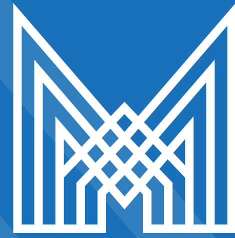


MASSIVE MINERALS

Cost–Free Royalty

Definitions

- Royalty
  - The landowner's share of production, free of expenses of production.
  - Usually subject to costs incurred after production, e.g. production or gathering taxes, costs of treatment to render product marketable, costs of transportation to market.
- Cost-free royalty
  - Landowner's share of production, free of expenses of production, AND free of post-production costs.

Definitions

- Post-production costs
  - Costs associated with making the product marketable after it is severed or removed from the ground.
  - Also called subsequent-to-production costs.
  - Includes costs associated with, transportation, gathering, dehydration, separation, compression, treatment, or other processing, and taxes (production, severance, gathering, windfall profits).

Definitions continued...

- Gathering
  - Collecting gas (or oil) at the point of production (wellhead) and moving it to a collection point for further movement through a pipeline's principal transmission system.
  - The collecting of gas (or oil) from various wells and bringing it by separate and several individual lines to a central point where it is delivered into a single line. *Lomak Petroleum, Inc. v. FERC, 206 F.3d 1193, 1196, (D.C. Cir. 2000)*

Definitions continued…

- Transportation
  - Bringing production from the wellhead to offsite point of sale, via rail cars, trucks, tanker vessels, and through pipelines.
  - Movement of gas through a pipeline's principal transmission system.

Definitions continued...

- Dehydration
  - Removal of water and basic sediment from the fluid produced from oil wells.
  - Removal of moisture from gas before it enters the purchaser's pipeline. (TXO Production Corp. v. State ex rel. Commissioners of the Land Office, 903 P.2d 259, 262, (Okla. 1994)
- Separation
  - A process whereby liquid hydrocarbons are separated from gas.
  - Gas separation – removal of dissolved gas from crude oil.
- Compression
  - Compressing and cooling natural gas, which causes the liquid hydrocarbons therein to condense out.
  - Raising pressure of gas for transmission through pipe lines, while the gas is cooled, scrubbed, and dehydrated.

Definitions continued…

- Treatment
  - Separating sour gases – CO_2 and H_2S – from saleable natural gas streams ("gas sweetening")

- Processing
  - Basically just an amalgamation of all the processes described above.
  - Oil and gas wells produce a mixture of hydrocarbon gas, condensate or oil, water with dissolved minerals (usually including a large amount of salt), other gases (including nitrogen, carbon dioxide, and possibly hydrogen sulfide), and solids (including sand from the reservoir, dirt, scale, and corrosion products from the tubing. The purpose of oil and gas processing is to separate, remove, or transform these various components to make the hydrocarbons ready for sale.

Definitions continued…

- Processing cont'd
  - Any activity occurring beyond the inlet to a natural gas processing facility that changes the well stream's physical or chemical characteristics, enhances the marketability of the stream, or enhances the value of the separate components of the stream. Includes, but is not limited to, fractionation, absorption, adsorption, flashing, refrigeration, cryogenics, sweetening, dehydration within a processing facility, beneficiation, stabilizing, compression (other than production compression such as reinjection, wellhead pressure regulation, or the changing of pressures and temperatures in a reservoir), and separation which occurs within a processing facility. Wyo. Stat. Ann. § 39-14-201(a)(xviii).
  - In the context of federal royalty requirements for the Marketable Condition Rule, any process designed to remove elements or compounds (hydrocarbon and non-hydrocarbon) from gas, including absorption, adsorption, or refrigeration. Field processes which normally take place on or near the lease, such as natural pressure reduction, mechanical separation, heating, cooling, dehydration, and compression are not considered processing. The changing of pressures and/or temperatures in a reservoir is not considered processing.

How are royalties calculated?

- Royalty Valuation Methods
  - Market Value
    - What a willing buyer would pay a willing seller in an arms-length transaction.
    - Comparable sales – not always available
    - Arriving at "market value at the well" may involve subtracting reasonable transportation and processing costs from the market value at the point of sale.
  - Proceeds Value
    - Measurement of royalty based on the amount the lessee in fact receives under its sales contract.
    - Amount realized
- Time/Place of Royalty Valuation
  - At the wellhead/mouth of the well
  - Downstream sales

How are royalties calculated?

