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Review of Recent Postproduction Cost Cases From a Lessee-Lawyer's Perspective

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FROM A LESSEE'S PERSPECTIVE

I. INTRODUCTION

In Texas, a royalty interest in oil and gas production is cost-free, meaning that it does not bear the costs of producing the oil or gas. Those costs are borne 100% by the operator/payor/lessee. Costs incurred after production, referred to generally as postproduction[1] costs, are passed on to the royalty owner in his or her proportionate share. Like all general rules, this one may be changed by agreement between the parties, typically the oil and gas lease.

Whether or not an oil and gas lease (or other instrument) effectively changes the default rule that postproduction costs are proportionately deductible from royalty has been the subject of a number of important cases over the years and continues to spawn litigation. New and innovative means of marketing oil and gas production do not neatly fit into a postproduction cost category. Royalty owners are increasingly sophisticated and aggressive when leases are negotiated, and periodic swells in commodity price cause periodic leasing booms in Texas, and competition for leasehold.

Historically, Texas courts have analyzed royalty clauses as being one of two basic flavors: market value at the well clauses, and proceeds clauses. A market value at the well royalty will bear postproduction costs, since the royalty is valued before those costs are incurred. A proceeds clause will normally be free from postproduction costs, since the royalty is calculated from the sale of the gas, which normally (but not always) takes place downstream, that is, after the costs have been borne. The gas becomes more valuable the further it gets from the well.

The Texas Supreme Court has in recent years (and months) renewed its apparent interest in these disputes over the tenaciously difficult issue of postproduction costs. It seems to this author that the Court has somewhat moved away from the idea that clear, if controversial, rules can apply, towards an analytical framework requiring each instrument to be construed in isolation from precedent (unless the precedent happens to involve literally the same disputed words). This trend is good for litigators but hard on operators, who value predictability.

This paper will review the most recent batch of post-*Heritage* and post-*Hyder* cases: *Burlington v. Texas Crude*, *BlueStone v. Randle*, *Engler v. BlueStone*, and *Devon v. Sheppard*[2] and note a few high-level topics of interest, primarily the add-back provision discussed in *Devon v. Sheppard*. It will do so from the perspective of a lawyer who normally represents operators/lessees in these cases.[3] This is therefore not necessarily intended to be an objective review of this area of the developing law.

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[1] This paper will call them "postproduction costs" rather than "post-production costs" or "post production costs" because that is what the Texas Supreme Court has most recently done, in *BlueStone v. Randle* (2021) and in *Engler v. BlueStone* (2022).

[2] Shortly after this paper was due, the Supreme Court granted the Petition for Review in *Devon v. Sheppard*.

[3] Notice of bias: the author represented BlueStone at the trial court in both the *Randle* case and the *Engler* case, and at the Court of Appeals in *Engler*. He was involved, though not lead counsel, at the Supreme Court in both cases.

II. BACKGROUND - TO HERITAGE AND BEYOND

In the old days, natural gas was a byproduct, typically flared at the wellhead so that the crude oil could be produced and sold. This seemed like a bad idea to operators who had discovered massive new gas fields in Texas and sought a market for their product. In the mid-1940s, the Texas Railroad Commission convened hearings on the issue and issued a series of orders shutting in production until facilities to process the gas could be constructed.[4]

This spawned opportunity for some. As the story goes, Oscar Wyatt was flying over the Orange Grove oil field, saw the flares, and decided to build a series of smaller pipelines to gather the flared gas that was not of significant volumes to attract the larger, established pipeline companies.[5] Wyatt started Coastal States Gas Producing Company and built his pipelines, and in the 1960s procured long term fixed-price contracts with the cities of San Antonio, Austin, and Corpus Christi to supply them with gas for their gas utilities.[6]

Long term gas sales contracts for fixed prices caused lessees significant financial harm when coupled with market value at the well royalty provisions, which require the gas royalty to be paid on the basis of the value of the gas at the wellhead rather than the proceeds from its sale. In 1968, the Texas Supreme Court held that a lessee had to pay royalty on the market value of gas sold, even though the operator/lessee was only paid a fraction of that price for the gas under a 1935 contract which fixed the price at 2.3 cents per mcf. *Texas Oil & Gas Corporation v. Vela*, 429 S.W.2d 866 (Tex. 1968). The Court in *Vela* noted that the operator (or its predecessors-in-interest) could or should have made better deals, either a proceeds royalty clause or a gas sales contract with a price escalation provision, but did not. *Id.*, at 871.

In 1981, Court confirmed its holding from *Vela*, rejecting the lessee's arguments about "the practicalities of the natural gas industry." *Exxon Corp. v. Middleton*, 613 S.W.2d 240, 245 (Tex. 1981). The Court's opinion specifically notes that "before 1972, most natural gas was marketed under long-term contracts at fixed prices," but holds that these changed market conditions do not impact the construction of the gas royalty clause. *Id.*, at 244.

> Exxon's royalty obligations are determined from lease agreements which were executed prior to and wholly independent of the gas contracts. Vela, supra. When Exxon negotiated the gas contracts, it took the risk that the revenue therefrom would be sufficient to satisfy its royalty obligations. That subsequent increases in market value have made these obligations financially burdensome is no reason to compel this Court to disregard the plain and unambiguous terms of the royalty clause and rewrite it to conform to the meaning that Exxon, as drafter of the language, says was intended.

Id., at 245. *See also Yzaguirre v. KCS Resources, Inc.*, 52 S.W.3d 368 (Tex. 2001), which applies the same rule in the other direction, when the 1979 contract price greatly exceeded the value of the

[4] This historical discussion is based largely on David Prindle's excellent book, Petroleum Politics and the Texas Railroad Commission, University of Texas Press, 1981. Used copies are readily available on Amazon.
[5] Burka, Paul, "Power Politics," *Texas Monthly*, May 1975.
[6] *Id.*

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