

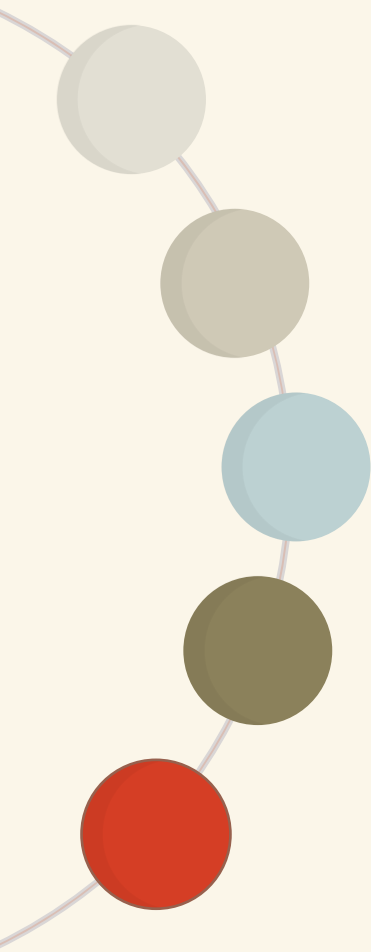
OG Energy Education Series

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Deduction of Post-Production Expenses

April 6, 2022

Overview

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- I. Historical Background of Deduction of Post-Production Expenses
 - II. Heritage Resources and Clauses Prohibiting Deductions
 - III. Recent Case Law Regarding the Deduction of Post-Production Expenses
 - IV. Comparison Between Texas and Other Jurisdictions

Historical Background of Deduction of Post-Production Expenses

Historical Background

- ❖ Under an oil and gas lease, the physical location of the “property” is the wellhead on the leased property.
- ❖ The wellhead is the location where the lessee reduced the oil or gas to its physical possession.
- ❖ Thus, historically, the wellhead, being the physical location of the property rights, was the location for calculating the value or price of the production under the oil and gas lease.

The Oil and Gas Lease

- ❖ The oil and gas lease will contain one (or more) royalty clauses in which the lessee agrees to pay the lessor a royalty.
- ❖ Royalty clauses may address:
 - Royalty based on “proceeds”
 - Royalty based on “amount realized”
 - Royalty based on “market value”
 - Value of gas sold at the well
 - Value of gas used off the leased premises
- ❖ The lessee acquires title to all of the oil and gas it produces and the lessor and other royalty do not acquire title to the production. As a result, if the lessee fails to comply with the terms of a royalty clause, the lessor may sue for breach of the lease, but does not have a cause of action for conversion.

Types of Royalty Clauses

❖ In Kind

- The lessee covenants to deliver to the credit of the lessor, in the pipeline the equal part of one-eighth (1/8) of the oil produced and saved.

❖ Net Proceeds

- The royalties to be paid by lessee on gas produced from said land and sold on or off the premises, are one-eighth (1/8) of the net proceeds at the well received from the sale thereof.

❖ Market Value

- The lessee covenants to pay royalties on gas, produced from said land and sold or used, the market value at the well of one-eighth (1/8) of the gas so sold or used.

Where is the Royalty Calculated?

- ❖ Traditionally, many oil and gas leases required that the lessee calculate the market value or price of its production “at the well” or “at the wellhead.”
- ❖ Other royalty clauses required broader terms, such as “in the field of production” and other clauses require the value to be calculated at a point downstream (value or consideration received by Lessee at the point of delivery of such gas).

Implied Covenant to Market

❖ The Implied Covenant to Market

- Imposes upon the lessee the duty to market hydrocarbons produced from a well and to obtain the best price and terms possible for the sale of production.
- Serves as the basis for the “first marketable product doctrine” (Oklahoma, Colorado, Kansas, West Virginia).
- Texas courts have concluded that the implied covenant to market does not permit courts to rewrite a lease agreement contrary to the parties intent, even if the a contrary interpretation would produce a more equitable agreement.

❖ Texas does not follow the first marketable product doctrine.

Deduction of Costs

- ❖ By definition, royalty is paid free of the costs of exploration, drilling and production of oil and gas (the “production costs”).
- ❖ Post-production costs/activities add value to the production in its raw state at the location of the wellhead prior to a final sale.
- ❖ Post-Production costs include:
 - Dehydration and separation
 - Compression
 - Removal of substances to make the production marketable
 - Gathering costs
 - Marketing

General Rule for Deduction of Costs

- ❖ The general rule is that royalty clauses based on “proceeds” or “amount realized” or “market value at the well” permit deduction of post-production costs from gas sales before paying royalties.
- ❖ Royalty, by definition, is a share of the “production.” The lessee is solely responsible for bearing all costs necessary to achieve “production.”
- ❖ Generally, the lessee was entitled to pay royalties on the basis of the value or price of its production at the wellhead, not a location downstream of the wellhead.

