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Texas Supreme Court Expands Upon the Rights of Oil and Gas Producers to Deduct Post-Production Costs in Burlington Resources Oil & Gas Company, L.P. v. Texas Crude Energy, LLC

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To the relief of oil and gas producers, the Texas Supreme Court ruled on March 1, 2019, in *Burlington Resources Oil & Gas Company, L.P. v. Texas Crude Energy, LLC* (No. 17-0266), that post-production costs were rightfully deducted when calculating overriding royalty 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." This ruling reversed the judgment of the court of appeals that found that "[e]ven assuming that, under the granting clause, the [royalty] is generally to be delivered 'at the well,' the parties are still free to allocate post-production costs as they see fit." The Court noted that the court of appeals misunderstood its decision in *Chesapeake Exploration, L.L.C. v. Hyder*, 483 S.W.3d 870 (Tex. 2016), and that it "never construed a contractual 'amount realized' valuation method to trump a contractual 'at the well' valuation point."

Case Background

Amber Harvest, LLC, an affiliate of Texas Crude Energy, owns overriding royalty interests in oil and gas leases operated by Burlington Resources Oil & Gas Co. LP ("Burlington"). These overriding royalty interests were set forth in assignments to Texas Crude Energy and Amber Harvest, LLC (collectively, "Texas Crude"). Each assignment includes a Granting Clause and a Valuation Clause.

The Granting Clause provides that "[s]aid 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." The Valuation Clause provided that "[t]he overriding royalty interest share of production shall be delivered to ASSIGNEE or to its credit **into the pipeline**, tank or other receptacle to which any well or wells on such lands may be connected, free and clear of all royalties and all other burdens and all costs and expenses except the taxes thereon or attributable thereto." The Valuation Clause also provided, as an alternative, that the assignee could elect to take the royalty in cash, in which case the value to be paid would be determined based upon the following "(i) **in the event of an arm's length sale on the leases, the amount realized from such sale of such production and any products thereof, (ii) in the event of an arm's length sale off of the leases, the amount realized for the sale of such production and any products thereof**, and (iii) in all other cases, the market value at the wells."

The parties agreed that the relevant contracts were unambiguous and amenable to judicial interpretation. The parties further agreed that all sales were arms-length and the assignee took its royalty payments in cash, not in kind.

The Texas Supreme Court's Analysis

The Court noted that, generally, oil and gas royalty interests are free of production expenses but "usually subject to post-production costs, including taxes … and transportation costs." This general rule, however, can be modified by agreement. The Court identified that the crux of the parties' dispute is whether Texas Crude holds royalties on products at the well (Burlington's position) or on treated and transported products at their downstream point of sale (Texas Crude's position).

Texas Crude contended that the general rule that royalty interests bear post-production costs was not applicable because the parties contracted otherwise. In particular, Texas Crude argued that, because the Valuation Clause specifies the royalty would be paid after sale of the product based on the "amount realized for such sale," and not based on the product's value at the well, post-production costs should not be included. The Court noted that in *Hyder*, a similar phrase, "the price actually received by Lessee" disallowed deduction of post-production expenses. However, the Court held that it must examine the entire Valuation Clause in its context and in conjunction with the Granting Clause, along with the other clauses to which the parties agreed. The Court went on to state that *Hyder* did not find that an "amount realized" valuation method frees a royalty holder from its usual obligation to share post-production costs even when the parties have agreed to value the royalty at the well. Therefore, the dispositive question for the Court was whether the parties agreed to an "at the well" valuation point or its equivalent.

In light of the Valuation Clause and the Granting Clause, as well as the inclusion of an "into the pipeline" provision within each, the Court found that the valuation point for the royalty was, essentially, "at the well." While Texas Crude argued that the "into the pipelines" provisions in the Valuation and Granting Clauses only applies to in-kind transfers, the Court ultimately found this argument to be unconvincing based, in part, on the "implausible results that flow from Texas Crude's position." In particular, the Court could find "no reason why the parties would reward the operator for leaving post-production efforts to a third party and penalize the operator for doing these enhancements."

Holding and Takeaway

The Court found that even though the Valuation Clause specifies that the royalty payment shall be calculated based on the "amount realized" from the sale, the agreements provided that the royalty interest shall be delivered "into the pipelines, tanks, or other receptacles with which the wells may be connected." This latter phrase fixed the royalty's valuation point at the physical location where the interest is to be delivered—at the wellhead or nearby. Thus, Burlington has the right to subtract post-production costs. This ruling expands the holding in *Heritage Res., Inc. v. NationsBank*, 939 S.W.2d 118 (Tex. 1996), in which the Court allowed post-production deductions for "market value at the well" leases.

This ruling is favorable for oil and gas producers and establishes that post-production costs can be deducted for "amounts realized" leases as long as other language (even if that other language appears to only address in-kind royalties) exists in the royalty clause that the valuation point for the royalty is at the well or nearby.