<u>Cost-Free Royalties --- Where Valuation Begins and Post-Production Cost Deductions End</u>

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Texas jurisprudence has long held that the royalty "stick" of the mineral estate is free of production costs. Although the royalty interest is not subject to production costs, royalty is usually subject to post-production costs. *Heritage Resources, Inc. v. NationsBank*, 939 S.W.2d 118, 122 (Tex. 1996). Nevertheless, parties are free to contract around this general rule and may allocate post-production costs however they see fit. *See id*. The ability to contract around default laws seems relatively simple. Whatever the law holds, the parties simply sign a contract to achieve a different result. Unfortunately, the courts have made this process much more difficult in the context of drafting around the post-production cost deduction default rules. And, 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 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 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 and how to draft around the default rules.

"Market value" is what a willing buyer would pay a willing seller in an arms-length transaction, generally determined by comparable sales. If comparable sales are unavailable, understanding the time/place of royalty valuation becomes of paramount importance. "Market value at the well," means value at the well, net of any value added to the product after it leaves the wellhead. *Judice v. Mewbourne Oil Company*, 939 S.W.2d 133, 135 (Tex. 1996). This method deducts postproduction costs. Thus, all increase in the ultimate royalty value attributable to the expenses incurred after production is built in to the market value at the well equation.

"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 product. 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, the equation contemplates post-production deductions. Thus, the coupling of "proceeds" or "amount realized" with "at the mouth of the well," results in the same valuation as "market value at the well."

II. No Post Production Deduction Clauses

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). In *Heritage Resources*, the royalty valuation method was "market

value at the well." 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. The court noted that the "no deductions" clause only prohibited deductions from the "*value* of the Lessor's Royalty." *See id*. (emphasis added). Accordingly, the court reviewed the "no deductions" clause in light of the "market value at the well" royalty valuation method, holding that because post-production cost deductions are inherent in this valuation method, the "no deductions" clause necessarily became "surplusage" and therefore had no effect. *Id*.

Since *Heritage Resources,* drafters have taken is two-fold approach. First, the drafter attempts to remove any language marrying the "no deductions" clause with the "royalty valuation" method. Second, drafters attempts to expressly disclaim the *Heritage Resources* holding in the lease addendum. The effectiveness of this solution, however, has been called into question due to a series of cases. *See Warren v. Chesapeake Exploration, L.L.C*., 759 F. 3d 413 (5th Cir. 2014)("no deductions" clause in addendum ineffective where royalty valuation method "at the well"); *Potts v. Chesapeake Exploration, L.L.C*., 760 F.3d 470 (5th Cir. 2014) ("no deductions" clause ineffective where royalty valuation method is "market value at the point of sale" but "point of sale" is at the well.)

After nearly 20 years, the Texas Supreme Court finally revisited *Heritage Resources* in the 2015 *Chesapeake Exploration, LLC v. Hyder* case.[1] *Hyder* involved multiple royalty clauses. One valued royalty as market value at the well, one valued royalty as price actually received, and one value royalty as "gross production obtained." The first two clauses were limited by the following: "The royalty reserved herein by [lessors] shall be free and clear of all production and post-production costs . . ." *Id*. The third clause, although containing no express post-production deduction limitation, was expressly called a "cost-free" royalty. *Id*. at 478. Finally, the lease included an express disclaimer of the *Heritage Resources* holding. *Id*. at 477.

The only issue that was explicitly decided by the Texas Supreme Court was whether the third royalty valuation method allowed for post-production cost deductions. *Hyder*, 2016 WL 352231 at 1. The court held that the "cost-free" designation prohibited the lessee from deducting post production costs. *See id*. at 2. Nevertheless, while the lessors in *Hyder* may have won the day, the war still seems to favor the lessees due to the court's analysis therein.

The first problem with *Hyder* is that it gives effect to the "cost free" language in the third royalty valuation method, but it ignores the "free and clear" language limitation on the other to two royalty clauses in the same lease. 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? Had the *Heritage Resources* case included the "cost free" language, would that result have been different, irrespective of the implication of timing? And, why is the term "cost free" effective

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[1] *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.

but the phrase “free and clear of all post-production costs” surplusage?

The second *Hyder* problem is that, in dicta, the court opines 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.

It’s important to note that in the 5th Circuit *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, the author (who wrote the concurrent opinion in *Heritage Resources)* 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, the Texas Supreme Court does not address *Potts* at all in *Hyder*. Unfortunately, in connection with the first two royalty clauses at issue in *Hyder*, 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 its analysis of the royalty clauses. Still, 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 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.

Finally, the *Hyder* dissent is worth note. The majority held that the "cost-free" language of the overriding royalty clause controlled, but 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.*

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 thus, no post-production costs have been incurred at the time of production. The dissent would have resolved 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 briefs on the merits have been submitted. 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*.

II. 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 fool-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 steers 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.