and gas principles and law in their interpretation of the contractual language.[9]

This Note suggests that the Texas Supreme Court erred in its holding of *Chesapeake Exploration*, and in doing so, failed to recognize well-known Texas oil and gas principles and law. This Note also suggests that the failure of the court to hold true to established Texas oil and gas law will lead to confusion among lessors and lessees, the need for contractual clarification, and unnecessary litigation. First, this Note looks to assess the majority's decision in *Chesapeake Exploration*, and how previous cases were used, or not used, in reaching that conclusion. Also, the Note takes a look at how the decision will impact future contract interpretations and create the need for additional judicial clarification. In doing so, Part II of this Note examines the background law leading up to *Chesapeake Exploration*. The examination is comprised of an in depth look into *Heritage Resources, Inc. v. Nationsbank*, along with a look at cases implementing the *Heritage* holding. Part III discusses the facts of *Chesapeake Exploration*. Part IV of the Note analyzes how the court arrived at its conclusion and the implications that its decision may have on future litigation. Part V concludes the Note.

II. BACKGROUND

To understand the effect the court's ruling may have on the future of the Texas oil and gas industry and subsequent litigation, it is necessary to review the law leading up to *Chesapeake Exploration, L.L.C. v. Hyder*, and more specifically the case of *Heritage Resources, Inc. v. Nationsbank*. A look at cases implementing the *Heritage* holding will also be helpful.

A. Heritage Resources, Inc. v. Nationsbank

When the Supreme Court of Texas delivered its opinion on *Heritage Resources, Inc. v. Nationsbank*, the public outcry could not be ignored.[10] So much so, the Supreme Court of Texas received over twenty amicus curiae

7. Chesapeake Exploration, L.L.C. v. Hyder, No. 14-0302, 2016 WL 352231, at *1 (Tex. Jan. 29, 2016).
8. *Id.* at *5.
9. *Id.* (Brown, J., dissenting).
10. Theriot & Downer, *supra* note 1, at 27.

briefs asking for a rehearing.[11] Requests were received from organizations "such as the Texas Land Commissioner, University of Texas, and even the Boy Scouts of America."[12] The reason for the outcry stemmed from the Supreme Court of Texas's holding that royalty clause language that seemingly prohibited postproduction cost failed to do so, and instead, held that postproduction costs are inherent in determining royalty value.[13]

Nationsbank, as trustee for the lessors, filed suit against the lessee, Heritage Resources, Inc., claiming that Heritage Resources improperly deducted post-production costs from the payment of Nationsbank's royalty.[14] Three royalty clauses were at issue, and all three stated "that there shall be no deductions from the value of Lessor's royalty by reason of any required processing, cost of dehydration, compression, transportation, or other matter to market such gas."[15] In order to determine if the correct royalty amount had been paid out, the court stated that it "must first determine the market value of the gas at the well."[16] The Texas oil and gas industry uses two methods for determining market value at the well.[17] One method is to use comparable sales, which are "comparable in time, quality, quantity, and availability of marketing outlets."[18] The second method is used when equivalent sales are not freely available.[19] The second method "involves subtracting reasonable post-production marketing costs from the market value at the point of sale."[20] The court determined that there were no comparable sales, thus adopting to use the second method.[21] The court stated, "Heritage must pay a royalty based on the market value at the point of sale less the reasonable post-production marketing costs."[22] In reaching its determination, the court stated that "the only conclusion [they] can draw is that the post-production clauses merely restate existing law."[23] The court in *Heritage* also identified a split within themselves on "whether 'market value at the well' includes or excludes post-production costs."[24] The court addressed this issue of inconsistency, by stating, "In construing language commonly used in oil and gas leases, we must keep in mind that there is a

11. *Id.*
12. *Id.*
13. Heritage Res., Inc. v. Nationsbank, 939 S.W.2d 118, 122–24 (Tex. 1996).
14. *Id.* at 120.
15. *Id.* at 120–21.
16. *Id.* at 123.
17. *Id.* at 122.
18. *Id.*
19. *Id.*
20. *Id.*
21. *Id.* at 123.
22. *Id.*
23. *Id.* at 122.
24. *Id.* at 127.

need for predictability and uniformity as to what the language used means."[25] The court left us with a more complete definition of "market value at the well," while leaving Nationsbank with a take nothing judgment.[26]

