Cost-Free Royalties --- Where Valuation Begins and Post-Production Cost Deductions End

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Texas jurisprudence has long held that the royalty "stick" of the mineral estate, whether the Lessor's royalty under a lease, a non-participating royalty created by conveyance or reservation, or an overriding royalty interest carved out of the leasehold estate[1], is free of production costs. *Delta Drilling Co. v. Simmons*, 338 S.W.2d 143, 147 (Tex. 1960). Although the royalty interest is not subject to costs of production, Texas courts have held that royalty is usually subject to post-production costs, including taxes, treatment costs to render it marketable, and transportation costs. *Heritage Resources, Inc. v. NationsBank*, 939 S.W.2d 118, 122 (Tex. 1996). That said, the courts have further long stated that parties are free to contract around this general rule, and by express agreement, the parties may allocate post-production costs however they see fit. *See id*.

The idea that parties to a contract are free to draft the specific terms by expressly setting those terms out in the document is a basic rule of contract construction throughout American jurisprudence. This idea seems relatively simple. If the default law holds one thing, and the parties want to alter that thing, they simply say so in the contract. When it comes to drafting around the default rules for post-production cost deductions from a royalty interest, however, the simplicity fades into a complex quagmire in which the courts have not been particularly helpful to practitioners.

The problem primarily lies in the manner in which a particular royalty is valued and the time/place where the value determination is made. Without an in-depth understanding of royalty

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[1] For convenience, this paper will focus on royalties created by lease agreements.

valuation methods, many drafters find themselves attempting to draft around default laws that simply cannot be altered. This is further complicated by the fact that there are numerous means of valuing a royalty.

I. Royalty Valuation Methods

The two primary methods of royalty valuation are "market value" and "proceeds value". The two primary times/places royalties are valued are "at the wellhead/mouth of the well" and "down-stream sales" to third parties. Understanding how, when, and where the royalty valuation takes place is the key to understanding how to allocate post-production cost deductions between the parties.

a. Market Value Method

Specifically, when a lease states that the royalty is to be determined based on "market value," the valuation method is what a willing buyer would pay a willing seller in an arms-length transaction. Evidence of market value can be comparable sales. However, comparable sales are not always available. This is where understanding the time/place of royalty valuation becomes important. If the lease states that the royalty is to be determined based on "market value at the well," Texas courts have held that, as a matter of law, this phrase means "value at the well, net of any value added by compressing the gas after it leaves the wellhead." *Judice v. Mewbourne Oil Company*, 939 S.W.2d 133, 135 (Tex. 1996). This method involves subtracting reasonable postproduction marketing costs from the market value at the point of sale. *See id*. Reasonable postproduction marketing costs include transporting the gas to the market and processing the gas to make it marketable. *See id*. Thus, when market value is calculated at the well, all increase in the ultimate value received at the downstream point of sale that can be attributable to the expenses incurred in transporting and processing the product must be deducted because that is the way to arrive at the value of the gas at the moment it escapes from the wellhead. *Ramming v. Natural Gas Pipeline Co. of America*, 390 F.3d 366, 59 (5th Cir. 2004) (applying Texas law); *Heritage Resources*, 939 S.W.2d 118.

b. *Proceeds Method*

"Proceeds" or "amount realized" royalty valuation methods require measurement of the royalty based on the amount the lessee in fact receives under its sales contract for the gas. *Bowden v. Phillips Petroleum Co.*, 247 S.W.3d 690 (Tex. 2008); *Yzaguirre v. KCS Resources, Inc.*, 47 S.W.3d 532 (Tex. App. Dallas 2000), *judgment aff'd*, 53 S.W.3d 368 (Tex. 2001)(A royalty based on proceeds is calculated on what the lessee actually receives for the oil and gas.) The caveat here, however, much like with the “market value” method, is the time/place of the valuation. If the lease language itself indicates that the point of sale takes place “at the well,” then, much like the net-back approach for “market value at the wellhead,” the equation, as a matter of law, contemplates post-production deductions. Thus, the coupling of “proceeds” or “amount realized” with “at the mouth of the well,” results in a distinction without a difference between the two types of valuation methods as far as post-production cost deductions are concerned.