Valuation Method	Time/Place of Valuation	Costs deducted?
Market value	At the wellhead	
Amount realized	At the wellhead	
Market value	At the point of sale	
Amount realized	At the point of sale	

- 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.

- 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. *Occidental Permian, Ltd. v. Helen Jones Foundation*, 333 S.W.3d 392, 399-400 (Tex. App.–Amarillo 2011, pet. denied).

Tana Oil and Gas Corp. v. Cernosek, 188 S.W.3d 354 (Tex. App.—Austin 2006, pet denied):

- Valuation clauses at issue:
  - 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.

Tana Oil and Gas Corp. v. Cernosek, 188 S.W.3d 354 (Tex. App.—Austin 2006, pet denied):

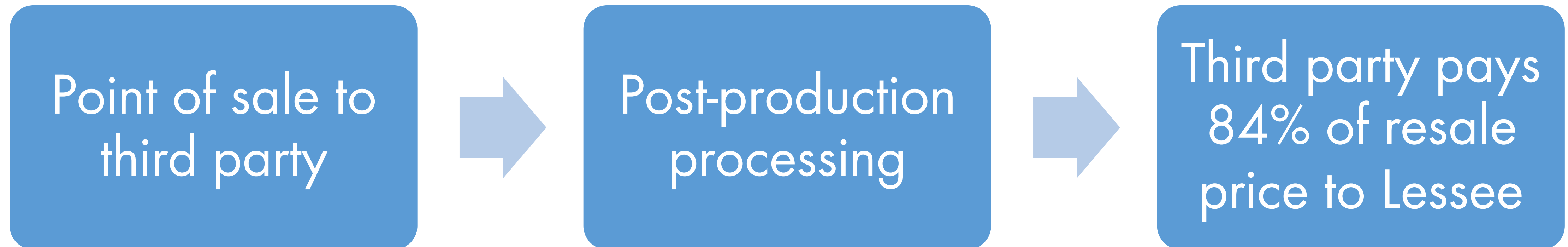
- Lessee sold the raw gas to a third party at the well. *See id.*

- The gas contract with the third party provided that the Lessee would be paid 84% of the amount the third party realized from the resale of processed and treated product. *See id.*

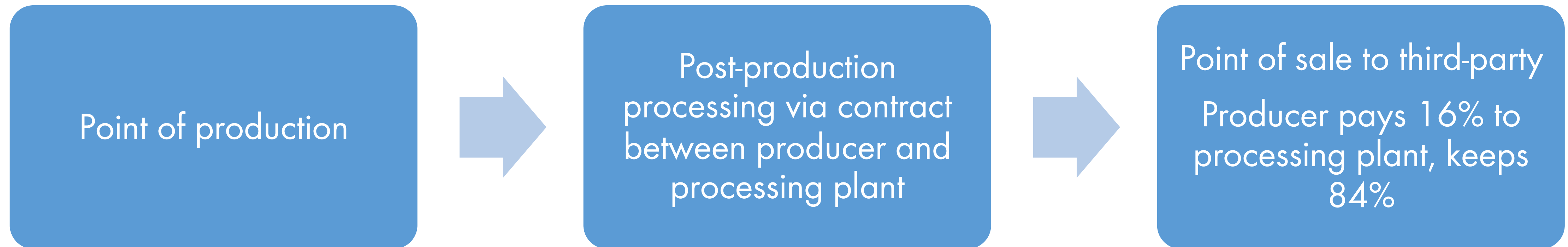
- Lessors argued that, because the Lessee was obligated to pay royalties on 100% of the total volume of gas sold at the well, the Lessors were entitled to royalties on the additional 16% of the proceeds realized from resale of the treated product, despite the fact the Lessee never received that amount. *See id.*

- The court held that the Lessors erred in equating the sale of raw gas at the well to the separate and distinct third-party sales made after treatment. 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. Accordingly, by paying the Lessors royalties based on 100% of the money it actually received, the Lessee 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.

Tana Oil and Gas Corp. v. Cernosek continued…



What about this?



How are royalties calculated?

Valuation Method	Time/Place of Valuation	Costs deducted?
Market value	At the wellhead	Yes
Amount realized	At the wellhead	Yes (or are they?)
Market value	At the point of sale	Depends on actual point of sale
Amount realized	At the point of sale	Depends on actual point of sale (or does it?)

So what do lessors do?

