Our Texas Heritage: The Summer of the No Deductions Clause

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I. Introduction

The dramatic rise in natural gas shale production has served as a catalyst for increased debate within and challenges to the oil and gas industry, both publicly and privately. One need only read the newspaper, attend a movie or watch television to become aware of increased environmental concerns, particularly with regards to hydraulic fracturing or "fracking." Perhaps the most divisive issue between stakeholders in oil and gas properties and the companies producing them, however, continues to be the age old question of money. While environmental concerns dominate the conversation in the media, the proper calculation and payment of royalties still gets the most ink in the courthouse.

While shale production has created a variety of new complications in the arena of proper royalty calculation, it has highlighted some longstanding ones as well. One that resurfaced with a vengeance this past year in Texas courts is the issue of "deductions" from royalty payments, particularly under leases that purport to prohibit such deductions. By definition, a "royalty" is paid free of the costs of "production,"1 which means that a royalty owner receives his or her royalty payment free of the costs of exploration such as drilling, surveying, reworking etc. As part of the royalty calculation process, however, lessees typically allocate costs that are incurred to process, treat and transport natural gas once it is already produced (referred to as "post-production" costs).

Understandably, royalty owners, hearing the reports of the booming oil and gas industry, often balk when their royalty check comes with an attached list of fees subtracted from their interests, leading many to attempt to contract out of this general rule. This article discusses three Texas cases decided this year that highlight the difficulties that parties often face in prohibiting deductions.

II. Deductions – The Fundamentals

A. "At the Well" States

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Courts in producing states fall into two basic camps on the issue of deductions. Some states, like Texas, follow the "at the well" rule. "At the well" states start with the general presumption that royalties are valued "at the well" free of the costs of production, but subject to any post-production costs that enhance the value of natural gas by moving, treating or processing it for sale in a market downstream from the wellhead. Although these jurisdictions sometimes disagree on the precise line between production and post-production activities, all agree that a lessee must generally deduct post-production costs from the price established downstream to properly calculate the upstream, wellhead value of the gas. These states include Texas, Louisiana, Montana, New Mexico, North Dakota and Pennsylvania.2

B. "First Marketable Product" States

The "at the well" rule is sometimes referred to as the majority rule. This majority is a slim one, however. A robust minority of jurisdictions, including Colorado, Kansas, Oklahoma and West Virginia, have adopted a contrary rule based upon the implied duty to market.3 These states hold that the lessee has an implied duty to make the natural gas marketable, which includes bearing all costs that are necessary to bring the gas into a marketable form. Other jurisdictions have reached the same result by statute.4 Like the "at the well" states, there is disagreement among these jurisdictions as to precisely when natural gas is "marketable," which is typically treated as a fact question.5 Most states, however, will permit the deduction of post-production costs that are incurred after the production reaches the first "market," such as interstate pipeline transportation costs.6

III. Contracting Out of the General Rules – the *Heritage* Debate

A. The *Heritage* Rule

All jurisdictions, whether they follow the "first marketable product" rule or the "at the well" rule, ostensibly recognize that an oil and gas lease is a contract and that the parties may alter the general rules by agreement. Actually accomplishing this result in practice, however, may be moredifficultthan one would expect. In Texas, the presumption that the general "at the well" rule applies is so strong that the Texas Supreme Court in Heritage Resources Inc. v. Nationsbank interpreted a lease as permitting the lessee to deduct transportation costs despite language in the lease specifically stating that there should be no deductions for transportation.7

In that case, the leases required that royalties be paid on "market value at the well," but this language was immediately followed by clauses stating that "provided, however, there shall be no deductions from the value of Lessor's royalty by reason of any required . . . transportation, or other matter to market such gas."8 The Texas Supreme Court applied a narrow reading of this "no deductions" clause, first noting that it only prohibited deductions from the "value of the Lessor's Royalty."9 The court then held that words such as "royalty" and "market value at the well" have generally understood meanings that permitted deductions to calculate wellhead value. Thus, the court held, the no deductions clause only applied after the lessee determined the wellhead value of the gas by deducting transportation costs from the downstream sales price. The lessee could continue to deduct post-production costs in order to calculate this wellhead value, and the no deductions clause necessarily became "surplusage as a matter of law."10