The court's decision received major backlash, leading to a motion for rehearing, in which a justice recused himself of the opinion, two justices left the majority and joined the dissent for the rehearing, leaving the author of the opinion as the only majority voter to stand behind the original opinion.[27] The motion for rehearing failed by "mere operation of law," as the majority opinion faltered.[28] Regardless of the chaos that followed the decision, *Heritag*e has carried on, but has left both lessors and lessees to struggle with trying to figure out what contractual language is ample enough to prohibit postproduction costs.[29] Despite the cloudiness that was left in its wake, *Heritage* is still good law, and is relied upon in opinions and dissents alike.[30]

B. A Look at Cases Following the Heritage *Holding*

Almost immediately, the holding in *Heritage* was being discussed and cited.[31] On the same day the Supreme Court of Texas decided *Heritagte*, the court also ruled on *Judice v. Mewbourne Oil Co.*[32] *Judice* involved another issue with lease language and the application of postproduction costs to royalties.[33] In *Judice*, lessors Samuel Judice and Kathryn Thompson brought suit against their lessee, Mewbourne Oil Co., for damages resulting from improper payment of royalties.[34] Mewbourne had deducted postproduction costs from the lessor's royalty.[35] The issue was whether or not the "market value at the well" and "net proceeds" language in the lease allowed the lessors may take their royalties free of postproduction costs.[36] The court looked to *Heritage* to confirm that the phrase, market value at the well, meant "value at the well, net of any value added by compressing the

25. *Id.* at 129.
26. *Id.* at 122–24.
27. Theriot & Downer, *supra* note 1, at 27.
28. *Id.*
29. *Id.*
30. *See* Chesapeake Exploration, L.L.C. v. Hyder, No. 14-0302, 2016 WL 352231, at *5 (Tex. Jan. 29, 2016) (Brown, J., dissenting); French v. Occidental Permian Ltd., 440 S.W.3d 1, 3 (Tex. 2014).
31. *See* Judice v. Mewbourne Oil Co., 939 S.W.2d 133, 135–38 (Tex. 1996).
32. *Id.* at 137.
33. *Id.* at 134.
34. *Id.* at 135.
35. *Id.*
36. *Id.* at 135–36.

gas after it leaves the wellhead."[37] The court again looked to *Heritage* to show it understood net proceeds to mean "before value is added by preparing the gas for market."[38] Using principles established in *Heritage*, the court held that Mewbourne was entitled to deduct postproduction costs from the lessor's royalty.[39]

In 2006, the view on postproduction costs established in *Heritage* was now considered to be the "general rule."[40] In *Cartwright v. Cologne Production Co.*, a lessor again attempted to use "net proceeds" and "market value at the well" language in an oil and gas lease reservation to prevent postproduction costs from being applied to a royalty.[41] The court stated, "'Net proceeds' expressly contemplates deductions, and we note once again that 'at the well' means before value is added by preparing the gas for market."[42] The court went on to discuss the effectiveness of specific phrases, and how they must be read in their proper context.[43] While discussing *Miller v. Speed*, the court identified the phrase "free of cost of producing," and discussed how the court in *Miller* determined that when the reservation was read in whole, the clause "clearly provided that royalty was to be calculated after the minerals were 'produced, saved and made available for market.'"[44]

III. *CHESAPEAKE EXPLORATION, L.L.C. V. HYDER*

Chesapeake Exploration leased 948 mineral acres in the Barnett Shale from the Hyder family.[45] In doing so, three royalty provisions were created, one of which being the basis for this litigation.[46] The provision detailing the overriding royalty "calls for 'a perpetual, cost-free (except only its portion of production taxes) overriding royalty of five percent (5.0%) of gross production obtained' from directional wells."[47] Two additional provisions within the lease were key in the formation of the court's decision.[48] The provisions provided that the Hyders had the option to take their royalty

37. *Id.* at 135.
38. *Id.* at 137.
39. *Id.*
40. Cartwright v. Cologne Prod. Co., 182 S.W.3d 438, 446 (Tex. App.—Corpus Christi 2006, pet. denied) (citing Heritage Res., Inc. v. Nationsbank, 939 S.W.2d 118, 122 (Tex. 1996)).
41. *Id.* at 444.
42. *Id.* at 445.
43. *Id.* (discussing Miller v. Speed, 259 S.W.2d 235 (Tex. Civ. App.—Eastland 1952, no writ)).
44. *Id.* at 445–46.
45. Chesapeake Exploration, L.L.C. v. Hyder, No. 14-0302, 2016 WL 352231, at *1 (Tex. Jan. 29, 2016).
46. *Id.* at *1–3.
47. *Id.* at *1.
48. *Id.*

share in kind or in cash, and that the decision rendered in *Heritage Resources Inc. v. Nationsbank* had no effect upon the lease at hand.[49]