- The "no deductions" clause:

The royalties payable to Lessor hereunder shall not be charged with any part of the costs and expenses for exploration, drilling, development, production, storage, processing, compressing, marketing, or transportation, except that Lessor's royalties shall bear its proportionate share of any severance, ad valorem, windfall profits or other taxes attributable to the production of oil and/or gas associated hydrocarbons from the leased premises or lands pooled therewith.

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

- Leases at issue required that royalties on gas be paid based upon the "market value at the well" methodology.
- Also included the following: "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.* 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.

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

- 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.

How are royalties calculated?

Valuation Method	Time/Place of Valuation	Costs deducted?	"No deduction" clause effective?
Market value	At the wellhead	Yes	No – *Heritage Resources*
Amount realized	At the wellhead		
Market value	At the point of sale		
Amount realized	At the point of sale		

What have the courts done post–*Heritage Resources*?

- Since Heritage Resources, countless leases have been executed with various "no deductions" or "cost-free" clauses added to addendums to prevent deduction of post-production costs from the royalty.
- Until late 2015, Texas courts had failed to examine the effectiveness of these approaches.
- Two 5th Circuit Court of Appeals' decisions that examined *Heritage Resources* in-depth are analyzed below.

First a disclaimer:

The following cases are of limited precedential value as they are decisions rendered by the 5th Circuit Court of Appeals interpreting Texas law.

Warren v. Chesapeake Exploration, L.L.C., 759 F.3d 413 (5th Cir. 2014):

- Royalty clause required that royalty be paid based on "... the amount realized by Lessee, computed at the mouth of the well ...."

- **"No deductions" clause:** All royalty paid to Lessor shall be free and clear of all costs and expenses related to the exploration, production, and marketing of oil and gas production from the lease including, but not limited to, costs of compression, dehydration, treatment and transportation.

Warren v. Chesapeake Exploration, L.L.C., 759 F.3d 413 (5th Cir. 2014):

- 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. 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.

Warren v. Chesapeake Exploration continued...

- 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 deductions" 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 deductions" clause likewise represented surplusage and thus had no effect on the royalty valuation. *See id*.

Key Takeaways

Valuation Method	Time/Place of Valuation	Costs deducted?	"No deduction" clause effective?
Market value	At the wellhead		
Amount realized	At the wellhead	Yes	No – *Warren*
Market value	At the point of sale		
Amount realized	At the point of sale		

Potts v. Chesapeake Exploration, L.L.C., 760 F.3d 470 (5th Cir. 2014):

- Royalty clause where valuation was based on "market value at the point of sale."
- It was undisputed that the point of sale was the mouth of the well.
- Lessee argued that the "no deductions" clause in the lease addendum was surplusage.

- The Fifth Circuit agreed, 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.
- 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.

Key Takeaways

Valuation Method	Time/Place of Valuation	Costs deducted?	"No deduction" clause effective?
Market value	At the wellhead		
Amount realized	At the wellhead		
Market value	At the point of sale	Depends on actual point of sale - *Potts*	Not really – *Potts*
Amount realized	At the point of sale		

What do lessors do post–*Heritage Resources*?

- First, drafters attempt to remove any language marrying the "no deductions" addendum clause from the "royalty valuation" method stated in the body of the lease.
  - Heritage Resources analysis appeared to rely strongly on the "no deductions" clause referring back to the "value of the Lessor's Royalty."
  - Drafters have attempted to untangle that language such that the "no deductions" clause might stand alone.
- Second, drafters have attempted to get around Heritage Resources by expressly disclaiming the Heritage Resources holding in the "no deductions" clause.

What do lessors do post–*Heritage Resources*?

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.

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).

Chesapeake Exploration, L.L.C. v. Hyder, 427 S.W.3d 472 (Tex. App. – San Antonio 2014) *aff'd* at 2016 WL 352331 (Tex. 2016):

- Royalty clauses:
  - 25% of the market value at the well of all oil ... as of the day it is produced and stored.
  - for gas, 25% of the price actually received by Lessee for such gas.
- No deductions clause: the royalty reserved 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. Lessor's royalty share shall also be free and clear of all costs of construction, operation or depreciation of any plant or other facilities or equipment used for processing or treating paid production.
- **Overriding royalty: a perpetual, cost–free (except only its portion of production taxes) overriding royalty of 5% of gross production obtained from directional wells drilled on the lease but bottomed on nearby land.**