Market Value at the Well

❖ Comparable Sales Method

- Lessee determined the market value of its production at the wellhead by averaging the prices that the lessee and other producers are receiving at the same time and in the same field, for oil or gas of comparable quality, quantity and availability.

❖ Workback or Netback Method

- Lessee determined the market value of its production at the wellhead by taking the sales price that it received for its production at a downstream point of sale, then subtracting the reasonable post-production costs that the lessee incurred after extracting the production.

Net Proceeds or Amount Realized

- ❖ Lessee calculated the royalty payments on the basis of the actual price of its production, measured at the wellhead.
- ❖ If the lessee sold its production to a third-party purchaser at the wellhead, then the lessee had to pay lessors their proportional royalty share of the actual price that the lessee received for its production.
- ❖ If the lessee sold its production at a point downstream of the wellhead, then lessee calculated the royalties owed under a workback method.

Heritage Resources and **Clauses Prohibiting Deductions**

Heritage Resources, Inc. v. NationsBank

- ❖ The Texas Supreme Court construed the phrase “market value at the well” in a lease that also contained language prohibited the deduction of post-production costs.
- ❖ The operator was selling the gas and deducting the transportation costs and paying royalty on the net amount as “market value.”
- ❖ The Texas Supreme Court affirmed the operator’s practice and held that when royalty is based on “market value” any subsequent language prohibiting deduction of post-production costs is surplusage and cannot be enforced.

Anti-Heritage Clauses

- ❖ Following the *Heritage* decision, many lessors sought to avoid the application of *Heritage* and the deduction of post-production costs and included anti-*Heritage* clauses.
- ❖ The inclusion of anti-*Heritage* clauses and the industry practice of deducting transportation and other post-production costs has led to a wave of royalty litigation.

Recent Case Law Regarding the Deduction of Post-Production Expenses

Post-Production Deduction Case Law

- ❖ Warren v. Chesapeake Exploration, L.L.C., 759 F.3d 413 (5th Cir. 2014)
 - The lease provided for royalties based upon “the amount realized by Lessee, computed at the mouth of the well.”
 - Lessors included a no deductions clause and an anti-Heritage provision.
 - The Fifth Circuit concluded the lease permitted post-production deductions and that Heritage still permitted the operator to net-back to a wellhead price.

Post-Production Deduction Case Law (Cont.)

- ❖ *Potts v. Chesapeake Exploration, L.L.C.*, 760 F.3d 470 (5th Cir. 2014)
 - The lease provided for royalties based on the “market value at the point of sale” and that all royalty “shall be free of all costs and expenses related to marketing.”
 - Chesapeake sold the gas to a Chesapeake affiliate at the wellhead and was paid a weighted average of sales proceeds minus the post-production costs incurred to bring the gas downstream.
 - The Court explained that “market value at the point of sale” was unambiguous and required the operator to value production wherever the gas was sold.

Texas Supreme Court's View of Post-Production Deductions

❖ *Chesapeake Exploration, L.L.C. v. Hyder*, 483 S.W.3d 870 (Tex. 2016)

- The provision in dispute provided 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 drilled from the surface of the lease but bottomed on other land.
- The lease also contained an anti-Heritage clause.
- The meaning of “cost free.”
- The Court concluded that an anti-Heritage clause did not free the royalty of post-production costs.

Recent Developments

- ❖ Burlington Resources Oil & Gas Co. LP v. Texas Crude Energy, LLC, 573 S.W.3d 198 (Tex. 2019)
 - Language provided: “Said overriding royalty interests shall be delivered to Assignee **into the pipelines,** tanks or other receptacles with which the wells may be connected, free and clear of all development, operating, production and other costs. However, ASSIGNEE shall in every case bear and pay all windfall profits, production and severance taxes assessed against such overriding royalty interest.”
 - The Texas Supreme Court held that post-production costs were rightfully deducted when calculating ORRI payments based on the “amount realized” from the sale when the royalty interest is to be delivered “into the pipelines, tanks, or other receptacles with which the wells may be connected.”