For example the following royalty valuation clauses were litigated in *Tana Oil and Gas Corp. v. Cernosek*, 188 S.W.3d 354 (Tex. App.---Austin 2006, pet denied):

1) to pay lessor for gas and casinghead gas produced from said land (1) when sold by lessee, [royalty fraction] of the amount realized by lessee, *computed at the mouth of the well*;

2) The royalties to be paid by Lessee are: ... (b) on gas, including casinghead gas and all (or other) gaseous substance(s), produced from said land provided that on *gas sold at the well(s) the royalty (royalties) shall be [royalty fraction] of the amount realized* from such sale;

3) Royalty on Gas: Lessee shall pay to Lessor as royalty on gas, including casinghead gas or other gaseous substance(s) produced

> from said land and sold on or off the premises [royalty fraction] of the *net proceeds* at the well received from the sale thereof. *See id.* at 356-57.

In *Tana Oil and Gas Corp.,* the lessor sold the raw gas to a third party at the well. *See id*. The gas contract with the third party provided that the lessor would be paid 84% of the amount the third party realized from the resale of processed and treated product. *See id.* At trial, the lessors argued that, because the lessee was obligated to pay royalties on 100% of the total volume of gas sold at the well, the lessors were entitled to royalties on the additional 16% of the proceeds realized from resale of the treated product, despite the fact the lessee never received that amount. *See id.*

The court held that the lessor's erred in equating the sale of raw gas at the well to the separate and distinct third-party sales made after treatment. *Tana Oil and Gas Corp*., 188 S.W.3d 354. The lessee sold raw gas at the well, before value was added, and thus never received all of the proceeds from the sales of the treated product. *See id*. Accordingly, by paying the lessors royalties based on 100% of the money it actually received, the lessor did in fact pay royalties on 100% of the total volume of raw gas that it sold at the well. *See id*. at 360-362.

Similarly, in *Occidental Permian, Ltd. v. Helen Jones Foundation*, the royalty valuation clause at issue involved "amount realized" from the sale of gas when gas was sold at the wells. 333 S.W.3d 392, 396 (Tex. App.---Amarillo 2011, pet. denied). In determining whether the lessee paid royalties accurately, the court held:

> royalty is calculated on the amount realized from sale only if the gas is sold at the well . . . There is no dispute that the "such sales" referred to are the sales of gas at the wells . . . the proceeds to which [lessors] pointed . . . were not proceeds of the sale of gas as produced at the wellhead, but those of the sale of natural gas liquids and residue gas after processing . . . [the lessors argue that] the amount realized thus includes amounts [the lessee] realized from its activities beyond the wellhead, including its gathering of the gas, its processing of the gas at [the plant] and its marketing of the extracted liquids. Evidence of proceeds received by [a third party] from sales of [treated] gas at locations far removed from the wellhead is not

evidence of the amount realized by [lessee] from a sale of raw gas at the well. Id. at 399-400.

It is important to note that the term "amount realized" has been construed by Texas courts to mean the proceeds received from the sale of the gas or oil. *Bowden*, 247 S.W.3d 690. The term appears to be synonymous with "net proceeds," however, only when it is not coupled with an "at the well" point of sale. *Tana Oil and Gas Corp*., 188 S.W.3d 354. The lines between such terms, however, have become blurred in the courts' various opinions. It will be especially important to remember this line-blurring when analyzing the Texas Supreme Court's most recent decision in this area of the law – *Chesapeake Exploration, L. L. C. v. Hyder*, 59 Tex. Sup. Ct. J. 290 (Tex. Jan. 29, 2016) *opinion substituted for Chesapeake Exploration, L. L. C. v. Hyder*, 58 Tex. Sup. Ct. J. 1182 (Tex. 2015). Before jumping ahead, however, it's necessary to review case law directly addressing attempts by parties to prohibit post-production cost deductions.

II. Effect of the Post-Production Cost Deduction Prohibition Clause (the "no deductions" clause)

a. Heritage Resources, Inc. v. NationsBank

The Texas Supreme Court's first major holding related to attempts to draft around post-production cost deductions came in the 1996 *Heritage Resources, Inc. v. NationsBank* case. 939 S.W.2d 118 (Tex. 1996). It is important to understand *Heritage Resources* in the context of royalty valuation. In *Heritage Resources*, the leases at issue required that royalties on gas be paid based upon the "market value at the well" methodology. However, the leases also included the following prohibition: "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." *Id*. at 120-121. It was this "no deductions" clause that was before the Texas Supreme Court.