The Hyders' argument was based on the fact that an overriding royalty, by nature, is free of production costs, thus leaving the overriding provision language to refer only to postproduction costs.[50] Chesapeake countered by stating that the cost-free language was "merely a synonym for overriding royalty," citing several cases in support.[51] Both the majority and dissent agreed that in the past, courts have recognized similar contractual language to be repetitive or stressing in nature.[52] Despite the brief agreement, the majority held that Chesapeake failed to prove that the language did not refer to postproduction costs in this situation.[53] They pointed out that the lease stated the overriding royalty was to be cost-free, except for postproduction taxes.[54] The court thus ruled that reserving postproduction taxes, while arguing that the cost-free language only referred to postproduction costs, "would make no sense," leaving the opportunity for the meaning of the contractual language to refer only to postproduction costs.[55] The dissent argued that the language was in fact repetitive language.[56] Identifying several Texas cases, Justice Brown indicated that "parties often allocate tax liability on the royalty owner while at the same time specifically emphasizing that the royalty is free from production costs."[57]

Chesapeake Exploration also argued that since the provisions indicate that the overriding royalty is to be paid on gross production, they are then "based on the market value at the wellhead, which bears postproduction costs."[58] The majority indicated the Hyders were helped by the provision giving them the option to take the royalty in kind, and holding that if they so choose that option, the royalty would not be subject to postproduction costs.[59] The majority agreed with the Hyder argument, and stated that since they have the option to take their overriding royalty in kind, they could "use the gas on the property, transport it themselves to a buyer, or pay a third

49. *Id.*
50. *Id.* at *3.
51. *Id.* (citing McMahon v. Christmann, 303 S.W.2d 341, 343 (Tex. 1957); R.R. Comm'n v. Am. Trading & Prod. Corp., 323 S.W.2d 474, 477 (Tex. Civ. App.—Austin 1959, writ ref'd n.r.e.); Midas Oil Co. v. Whitaker, 123 S.W.2d 495, 495 (Tex. Civ. App.—Eastland 1938, no writ)).
52. *Id.* at *3, *5.
53. *Id.* at *3.
54. *Id.*
55. *Id.*
56. *Id.* at *5 (Brown, J., dissenting).
57. *Id.*
58. *Id.* at *3 (majority opinion).
59. *Id.* at *4.

party to transport it to market as they might negotiate."[60] The dissent rebuts this argument by asserting that one method of accepting a royalty should not have an effect on the other, and that "the manner in which they accept their royalty should not determine the value they receive."[61] Justice Brown states that even if the Hyders were to take the gas in kind, postproduction and transportation costs would certainly be incurred in getting the gas to market.[62]

In their final argument, Hyder pointed to the provision that indicated they were to not be held to the *Heritage Resources* holding.[63] They stated that by placing this provision in the lease, this would clearly indicate that they intended their royalty value to not be effected by postproduction costs.[64] The court acknowledges the *Heritage* case, but holds that its influence is only to indicate that "the effect of a lease is governed by a fair reading of its text."[65] In the majority's final statement, it indicated that "[t]he disclaimer of *Heritage Resources*' holding does not influence our conclusion."[66] In the dissent, Justice Brown agreed with the majority's finding that *Heritage* does hold that a lease is governed by a fair reading of its text.[67] He goes on to highlight the similarities in royalty language between this case and the *Heritage* case, and indicated they were not to be ignored.[68] He points out that the language used in the two other oil and gas royalty provisions called for the royalty to be paid out "free and clear of all production and post-production costs and expenses, including but not limited to, production, gathering, separating, storing, dehydrating, compressing, transporting."[69] According to Justice Brown, the similarity of this detailed royalty language to language that was deemed ineffective in *Heritage*, gives less effect to the vague cost-free language in the overriding royalty provision.[70] He also argues that although "the disclaimer expressly extends to 'the terms and provisions of this Lease,' its location in the oil-and-gas-royalty clause highlights that it is intended to support the 'free and clear' language, not to give the simple 'cost-free' designation any additional meaning."[71]

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60. *Id.*
61. *Id.* at *5 (Brown, J., dissenting).
62. *Id.*
63. *Id.* at *4 (majority opinion).
64. *Id.*
65. *Id.* at *5.
66. *Id.*
67. *Id.* (Brown, J., dissenting).
68. *Id.*
69. *Id.* (internal quotation marks omitted).
70. *Id.*
71. *Id.*

Although Justice Brown's dissent was joined by three additional justices, the majority, consisting of five justices, stated "the lease text clearly frees the gas royalty of postproduction costs, and reasonably interpreted, we conclude, does the same for the overriding royalty."[72] This finding confirmed the appellate court's affirmation of the trial court's judgment in favor of the Hyders, "awarding them $575,359.90 in postproduction costs that Chesapeake wrongfully deducted from their overriding royalty."[73]