The Heritage opinion received harsh public criticism at the time it was decided. The Texas Supreme Court received more than 20 amicus curiae briefs asking the court to rehear the case, including from such organizations such as the Texas Land Commissioner, University of Texas, and even the Boy Scouts of America.11 A motion for rehearing soon followed, and the majority opinion collapsed. One justice recused himself, two justices joined the dissent and another left the majority to join the concurrence. Thus, the motion for rehearing was denied by mere operation of law, with only its author continuing to adhere to the original majority opinion. Justice Gonzalez cautioned in his dissent to the denial of rehearing that, "[b]ecause we are without majority agreement on the reasons supporting the judgment, . . . the judgment itself has very limited precedential value and controls only this case" and that" "[c]ases relying on the new rule of law pronounced in [the original majority opinion] are similarly restricted."12

Despite this harsh criticism, the Heritage opinion appears to have stood the test of time, and ever since, parties on both sides of a lease have struggled to determine what language is sufficient to effectively prohibit deductions. That debate continues today and serves as the focal point for two recent Fifth Circuit decisions and a third case currently before the Texas Supreme Court.

B. Warren v. Chesapeake Exploration, L.L.C.

On July 16, 2014, the Fifth Circuit issued its opinion in Warren v. Chesapeake Exploration, L.L.C.13 Judge Priscilla R. Owen, the former Texas Supreme Court justice who authored the concurring opinion in Heritage, wrote for the court. The Warren Court examined no deductions clauses similar to those addressed in Heritagethat were contained in addenda to pre-printed lease forms. The court separated these leases into two groups for its analysis.

The first lease form provided for royalties based on “the amount realized . . . computed at the mouth of the well,” but then contained an addendum that stated “all royalty paid” would be “free of all costs and expenses . . . including . . . costs of compression, dehydration, treatment and transportation.”14 The addendum also contained a clause expressly stating that the addendum would supersede any inconsistent provisions in the pre-printed lease and that “all other printed provisions of this Lease . . . are in all other things subrogated to the express and implied terms . . . of this Addendum.”15

By including the no -deductions clause in an addendum to the lease that explicitly provides that the addendum controls, one could argue that the parties more clearly evidenced the intent to prohibit deductions than in Heritage, where the no deductions clause was part of the base royalty calculation provisions. The Fifth Circuit disagreed, however, and held that Heritage permitted the lessee to continue taking deductions to calculate the upstream wellhead value, despite the addendum. Judge Owen explained that Heritage “require[s] a careful examination of the various terms and phrases that the parties use.”16 After carefully construing the pre-printed lease with the addendum, the court ultimately concluded that the parties had failed to change the general rule. Like the lease in Heritage, the lease in Warren explicitly required that royalties be calculated “at the mouth of the well.” There was nothing in the addendum that changed this point of valuation. Therefore, the no deductions clause constituted surplusage.17 Importantly, the fact that the no-deductions clause was contained in an addendum made no substantive difference because the addendum only controlled in the event of a conflict or inconsistency. Heritage required that the two clauses be harmonizedand, thus, there was no conflict.18

The court stated that the second lease form “differed substantially” from the other, but, because the parties had not picked up on this fact until the reply briefs, the court was forced to dismiss the case without prejudice.19 Though the Fifth Circuit did not elaborate on how the second form differed, it is apparent that the addendum in the second form provided that royalties were based on “market value at the point of sale,” suggesting that a change to the point of valuation from the wellhead to the “point of sale” may have altered the result under the second lease form.20 This question would not remain unanswered for verylong.

C. Potts v. Chesapeake Exploration, L.L.C.

Less than two weeks later, in Potts v. Chesapeake Exploration, LLC,21 Judge Owen addressed this “market value at the point of sale” language in a case involving the same defendants and essentially the same facts. Like the second lease form at issue in Warren, the lease in Potts required royalties to be calculated as the “market value at the point of sale,” and contained a no deductions clause. Chesapeake argued that this language still did not prohibit deductions in this particular case because the wellhead and the “point of sale” were one and the same. Chesapeake, like many producers in the modern market, used a series of affiliates to market production. The upstream producing entity sold gas in this area at the wellhead to a midstream affiliate. This affiliate then performed all of the post-production activities to process and deliver the gas to third- party purchasers at various downstream delivery points. Chesapeake’s midstream affiliate paid Chesapeake a weighted average of these downstream sales minus the post-production costs and fees incurred between

the wellhead and delivery.22 Thus, Chesapeake argued, the relevant “point of sale” was the wellhead, where Chesapeake transferred title to its midstream affiliate, and, therefore, Chesapeake was required to deduct post-production costs in order to properly calculate market value at this point.