The court noted that the "no deductions" clause only prohibited deductions from the "value of the Lessor's Royalty." *See id*. Accordingly, the high court could not review the clause in a vacuum. *See id*. Instead, the court had to review the "no deductions" clause in light of the lease royalty valuation method, and the lease required a "market value at the well" methodology. As demonstrated by the royalty valuation case law, a market value at the well valuation method only applies after the lessee determines the wellhead value of the gas, and this is determined *by deducting post-production costs from the downstream sales price*. *See id*. at 122-123. Thus, as the *Heritage Resources* concurrence astutely recognized: the "concept of 'deductions' of marketing costs from the value of the gas is meaningless when gas is valued at the well." *Id*. at 130.

In this connection, the court held that the lessee could deduct post-production costs in order to calculate the wellhead value. *Heritage Resources*, 939 S.W.2d at 123. Therefore, the "no deductions" clause necessarily became "surplusage as a matter of law." *Id*. In other words, post-production cost deductions are built into the value of the Lessor's Royalty under the "market value at the well" valuation method, and thus, the no-deductions prohibition is automatically rendered meaningless by said methodology.

The *Heritage Resources* decision has been the law of the land since 1996, and since that time, practitioners and drafters have struggled to determine what language can sufficiently prohibit post-production cost deductions. The primary approach drafters have taken is two-fold. First, the drafter attempts to remove any language marrying the "no deductions" addendum clause from the "royalty valuation" method stated in the body of the lease. The *Heritage Resources* analysis appeared to rely strongly on the "no deduction" clause language referring back to the "value of the Lessor's Royalty." *See id*. Thus, drafters post-*Heritage Resources* have attempted to untangle that language such that the "no deductions" clause might stand alone. The second part of the approach to draft around *Heritage Resources* has been to expressly disclaim the *Heritage Resources* holding in the lease addendum.

The following is an example of this two-fold lease addendum approach where the royalty valuation method set out in the body of the lease was the "amount realized by lessee, computed at the mouth of the well":

> Royalties tendered to the Lessor under this Lease shall be made without deductions for producing, gathering, storing, separating, dehydrating, compressing, transporting, pipelining or any other costs or expenses needed to make the product saleable or to transport it to market . . .
>
> Additionally, said royalties shall never bear, either directly or indirectly, under any circumstances, the costs or expenses (including depreciation) to construct, repair, renovate, or operate any pipeline, plant, or other facilities or equipment used in connection with the treating, separation, extraction, gathering, processing, refining, compression, transporting, manufacturing, or marketing of oil or gas produced from the leased premises or lands pooled therewith. In no event shall Lessor receive a price less than Lessee in sales to non-affiliates.
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> It is the intent of the parties that the provisions of this Paragraph 19 are to be fully effective and enforceable and are not to be constructed as "surplusage" under the principles set forth in *Heritage Resources v. NatlonsBank*, 939 S.W.2d 118 (Tex. 1996).

This language, at first glance, appears sufficient to avoid the *Heritage Resources* holding. Parties can draft around existing law. Unlike *Heritage Resources*, this clause is not tied directly to the lease's royalty valuation method. The parties set out in detail what expenses cannot be deducted from the royalty. And, this clause expressly disclaims the *Heritage Resources* holding.

b. *<u>The 5th Circuit Companion cases</u>*

For nearly 20 years since the *Heritage Resources* opinion, thousands of leases have been executed with various clauses, similar to the one above, added to addendums to prevent the deduction of post-production costs from the royalty. Until late last year, Texas courts had failed to examine the effectiveness of these approaches. Only a handful of cases have examined *Heritage*

Resources in-depth over the last two decades. Two of those are 5th Circuit Court of Appeals' decisions, and their precedential value on state law is relatively weak – other than the fact that both opinions were authored by Justice Priscilla Owens, who wrote the much followed concurrent opinion in the *Heritage Resources* case while she was still sitting on the Texas Supreme Court's bench.

1) Warren v. Chesapeake Exploration, L.L.C.

In the first case, *Warren v. Chesapeake Exploration, L.L.C.*, 759 F. 3d 413 (5th Cir. 2014), the 5th Circuit interpreted a "no deductions" clause that was similar to the clause at issue in *Heritage Resources*. The court, relying on *Heritage Resources*, held that such a clause only prohibits deductions from certain points of valuation. *See id*. at 418. The point of valuation in the Warren lease was at the mouth of the well. *See id*. As set forth in *Heritage Resources*, where the point of valuation is at the mouth of the well, said valuation point includes post-production costs as a matter of law. *See id*. As such, the "no deductions clause had no effect because the royalty valuation equation had already taken into account said deductions.

