UT LAW CLE | THE UNIVERSITY OF TEXAS SCHOOL OF LAW

PRESENTED AT

2023 Gas and Power Institute

October 27, 2023
Houston, TX

Post-Production Cost Deductions from Royalty and Why it Matters to the Midstream Sector

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<u>POST-PRODUCTION COST DEDUCTIONS FROM ROYALTY AND WHY IT MATTERS TO THE MIDSTREAM SECTOR</u>

I. INTRODUCTION

The evolving and, at times, bewildering issue of the deductibility of post-production costs continues to be examined at length by Texas courts. Since the foundational holding in *Heritage Resources*, subsequent holdings by Texas courts are as likely to distinguish that holding as they are to follow it, making Texas law on a given deductibility question sometimes difficult to assess. This paper will explore and review the seminal cases on the topic and the complicated web of decisions issued in recent years that have both limited and expanded *Heritage Resources*. The Texas cases on this topic tend to inherently generate controversy because they pit lessor-oriented stakeholders against industry-side stakeholders. However, this paper is intended to objectively review this area of law so that lawyers arguing either side of this complicated topic will be as informed as possible about the cases working for and against their client's position.

II. FOUNDATIONAL CASES – *HERITAGE RESOURCES* & *JUDICE*

a. *Heritage Resources, Inc. v. NationsBank, Co.,* 939 S.W.2d 118 (Tex. 1996)

In *Heritage Resources*, the Texas Supreme Court directly addressed the issue of the deductibility of post-production costs for the first time in a plurality opinion. *Heritage Res., Inc. v. NationsBank, Co.*, 939 S.W.2d 118 (Tex. 1996). In this seminal case, NationsBank was the owner and trustee of certain oil and gas interests and Heritage was the lessee and operator under a number of oil and gas leases covering such interests. *Id.* at 120. Heritage owned an undivided working interest in some of the leases and sold gas off the leased premises. *Id.* Heritage deducted the cost to transport the gas from the wellhead to the point of sale as a post-production cost from the sales price before calculating royalties. *Id.* In other words, Heritage charged the lessor's royalty with its proportionate share of the cost of transportation of the produced gas, reducing the royalty amount paid.

When NationsBank realized that Heritage was deducting severance transportation charges from the purchase price, it objected to the deduction and sued, arguing that specific language in the leases prohibited the deduction. *Id.* In relevant part, one of the leases read as follows: "In consideration of the premises, Lessee covenants and agrees … [t]o pay the Lessor 1/4 of the *market value at the well* for all gas (including substances contained in such gas) produced from the leased premises; *provided, however, that there shall be no deductions from the value of Lessor's royalty by reason of any required processing, cost of dehydration, compression, transportation, or other matter to market such gas*." *Id.* at 120-21 (emphasis added).

The court ultimately had to determine "if Heritage improperly deducted transportation costs from the royalty payments. The critical clause in all three leases is the requirement that Heritage pay the royalty interest owners their fractional interest of 'the market value at the well' of the gas produced." *Id.* at 121. The Court's plurality held that Heritage properly deducted transportation costs in calculating the royalties.

The plurality reasoned that "the trade meaning of royalty and market value at the well renders the post-production clauses surplusage as a matter of law. … Market value at the well has a commonly accepted meaning in the oil and gas industry," which is "the price a willing seller obtains from a willing buyer." *Id.* at 122. The buying and selling parties can reach the same value by "subtracting reasonable post-production marketing costs from the market value at the point of sale" despite the preference of the comparable sales method. *Id.* at 120. The plurality stated that "the only conclusion we can draw is that the post-production clauses merely restate existing law." *Id.* Ultimately, the plurality held that since the royalty was calculated "at the well" for valuation purposes, i.e., prior to the point at which the value of the production was enhanced by post-production costs, then deductions for such value enhancements were permissible because they were deductions from the downstream point of sale, not from the agreed-upon valuation point at the wellhead. *Id.* at 122.

In a concurring opinion, Justices Owen and Hecht opined that the parties to the lease may not have all agreed on the trade meaning of "market value at the well" at the time of execution. *Id.* at 124 (Owen, J., concurring). Justice Owen addressed the lack of uniformity on relevant and related prior judicial decisions, and in many of those decisions, the court did not address which party is responsible for post-production costs. *Id.* at 125. However, Justice Owen shared the plurality's view that "[t]he concept of 'deductions' of marketing costs 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 130.

In their dissent, Justices Gonzalez and Abbott did not agree with "trade meaning" approach taken by the plurality, focusing instead on the plain language of the lease. Simply put, it was enough that the agreement contained language reading 'no deductions': "What could be more clear? This provision expresses the parties' intent in plain English, and I am puzzled by the Court's decision to ignore the unequivocal intent of sophisticated parties who negotiated contractual terms at arm's length." *Id.* at 131 (Gonzalez, J., dissenting).

b. ***Judice v. Mewbourne Oil Co.*, 939 S.W.2d 133 (Tex. 1996)**

Much like *Heritage Resources,* and notably decided on the same day, the court in *Judice v. Mewbourne Oil Co.* addressed "whether post-production compression costs can be allocated to royalty owners under the terms of certain oil and gas leases and division orders." *Judice v. Mewbourne Oil Co.*, 939 S.W.2d 133, 134 (Tex. 1996). Like *Heritage Resources, Judice* stands for the proposition that "[v]alue at the well means the value of the gas before … other value is added in preparing and transporting the gas to market." *Id.* at 136.

In 1978, Kathryn A. Judice entered into oil and gas leases with Mewbourne Oil Company. The two relevant leases in this case contained the following royalty language: "In consideration of the premises the said Lessee covenants and agrees … [t]o deliver to the credit of Lessor … three thirty-seconds (3/32) … of the *market value at the well* of all gas produced, and saved from said leased premises." *Id.* at 135 (emphasis added).

Mewbourne deducted a pro rata share of post-production compression costs from lessor's royalty. The Judices sued Mewbourne, alleging that the deduction was improper because of conflicting language in certain division orders provided by Mewbourne and signed by the Judices. *Id.* Specifically, the Judices argued that post-production costs

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