Recent Developments

❖ *BlueStone Nat. Res. II, LLC v. Randle*, 620 S.W.3d 380 (Tex. 2021)

- The royalty provision in the lease provided: “on gas, including casinghead gas, or other gaseous substance produced from said land and sold or used off the premise...the market **value at the well** of one eighth of the gas so sold or used, provided that on gas sold by Lessee the market value shall not exceed the amount received by Lessee for such gas computed at the mouth of the well, and on gas sold at the well the royalty shall be one-eighth of the amount realized by the Lessee from such sale.”
- The royalty provision in the Addendum provided: “LESSEE AGREES THAT all royalties accruing under this Lease (including those paid in kind) shall be without deduction, directly or indirectly, for the cost of producing, gathering, storing, separating, treating, dehydrating, compressing, processing, transporting, and otherwise making the oil, gas[,] and other products hereunder ready for sale or use. Lessee agrees to compute and pay royalties on the **gross value received**, including any reimbursements for severance taxes and production related costs.”

“Into the pipeline” Revisited

- ❖ *Nettye Engler Energy, LP v. BlueStone Nat. Res. II, LLC*, 2022 Tex. LEXIS 144 (Tex. 2022)
 - The deed provided that the royalty owner’s share be delivered “free of cost in the pipe line, if any, otherwise free of cost at the mouth of the well or mine.”
 - The royalty owner argued that “in the pipe line” meant a transportation pipeline rather the gas gathering pipelines located on the wellsite.
 - The Court concluded that a “gas gathering pipeline is a ‘pipeline’ in common, industry, and regulatory parlance, and the deed does not limit the delivery location to any specific pipeline nor prohibit delivery to a pipeline at or near the well, if any.”

At the well valuation point

- ❖ *Shirlaine West Props. Ltd v. Jamestown Res., L.L.C.*, 2021 Tex. App. LEXIS 9379 (Tex. App. – Ft. Worth 2021)
 - The royalty provision provided:
 - “pay Lessor for gas including casinghead gas and other gaseous substances produced from said land and sold or used on or off the premises twenty-five percent (25%) of the market value at the point of sale, use or other disposition of all such gas.”
 - “If Lessee realizes proceeds of production after deduction for any expenses of production, gathering, dehydration, separation, compression, transportation, treatment, processing, storage or marketing, then the proportionate part of such deductions shall be added to the total proceeds received by Lessee for purposes of this paragraph.”
 - The valuation point was the wellhead, which is where the point of sale occurred, thereby making deduction of post-production expenses permissible.

Comparison Between Texas and Other Jurisdictions

First Marketable Product Approach

- ❖ Oklahoma does not follow the Texas approach, but instead has adopted the first marketable product approach.
- ❖ The first marketable product approach is based on the implied covenant in oil and gas leases to market.
- ❖ Under this approach, the phrase “at the well” may not actually mean at the well, but potentially a point much farther downstream when the gas is sold to a third party.
 - *Clough v. Williams Prod. RMT Co.*, 179 P.3d 32, 37 (Colo. App. 2007) (explaining that “the point where a marketable product is first obtained is the logical point where the exploration and production segment of the oil and gas industry ends, is the point where the primary objective of the lease contract is achieved, and therefore is the logical point for calculation of royalty.”).

First Marketable Product Approach (Cont.)

❖ *Wood v. TXO Production Corporation*

- Lease provided for “3/16 at the market price at the well for gas sold.”
- The lessee-built compressors and deducted compression costs.
- The court explained that the gas is sold at the point it enters the pipeline and because the pipeline was located on the property, there could not be any transportation costs to deduct and if the parties intended to deduct compression costs, then it should have been allocated in the lease.

First Marketable Product Approach (Cont.)

❖ *TXO Production Corp. v. State ex rel. Commissioners of Land Office*

- Post-production costs could not be deducted because the lessee has a duty to achieve a marketable product and bears all expenses necessary to achieve a marketable product.
- The court considered costs for dehydration and gathering and concluded that because the processes occurred before the gas entered the pipeline, the processes were necessary to achieve a marketable product.

First Marketable Product Approach (Cont.)

❖ *Mittelstaedt v. Santa Fe Minerals, Inc.*

- The royalty clause provided: “3/16 of the gross proceeds, at the mouth of the well, received by lessee for the gas.”
- The lessee sent the gas to third parties to handle post-production processes before the gas was sent downstream and entered the pipeline where a sale could be made.
- The court concluded that the deduction of those expenses was impermissible.

First Marketable Product Approach (Cont.)

❖ *Mittelstaedt v. Santa Fe Minerals, Inc.*

- The court concluded that a lessee can deduct post-production costs if the lessee can show:
 - That the costs enhanced the value of an already marketable product;
 - That such costs are reasonable; and
 - That actual royalty revenues increased in proportion with the costs assessed against the nonworking interest.
- ❖ The court also explained that the lessee must bear all transportation costs necessary to achieve a marketable product (or bringing the gas to third parties).