The major difference between *Heritage Resources* and *Warren* was that the "no deductions" clause appeared in the addendum of the lease rather than in the lease royalty clause itself. The court found this difference irrelevant. The addendum only controlled when it conflicted with the pre-printed portion of the lease. *See id*. at 419. Because *Heritage Resources* held that the no deduction clause was surplusage to, rather than inconsistent with, the lease royalty clause, the *Warren* court followed suit, holding there was no conflict, and the addendum no deduction clause likewise represented surplusage and thus had no effect on the royalty valuation. *See id*.

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

In *Potts v. Chesapeake Exploration, L.L.C.*, 760 F.3d 470 (5th Cir. 2014), a companion case the 5th Circuit released two weeks after *Warren*, the court addressed a royalty clause where valuation was based on "market value at the point of sale." *Id*. at 471. It was undisputed that the point of sale was the mouth of the well. *See id*. at 474. In this connection, the lessee argued that the "no deductions" clause in the lease addendum was tantamount to surplusage. *See id*. The Fifth Circuit agreed, and Justice Owen quoted from her *Heritage Resources* concurrence, stating again 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." *Id*. at 475.

It is important to note that the lessors in *Potts* claimed that they had relied on Justice Owen's own suggestion from her *Heritage Resources'* concurrence in drafting the lease. *See id*. at 476. Specifically, the *Heritage Resources* concurrence noted that had the royalty owners intended a different result, they could have drafted the lease such that "they would receive royalty based on the market value at the point of delivery or sale." *Potts*, 760 F.3d at 476. In response to this argument, Justice Owen pointed out that her concurrence was designed only to advise parties to choose the point where royalties are valued. *See Id*. Thus, the lessors believed the major distinguishing factor between *Potts* and *Heritage Resources* was the "point of sale" language versus the "market value at the mouth of the well" language.

Justice Owens disabused the parties of that notion in stressing that time and place are the relevant factors to be reviewed. *See id*. In other words, "point of sale" is meaningless standing alone. A determination of "where" that point of sale takes place must be made before the effectiveness of a post-production cost deduction clause can be considered. Accordingly, there was no true distinction between the languages of the two leases at issue in the two cases.

c. *<u>Heritage Resources Revisited – Chesapeake Exploration, L.L.C. v. Hyder.</u>*

After nearly 20 years, the Texas Supreme Court has finally revisited *Heritage Resources* in the 2015 *Chesapeake Exploration, LLC v. Hyder* case.[2] The main issue in *Hyder* involved the interpretation of an overriding royalty clause. 2016 WL 352231 at 1. The lease at issue contained three royalty provisions. The first two are as follows:

1) twenty-five percent (25%) of the market value at the well of all oil **. . .** as of the day it is produced and stored;

2) for [gas], twenty-five percent (25%) of the price actually received by [lessees] for such gas. *Chesapeake Exploration, L.L.C. v. Hyder*, 427 S.W.3d 472, 476 (Tex. App.---San Antonio 2014) *aff'd* at 2016 WL 352231 (Tex. 2016).

These royalty clauses contained the following limitation:

> The royalty reserved herein by [lessors] shall be free and clear of all production and post-production costs and expenses, including but not limited to, production, gathering, separating, storing, dehydrating, compressing, transporting, processing, treating, marketing, delivering, or any other costs and expenses incurred between the wellhead and [lessee's] point of delivery or sale of such share to a third party. *Id*.

And, the overriding royalty clause provided as follows: "a perpetual, cost-free (except only its portion of production taxes) overriding royalty of five percent (5.0%) of gross production obtained." *Id*. at 478. And, the lease further included the following disclaimer of *Heritage Resources*: "[lessor] and [lessee] agree that the holding in the case of *Heritage Resources, Inc. v. NationsBank,* 939 S.W.2d 118 (Tex.1996) shall have no application to the terms and provisions of this Lease." *Id*. at 477.