IV. ANALYSIS OF THE *CHESAPEAKE* DECISION

The Supreme Court of Texas's decision in *Chesapeake Exploration* could lead to more litigation and court required interpretation, as more and more landowners are including, and reviewing, similar contractual disclaimers.[74] More specifically, the "misinterpretation of this 'cost free' language will throw into dispute thousands of royalty provisions in oil and gas leases and overriding royalty instruments throughout Texas."[75] The court's decision, along with the reasoning used, was contrary to "settled Texas oil and gas law principles."[76]

By determining that a royalty value may differ if a lessor decides to take their royalty in kind versus in cash, the majority created the basis on which to rule the overriding royalty's cost free language applied to postproduction costs.[77] By ruling an overriding royalty's value may be contingent on whether one decided to take it in kind versus in cash,[78] the court creates direct conflict with its previous holding in *Heritage*, where it was determined that value of a lessor's royalty is found by "determining the market value at the well and multiplying it by the fraction specified in the royalty clause."[79] In the *Heritage* holding, the court continued to explain, in order to determine the market value at the well, the lessee must subtract "reasonable post-production marketing costs."[80] This basic principle of Texas oil and gas has been upheld and supported in the years after *Heritage*.[81]

72. *Id.* (majority opinion).
73. *Id.* at *2.
74. Theriot & Downer, *supra* note 1, at 29–30.
75. Brief of *Amicus Curiae* Texas Oil & Gas Ass'n at 3, Chesapeake Exploration, L.L.C. v. Hyder, No. 14-0302, 2016 WL 352231 (Tex. Jan. 29, 2016) [hereinafter Amicus Brief].
76. *Id.* at 4.
77. *Chesapeake Exploration, L.L.C.*, 2016 WL 352231, at *4.
78. *Id.*
79. Heritage Res., Inc. v. Nationsbank, 939 S.W.2d 118, 122 (Tex. 1996).
80. *Id.* at 123.
81. *See* Judice v. Mewbourne Oil Co., 939 S.W.2d 133, 135–38 (Tex. 1996); Cartwright v. Cologne Prod. Co., 182 S.W.3d 438, 446 (Tex. App.—Corpus Christi 2006, pet. denied).

Furthermore, even if one has opted to take their royalty in kind as unprocessed gas, it has been established that "[t]he market price of the processed gas reflects the value of the unprocessed gas at the well only if reasonable postproduction processing costs are deducted."[82] According to the facts in *Chesapeake*, whether a lessor has chosen to take their royalty in cash or in kind, Texas courts have stated, "deduction of post-production costs ensures that the minerals are valued, for purposes of determining the cash royalty . . . just as if the royalty owner had taken his royalty in kind."[83] After using established Texas oil and gas law and principles to show how a royalty value is established, the broad "cost free" language used in the *Chesapeake* case can only lead to the conclusion that it was repetitive language, reiterating the rule for production costs, and not language intended to be applied to postproduction costs.[84]

V. CONCLUSION

The Supreme Court of Texas incorrectly decided *Chesapeake Exploration L.L.C. v. Hyder*. Using plenty of case law, the dissent correctly analyzed the facts of the case and then rejected the majority's view. By going against established Texas oil and gas law and principles, this holding will cause confusion between lessors and lessees. The "predictability and uniformity" that was sought in *Heritage*[85] has now been removed with the holding rendered in *Chesapeake*. The holding will lead to unnecessary future clarification by the courts. Furthermore, there will be a multitude of lawsuits as a result of the holding, many of which will be seeking a determination of the value difference between taking a royalty in cash versus in kind.[86] Lessors that have the option to take their royalty in kind or in cash, may take this holding and look to gain financially by filing a suit for underpayment from previous cash disbursements. In addition, they may also look to burden the lessee with postproduction costs, by choosing to take their royalty in cash over in kind.[87] Instead of further strengthening established Texas oil and gas law and principles, the Supreme Court of Texas added to the already cloudy contractual waters of oil and gas leases with their holding. The courts will be asked to clarify this holding against previous ones, as the struggle for determining who is responsible for postproduction costs carries on.

Gabriel Gonzalez

82. French v. Occidental Permian Ltd., 440 S.W.3d 1, 3 (Tex. 2014).
83. Amicus Brief, *supra* note 75, at 12.
84. *Id.* at 17.
85. *Heritage Res., Inc*., 939 S.W.2d at 129.
86. Amicus Brief, *supra* note 75, at 22–23.
87. *Id.*