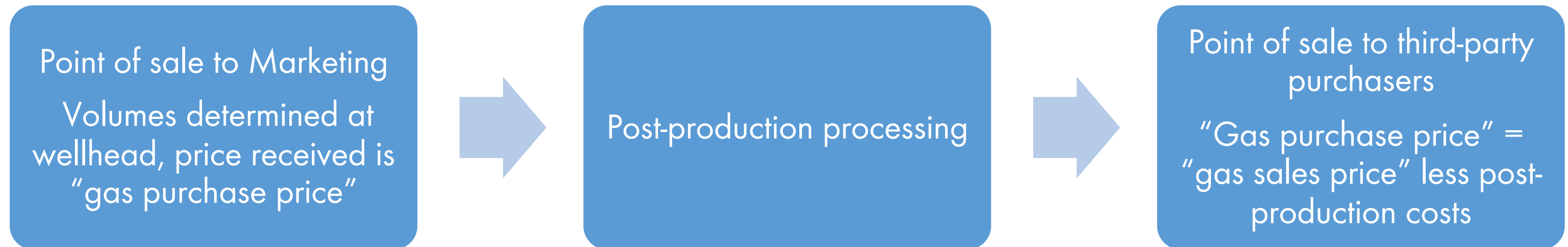
Chesapeake Exploration, L.L.C. v. Hyder, 427 S.W.3d 472 (Tex. App. – San Antonio 2014) *aff'd* at 2016 WL 352331 (Tex. 2016):

- *Heritage Resources* disclaimer: 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 the Lease.

Chesapeake Exploration, L.L.C. v. Hyder continued…

- Chesapeake sells all the gas produced to an affiliate, Chesapeake Energy Marketing, Inc. ("Marketing"), which then gathers and transports the gas through both affiliated and interstate pipelines for sale to third-party purchasers in distant markets.
- Marketing pays Chesapeake a "gas purchase price" for volumes determined at the wellhead. The gas purchase price is calculated based on a weighted average of the third-party sales price received (the "gas sales price"), less post-production costs.
- The overriding royalty Chesapeake pays the Lessors is 5% of the gas purchase price. Lessors contend that their ORR should be based on the gas sales price.

Chesapeake Exploration, L.L.C. v. Hyder continued…



Chesapeake Exploration, L.L.C. v. Hyder continued…

- **Holding:** "Cost-free" in the overriding royalty provision includes post-production costs such that they cannot be deducted from the royalties paid to Lessors.
- The Court discusses the fact that the Lessors could have taken their overriding royalty in kind, in which case they might or might not incur post-production costs. But the choice of how to take their royalty and, consequently, whether to possibly incur post-production costs is left to them.
- The Court does not accept Chesapeake's argument that cost-free in the overriding royalty provision refers only to production costs because "… production taxes … are postproduction expenses …", and "[i]t would make no sense to state that the royalty is free of production costs, except for postproduction taxes (no dogs allowed, except for cats)."

Chesapeake Exploration, L.L.C. v. Hyder continued…

- At the same time, the Court does not accept the Lessors' argument that "cost-free" in an overriding royalty provision cannot refer to production costs, stating that "… a taxes exception to freedom from production costs is not uncommon in leases, suggesting only that lease drafters are not always driven by logic."
- Gross production is the entire amount produced, including that used by Chesapeake or lost in post-production operations (aka the amount at the wellhead). Specifying that the volume on which royalty is due is determined at the wellhead says nothing about whether the overriding royalty must bear its share of post-production costs.

Chesapeake Exploration, L.L.C. v. Hyder continued…

- Some disturbing dicta.
  - "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 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."
  - The gas royalty does not bear post-production costs, not because it is based on a volume other than full production, but because it is based on the price actually received by the Lessee, not the market value at the well.

Key Takeaways

Valuation Method	Time/Place of Valuation	Costs deducted?	"No deduction" clause effective?
Market value	At the wellhead		
Amount realized	At the wellhead	Maybe not – *Hyder*	Not really – *Hyder*
Market value	At the point of sale		
Amount realized	At the point of sale	Maybe not - *Hyder*	Not really – *Hyder*

*A disclaimer of the Heritage Resources holding cannot free a royalty of post-production costs when the text of the lease itself does not do so. – *Hyder*

YOUR PARTNER IN CREATING MASSIVE, OUTSIZED VALUE

QUESTIONS?