The lease itself permitted the lessee to use existing well pads on the leased property for production from adjacent lands in exchange for an overriding royalty payment to the lessors for

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[2] *Chesapeake Exploration, L. L. C. v. Hyder*, 2016 WL 352231 1. ; 59 Tex. Sup. Ct. J. 290 (Tex. Jan. 29, 2016) *opinion substituted for Chesapeake Exploration, L. L. C. v. Hyder*, 58 Tex. Sup. Ct. J. 1182 (Tex. 2015). *Please note, the original opinion was withdrawn and a new opinion substituted in its place on January 29, 2016. A detailed review of the substituted opinion, however, demonstrates no significant, substantive changes between the original and the new opinion. Citations in this paper will be made to the Texas Supreme Court's most recent *Hyder* opinion.

said production. *Hyder,* 2016 WL 352231 at 1. The lessee deducted post-production costs from both the gas royalty and the overriding royalty. *See id.* at 2. The lessors sued. The trial court held that the lessee breached the lease by charging the lessors' royalties with such costs, and the lessee appealed.

On appeal, the San Antonio court considered a number of issues. *Hyder,* 427 S.W.3d 472. The first issue was whether the gas royalty clause allowed for post-production cost deductions. *See id*. The appellate court distinguished the gas royalty clause from *Heritage Resources* based on the "free and clear" of post-production cost language in the royalty clause as well as the express disclaimer of *Heritage Resources* in the lease. Id. at 477-478. Accordingly, the appellate court upheld the trial court's ruling that the lessees had breached the lease in deducting such cost from the lessor's gas royalty. *See id.*

As to the overriding royalty clause, the lessee argued that an overriding royalty is cost free as to production expenses, but like a lease royalty, the lessors are still subject to post-production costs. In relying on *Heritage Resources*, the lessee claimed the addition of the "cost free" language to the overriding royalty clause was simply surplusage – illustrating the nature of the interest as defined by law. The San Antonio court disagreed, holding:

> While we acknowledge an overriding royalty is normally subject to post-production costs, we also acknowledge Texas law allows the parties to modify this default rule. We must also "presume that the parties to a contract intend every clause to have some effect. Although the lease recites the parties agreed to a "cost free (except only its portion of production taxes) overriding royalty," adopting appellants' interpretation would render the term "cost free" meaningless and require us to determine the parties' true intent was to provide a traditional "overriding royalty," or a "cost free (except only to its portion of production taxes and post-production costs) overriding royalty." Consequently, adopting such interpretation would require us to rewrite the lease and alter the parties' contract which we may not do. *Id*.

Consequently, the lessee sought review from the Texas Supreme Court, which the high court granted.

The only issue that was explicitly decided by the Texas Supreme Court was whether the lessors' overriding royalty was subject to post-production cost deductions. *Hyder,* 2016 WL 352231 at 1. The lessors argued that the "cost-free" language, when paired with the express disclaimer of *Heritage Resources,* prohibited the lessee from deducting post-production costs from overriding royalty. Lessee again countered that the "cost free" language was simply surplusage. *See id*. at 2. The Texas Supreme Court sided with the lessors and affirmed the appellate court decision. *See id*. at 5.

The most interesting points made in the high court's decision are multi-fold – the least of which is the impact of the result with respect to the specific overriding royalty clause. While the lessors in *Hyder* may have won the day, the war still seems to favor the lessees. First, although the court stated the only issue before it was the effect of the overriding royalty clause, the court specifically addressed the gas royalty clause:

> The gas royalty in the lease does not bear postproduction costs because it is based on the price Chesapeake actually receives for the gas through its affiliate, Marketing, after postproduction costs have been paid. Often referred to as a "proceeds lease" , the price-received basis for payment in the lease is sufficient in itself to excuse the lessors from bearing postproduction costs . . . But the royalty provision expressly adds that the gas royalty is "free and clear of all production and post-production costs and expenses," and then goes further by listing them. This addition has no effect on the meaning of the provision. It might be regarded as emphasizing the cost-free nature of the gas royalty, or as surplusage. *Id*. at 2.

This language is troubling for a number of reasons. First, unlike the appellate court decision, this language gives no effect to the "free and clear" language but holds it is nothing more than surplusage. If that is the case, then how is the "cost free" language used in the overriding royalty clause any more sufficient?