The Fifth Circuit agreed and held that, since the sale factually took place at the wellhead, Chesapeake had properly deducted post-production costs to calculate the wellhead value of the natural gas.23 Quoting language from her Heritage concurrence, Judge Owen noted that the "concept of 'deductions' . . . from the value of the gas is meaningless when gas is valued at the well. Value at the well is already net of reasonable marketing costs."24 Because Chesapeake had not taken deductions from the value at the wellhead point of sale, Chesapeake did not violate the provisions of the lease.25

The plaintiffs in Potts argued strenuously, among other things, that this interpretation frustrated the intent of the parties because the plaintiffs specifically included the "point of sale" language in the leases to contract around the Heritage rule. The plaintiffs argued that they had relied on Judge Owen's own guidance from her concurrence in Heritage in which then-Justice Owen stated that if the parties "had intended that the royalty owners would receive royalty based on the market value at the point of delivery or sale, they could have said so."26

Judge Owen responded that the point of her concurrence was only to stress that parties may choose the point where royalties are valued, and that the court must apply the specific language chosen by the parties.27 Here, the plaintiffs had chosen to value royalties at the point of sale, which just happened to be at the wellhead where the affiliate sale took place.28 Perhaps the plaintiffs should have read the rest of the concurrence: "There is little doubt that at least some of the parties to these agreements subjectively intended the [no deductions clause] to have meaning," but "[w]e cannot re-write the agreement for the parties."29

D. Chesapeake Exploration, L.L.C. v. Hyder

The Warren court determined that merely including a no deductions clause in an addendum does not alter the general rule contained in Heritage. Meanwhile, the Potts decision demonstrates that even express changes to the point of valuation may not alter the "at the well" rule in every case. In what has the potential to be the finale to this 2014 Heritage trilogy, the Texas Supreme Court recently requested full briefing in Chesapake Exploration, L.L.C. v. Hyder,30 where the lessors took a different approach, expressly disclaiming Heritage altogether.

Hyder is interesting for a variety of reasons. The main focus before the Texas Supreme Court, however, is the proper interpretation of the overriding royalty clause ("ORRI"). The Hyder lease permitted Chesapeake to use existing well pads on the leased premises to produce from adjacent lands. In return, the Hyders received a "cost-free (except only its portion of production taxes) overriding royalty of . . . (5.0%) of gross production obtained from each such well[.]"31 The landowner royalty clause, contained in a separate section of the lease, broadly disclaimed Heritage, stating that the parties agreed "that the holding in the case of [Heritage Resources v. Nationsbank] shall have no application to the terms and provisions of this Lease."32

The plaintiffs argued that the "cost-free" language, when paired with the express disclaimer of Heritage, prohibited Chesapeake from deducting post-production costs from payments under the ORRI. Chesapeake argued, in turn, that the word "cost-free" did nothing more than restate the general rule that an overriding royalty is free of the costs of production, but subject to post-production costs. The San Antonio Court of Appeals held for the plaintiffs, interpreting the words "cost free" as prohibiting both production and post-production costs.

The opinion has caused somewhat of a stir within the industry. Although the lease arguably contains unique language due to the Heritage disclaimer, the opinion does not appear to rest on this fact. The decision contains very little discussion of Heritage at all, stating only that Chesapeake's citations to Heritage were "unpersuasive" because of the disclaimer in the landowner royalty clause.33 Instead, the appellate court's decision states that the words "cost free" are sufficient to contract out of Texas's general "at the well" rule and to prohibit deductions expressly. A contrary result, the court explained, would fail to give effect to the terms "cost free" and render this language meaningless.34

Chesapeake filed a petition for review, which is supported by an amicus brief filed by the Texas Oil and Gas Association ("TXOGA"). Chesapeake and TXOGA primarily argue that the appellate court failed to address the words "gross production" in the ORRI clause and to acknowledge that an ORRI, by its very nature, is an "in-kind" interest that must be valued at the wellhead at the time of production. When the words "cost free" are construed with this wellhead point of valuation, Chesapeake argues, the clause clearly refers only to the costs of production.35

The Heritage disclaimer presents the most obvious wrinkle to this argument. Chesapeake's position depends to some degree on the same "cost free" versus point of valuation matchup at issue in the Heritage decision. In the most recent briefing, the plaintiffs appear to rely primarily on the uniqueness of their lease in including the express reference to Heritage rather than a broad interpretation of the words "cost free" in general.36 If the Supreme Court grants the petition for review, it could potentially decide the issue on the "no Heritage" clause alone without even having to address the general meaning of the words "cost free." Though a narrow approach, the enforceability of these types of clauses would still have far reaching implications as landowners increasingly include express references to Heritage in royalty clauses.

Chesapeake's brief on the merits was due on October 22, 2014, with the plaintiffs' due on November 11, 2014. With the recent decisions in Warren and Potts, there is a strong chance that the court will grant review. While unlikely, it is possible that the Supreme Court could review the Heritage decision altogether, perhaps even vindicating Justice Gonzalez's predictions regarding the limited precedential value of the decision. Either way, the resurgence of the Heritage issue this summer clearly suggests the need for more judicial guidance.