Colorado

- ❖ The Colorado Supreme Court has concluded that in the absence of an express allocation in the lease, the implied duty to market requires the lessee to bear all costs necessary to bring the gas to a marketable state.
- ❖ If the produce is already marketable at the wellhead and post-production costs are incurred to merely enhance the value of already-marketable gas, those costs may be shared by lessee and lessor.



Colorado (Cont.)

❖ Enhancement Test (less must show):

1. The costs are reasonable; and
2. Actual royalty revenues increase in proportion with the costs assessed against the nonworking interest.

❖ Post-marketability transportation costs are deductible if they are reasonable and that lessees are not required to establish that such costs enhance the value of the gas or increase royalty revenues.

- *Lindauer v. Williams Prod. RMT Co.* , 381 P.3d 378, 378, 383 Colo. App. 2016)

Ohio

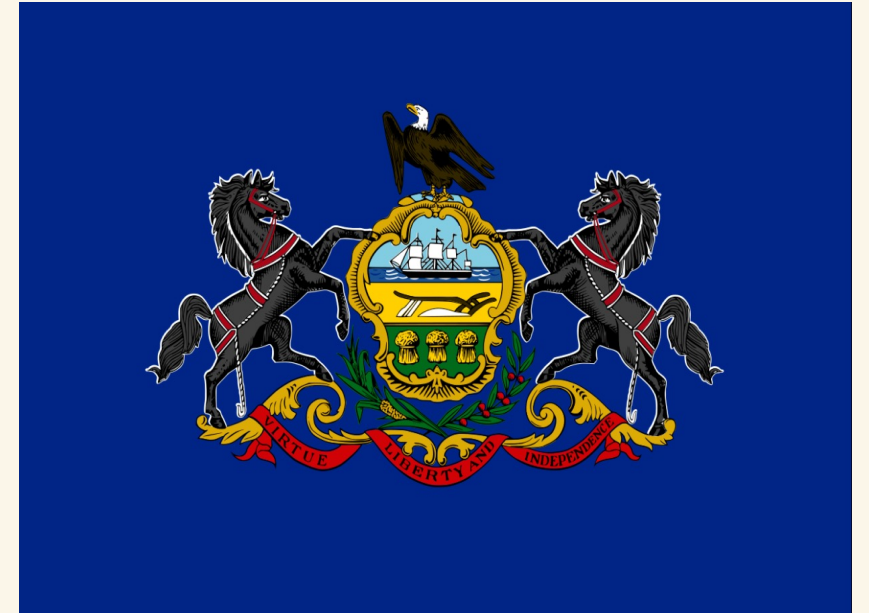
- ❖ Ohio law treats an oil and gas lease as a contract between the lessee and lessor.
- ❖ *Lutz v. Chesapeake Appalachia, LLC*, 2017 U.S. Dist. LEXIS 176898 (N.D. Ohio Oct. 25, 2017) concluded that the Ohio Supreme Court would adopt the “at the well” approach.
- ❖ The N.D. Ohio explained that the language “market value at the well” in the oil and gas lease would be rendered meaningless if the “at the well” approach was not followed.



Pennsylvania

❖ *Kilmer v. Elexco Land Servs.*, 605 Pa. 413 (2010)

- Royalty provision provided: “Lessor shall receive as its royalty one eighth (1/8th) of the sales proceeds actually received by Lessee from the sale of such production, less this same percentage share of all Post Production Costs”
- Court did not change the meaning of “royalty” from common practice in the industry
- Established that deduction of post-production costs does not violate the PGMRA.



West Virginia

- ❖ Courts (*Wellman & Tawney*) have applied a modified version of the first marketable product approach.
- ❖ The royalty clause provided: “one-eighth (1/8) of the proceeds from the sale of gas as such at the mouth of the well.”
- ❖ The Court rejected the lessee’s attempt to deduct post-production (transportation) costs and explained:
 - “If an oil and gas lease provides for a royalty based on proceeds received by the lessee, unless the lease provides otherwise, the lessee must bear all costs incurred in exploring for, producing, marketing and transporting the product to the point of sale.”
- ❖ *Leggett v. EQT Prod.*, 239 W. Va. 264 (2017) and W. Va. Code § 22-6-8(e).



New Mexico

- ❖ The Tenth Circuit concluded that New Mexico follows the “at the well” approach and permits the deduction of post-production expenses.
- ❖ The Tenth Circuit explained that although lessees have an implied obligation to render gas marketable, the lessee is under no obligation to bear those costs alone.



Louisiana

- ❖ General Rule – calculates royalties at the wellhead and permits deductions
- ❖ La. Rev. Stat. Ann. § 31:80 – permits the deduction of post-production expenses from royalty.



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