Second, the court seems to be saying that by making a lease a "proceeds lease," this, in and of itself, is sufficient to avoid post-production cost deductions from the lessor's royalty. *See id*. at 2. But, this conclusion is inconsistent with prior law relating to "proceeds leases." The high court has previously held that a "proceeds lease" that uses a "net proceeds" methodology, per se, contemplates post-production cost deductions. This is so because a "net proceeds" calculation is synonymous with the amount realized, calculated at the mouth of the well. Conversely, a "gross proceeds" lease would theoretically not allow such deductions. *See Judice*, 939 S.W.2d at 136.

This is where the various court decisions begin to blur meanings. In the *Potts* case, the lease at issue was a proceeds lease, but the court held that the lessor's royalty still bore the cost of post-production activities. In that case, Justice Owens was very careful to stress that the underlying reasoning behind *Heritage Resources* was not a matter of "market value" versus "proceeds" methodologies. The *Heritage Resources* reasoning stems from the "when and where" valuation --- specifically, at what point is the royalty valued: at the well or downstream after processing? In *Potts*, the point of sale was at the well; thus, the lessor's royalty included post-production cost deductions. This "timing" analysis, although perhaps overly complicated, at least makes logical sense and provides a more solid understanding of the rule set out in *Heritage Resources*.

But, *Potts* is a 5th Circuit case, and the Texas Supreme Court does not address *Potts* at all in *Hyder*. Unfortunately, in connection with the gas royalty clause, the court does not address the "timing" analysis either. In failing to do so, the question of whether a "no deductions" clause will have any effect on a "proceeds" lease that calculates royalty at the mouth of the well is left unclear. The *Hyder* case expressly states: "the price-received basis for payment in the lease is sufficient in itself to excuse the lessors from bearing postproduction costs." *Hyder*, 2016 WL 352231 at 2. Standing alone, that statement seems to imply that timing does not matter – call it a proceeds lease and no deductions. But, as noted, such an implication flies in the face of long-standing Texas law with respect to how a price paid at the well calculation is derived, and it undermines the only logical reasoning behind the *Heritage Resources* holding – that timing is the key. If this *Hyder* statement relates solely to "gross proceeds" leases, it could be harmonized with existing law. But, a "net proceeds" lease, as examined in both *Judice* and *Potts,* is a different animal altogether.

Another aspect of the *Hyder* case that is interesting is the court's rejection of the *Heritage Resources* disclaimer. In the context of "timing," again, this holding makes sense. If a royalty is valued at the well – be it market value or actual price received – those calculations include post-production cost deductions, and thus, a disclaimer of the *Heritage Resources* holding is as ineffective as a "no deductions" clause. But, again, the court veers away from the timing analysis in both its analysis of the gas royalty clause and the overriding royalty clause. The bottom line seems to be that a disclaimer of *Heritage Resources* is of no effect under any circumstances.

As to the specific holding in the case as it relates to the overriding royalty clause, the court states:

> *Heritage Resources* does not suggest, much less hold, that a royalty cannot be made free of postproduction costs. *Heritage Resources* holds only that the effect of a lease is governed by a fair reading of its text. A disclaimer of that holding, like the one in this case, cannot free a royalty of postproduction costs when the text of the lease itself does not do so. Here, the lease text clearly frees the gas royalty of postproduction costs, and reasonably interpreted, we conclude, does the same for the overriding royalty. The disclaimer of *Heritage Resources'* holding does not influence our conclusion. *Id*. at 5.

Again, however, the court does not provide any "clear" reasoning for why the "cost free" language frees the gas royalty (and by extension thereof the overriding royalty) of post-production costs. Is "cost free" now a defined term of art that, regardless of timing of royalty valuation, frees the royalty (any royalty) of bearing post-production costs? For example, had the *Heritage*

Resources case included the "cost free" language, would that result have been different, irrespective of the mental gymnastics used in that case to implicate timing as the only relevant factor? And, why is the term "cost free" effective but the phrase "free and clear of all post-production costs" surplusage? These are some of the many questions drafters will have to face in the aftermath of *Hyder*.

Finally, the *Hyder* dissent is worth note. While the majority held that the "cost-free" language of the overriding royalty clause controlled, the dissent focused on the "gross production" language. *Hyder, dissent*, 2016 WL 352231. The dissent notes that "gross production" is not as familiar a term as "market value at the well" or "amount realized, calculated at the mouth of the well." *Id*. But, based on the standard definition of "gross" and "production," the dissent concludes this phrase is synonymous with an "at the well" calculation. *See id.*

> Post-production activities will add value to the Hyders' overriding royalty—their share of minerals produced from the directional wells—but they have not yet done so at the time of production. Though the overriding royalty may not have been expressed using the familiar market-value-at-the-well language, I read its value as being just that. *Id*.