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Endnotes

*1 French v. Occidental Permian Ltd., ___ S.W.3d ____ (Tex. 2014), Tex. LEXIS 533, at *4-5 (Tex. June 27, 2014).*

2 Judice v. Mewbourne Oil Co., 939 S.W.2d 133 (Tex. 1996); Culpepper v. EOG Res., Inc., 47,154-CA (La. App. 2 Cir. 05/16/12), 92 So.3d 1141; Montana Power Co. v. Kravik, 586 P.2d 298 (Mont. 1978); ConocoPhillips Co. v. Lyons, 299 P.3d 844 (N.M. 2012); Bice v. Petro-Hunt, L.L.C., 768 N.W.2d 496 (N.D. 2009); Kilmer v. Elexco Land Servs., Inc., 990 A.2d 1147 (Pa. 2010).

3Garman v. Conoco, Inc., 886 P.2d 652 (Colo. 1994); Gilmore v. Superior Oil Co., 192 Kan. 388, 388 P.2d 602 (Kan. 1964); Wood v. TXO Prod. Corp., 854 P.2d 880 (Okla. 1992); Estate of Tawney v. Columbia Natural Res., LLC, 633 S.E.2d 22 (W. Va. 2006).

4 See, e.g., Mich. Comp. Laws § 324.61503b.

5 See Coulter v. Andarko Petroleum Corp., 292 P.3d 289, 305-06 (Kan. 2013) (discussing the potential differences between the Colorado and Kansas versions of the first marketable product doctrine).

6 See, e.g., W.W. McDonald Land Co. v. EQT Prod. Co., 983 F. Supp.2d 790, 2013 U.S. Dist. LEXIS 165427(S.D. W.Va. 2013).

7 Heritage Res., Inc. v. Nationsbank, 939 S.W.2d 118, 120-21, (Tex. 1996).

8 Id.

9 Id. at 122.

10 Id. at 123.

11 Heritage Res., Inc. v. Nationsbank, 960 S.W.2d 619 (Tex. 1997) (Gonzalez, J., dissenting on rehearing).

12 Id. at 620.

13 Warren v. Chesapeake Exploration, L.L.C., No. 13-10619, 2014 U.S. App. LEXIS 13562 (July 16, 2014).

14 Id. at 7-8.

15 Id. at 8.

16 Id. at 10.

17 Id. at 13-14.

18 Id. at 13.

19 Id. at 19-20.

20 Id. at 19.

21 Potts v. Chesapeake Exploration, L.L.C., No. 13-10601, 2014 U.S. App. LEXIS 14448 (5th Cir. July 29, 2014).

22 Id. at 3.

23 Id. at 8-12.

24 Id. at 12 (quoting Heritage, 939 S.W.2d at 130 (Owen, J., concurring)).

25 Id. at 9.

26 Heritage, 939 S.W.2d at 131 (Owen, J., concurring) (emphasis original).

*27 Potts, 2014 U.S. App. LEXIS 14448, at *14-15.*

28 Id. at 14-15.

29 Heritage, 939 S.W.2d at 130-31 (Owen, J., concurring).

30 Chesapeake Exploration, L.L.C. v. Hyder, 427 S.W.3d 472 (Tex. App. –San Antonio 2014, pet. filed.).

*31 Response to Petition for Review, at *2, available at http://www.search.txcourts.gov/SearchMedia.aspx?MediaVersionID=2682cb83-c014-4ea4-9229-2428896b1144&coa=cossup&DT=BRIEFS&MediaID=5f609e08-20d3-41bb-9be0-f486589dd723 (Case No. 14-0302).*

32 Hyder, 427 S.W.3d at 477.

33 Id. at 479.

34 Id. at 479-80.

35 See, e.g., Pet. for Review, at 5-11, available at http://www.search.txcourts.gov/SearchMedia.aspx?MediaVersionID=df4d9a35-13f3-4fc7-b1ca-2b63d4016ffb&coa=cossup&DT=BRIEFS&MediaID=15722779-4efa-440c-9052-89263a7017b2 Case No. 14-0302).

36 Response to Petition for Review, at 5, available at http://www.search.txcourts.gov/SearchMedia.aspx?MediaVersionID=2682cb83-c014-4ea4-9229-2428896b1144&coa=cossup&DT=BRIEFS&MediaID=5f609e08-20d3-41bb-9be0-f486589dd723 Case No. 14-0302).