Under such a reading, the dissent would have held that the "cost free" language was surplusage because, as *Heritage Resources* holds, a "no deductions" prohibition clause cannot free a royalty from a valuation method that is inherently based on a post-production cost deduction calculation. In other words, gross production is what is obtained at the well, and as the dissent argues, in light of *Heritage Resources*:

> here, no post-production costs have been incurred at the time of production, and it means nothing to say the overriding royalty is free of those yet-to-be incurred costs. I would resolve this tension to give full meaning to "gross production," which defines the interest where "cost-free" is only an adjective describing it. *Id*.

Despite the inherent problems with the new *Hyder* decision, the Texas Supreme Court now has the opportunity to clarify the opinion in light of the problems raised by the dissent as the case of *Commissioner of General Land Office of State of Texas v. Sandridge Energy*, Inc. is now at the high court and briefing on the merits has been requested. 454 S.W.3d 603 (Tex. App.---El Paso 2014, pet filed). *Sandridge Energy* involves the interpretation of the following clause: "gross production or the market value thereof such value to be based on the highest market price paid or offered for gas of comparable quality in the general area where produced and when run, or the gross price paid or offered to the producer whichever is greater." *Id*. at 608. The El Paso court of appeals determined this clause equivalent to be a market-value at the well valuation. *See id*. at 616. It will be interesting to see if the high court grants petition for review, and if so, how the opinion attempts to harmonize the case with *Hyder*.

III. WHERE DO WE GO FROM HERE?

After 20 years of drafting around *Heritage Resources*, the majority of practitioners are looking back and realizing that their efforts to work around the holding were most likely in vain. Due to the Hyder opinion, Lessors who may have seen their royalty free of post-production costs could now be receiving royalty checks for lower amounts. The question now is: How do we draft a royalty valuation clause and/or no-deductions clause to meet the understanding of the parties?

At first glance, for lessees, the answer seems relatively clear. If the royalty is calculated as the market value "at the mouth of the well," the royalty is subject to post-production costs irrespective of the addition of a no-deductions clause or a Heritage Resources disclaimer. But, due to the *Hyder* language that the price-received basis for payment is "sufficient in itself to excuse the lessors from bearing postproduction costs," the implication is that any "proceeds" could free the lessor's royalty from postproduction costs whether it is a gross proceeds or a net proceeds lease. This may be an unintended consequence of the Hyder language, but the argument is not ripe for adjudication, and drafters will have to hope the high court eventually clarifies this language. In the meantime, if the lessee wants the lessor to bear post-production costs, the safest bet is to calculate the lessor's royalty as market value at the well.

For lessors, the picture is even less clear. Drafters now know that a market value at the well royalty valuation will render a no deductions clause surplusage no matter what language they use in the no deductions clause. But, what about "market value at the point of sale"?

This will depend on "where" the actual point of sale occurs. If evidence demonstrates the point of sale is "at the well," the lessor is back to square one and a no deductions clause will be ineffective. Thus, it becomes imperative that the lessor determine "where" the actual point of sale will occur before relying on this language. Moreover, a lessee may change its point of sale over the course of a lease. Accordingly, lessors may need to firm up the point of sale language to something more specific such as: "cost free royalty, calculated by the market value at the final point of sale, downstream, after all processing, transporting, gathering, marketing, and other post production operations have occurred.

As to a proceeds lease, lessors, like the lessees, would be at risk relying on the Hyder language. To be full-proof, a proceeds lease should be just as specific as a market value lease. Therefore, the royalty valuation clause should specifically state that the royalty is "cost free, calculated by the gross proceeds or total amount realized at the final, downstream point of sale, after all processing, transporting, gathering, marketing, and other post production operations have occurred.

CONCLUSION

Whether the drafter is preparing a lease favorable to a lessor or lessee, the traps inherent in formulating a cost-free or burdened royalty are now abundant due to the confusing nature of the case law. As noted, the courts' analyses logically turn on timing. However, because Hyder arguably stirs away from this logic, the effects of proceeds leases are now unclear. Thus, drafters, in order to be safe, should use succinct, specific language in the royalty valuation clause and stop relying on no-deduction addendums until Texas courts hopefully, one day, shore up this issue with a clear, bright-line edict.