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ROYALTY LITIGATION: RECENT TRENDS AND WHAT'S ON THE HORIZON?

Mark Rodriguez

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MARKETABLE CONDITION
SCORE CARD

Majority: No Marketable Condition Rule

- Texas, California, Louisiana, Mississippi, North Dakota, Pennsylvania

Minority: Marketable Condition Rule

- Colorado, Kansas, Oklahoma, West Virginia, Wyoming

Unclear

- New Mexico, Arkansas, Montana

MARKETABLE CONDITION
TEXAS: MAJORITY RULE

Texas

- *Heritage Resources, Inc. v. NationsBank*, 939 S.W.2d 118 (Tex. 1996).
  - Trustee sued lessee/operator to recover transportation costs deducted in calculating royalty under "market value at the well" leases.
  - Lease clause provided "no deductions from the value of Lessor's royalty" for "processing, dehydration, compression, transportation, or other matters to market such gas."
  - Gas sold off the lease and lessee deducted transportation from wellhead to point of sale.

MARKETABLE CONDITION
TEXAS: MAJORITY RULE

- *Heritage Resources*
  - Texas Supreme Court reversed in favor of lessee… key provision is "at the well."
  - "No deductions" clauses restate existing law and are "surplusage as a matter of law."
  - "Court of appeals disregarded generally accepted meanings of 'market value at the well' and 'royalty.'"

MARKETABLE CONDITION
TEXAS: MAJORITY RULE

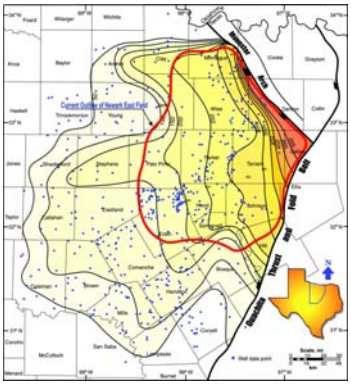
Heritage is not Absolute

- *Yturria v. Kerr-McGee Oil & Gas Onshore LLC*, 291 Fed. Appx. 626 (5th Cir. 2008).
  - Royalty owners filed suit for improper deduction of transportation and treating charges.
  - Leases had "post-production costs" provisions that said Lessors shall never bear costs for post-production activities.
  - **Not a "market value at the well" case.**
  - Court refused to rewrite agreement and held that lease provision trumped general rule on sharing of post-production costs.
  - General rule may be modified by the parties through agreement.

CHESAPEAKE EXPLORATION, L.L.C. V. HYDER
POST-PRODUCTION DEDUCTIONS

Barnett Shale lease

- Overriding royalty clause:
  - "perpetual, *cost-free* (except only its portion of production taxes) overriding royalty of five percent (5.0%) of gross production" from wells drilled on leased premises but bottomed on adjoining land not subject to lease.

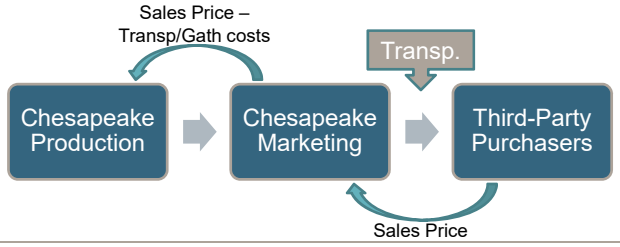


CHESAPEAKE EXPLORATION, L.L.C. V. HYDER
POST-PRODUCTION DEDUCTIONS

Facts

- Chesapeake sold production to marketing affiliate Chesapeake Energy Marketing, Inc.
- Chesapeake Marketing gathered and transported production to third-party purchasers in downstream markets.
- Chesapeake Marketing paid Chesapeake on weighted average of third-party sales *LESS* gathering and transportation costs.
- Chesapeake calculated overriding royalty based on price received from Chesapeake Marketing (weighted average of third-party sales LESS gathering and transportation costs).

Question before the Court: Should overriding royalty owners bear gathering and transportation costs incurred by Chesapeake Marketing?



CHESAPEAKE EXPLORATION, L.L.C. V. HYDER
POST-PRODUCTION DEDUCTIONS

- **Trial and Court of Appeals**
  - Hyders (ORRIOs) sued Chesapeake for charging overriding royalty with post-production transportation and gathering costs.
    - After bench trial, trial court entered judgment for Hyder Family
    - Court of appeals affirmed
    - Chesapeake appealed to the Supreme Court
    - Supreme Court withdrew original opinion and substituted on January 19, 2016

CHESAPEAKE EXPLORATION, L.L.C. V. HYDER
POST-PRODUCTION DEDUCTIONS

- **Parties' Positions**
  - **Hyder Family**
    - "Cost-free" means overriding royalty is free from all costs—production and post-production.
    - Because overriding royalty is free of production costs as a matter of law, "cost-free" language could only be intended to except royalty from post-production costs as well.
  - **Chesapeake**
    - "Cost-free" language only emphasizing fact that overriding royalty is free of production costs.
    - Common drafting redundancy (see *Heritage Resources*)

CHESAPEAKE EXPLORATION, L.L.C. V. HYDER
POST-PRODUCTION DEDUCTIONS

- **Supreme Court's Holding**
  - Reaffirming general rule
    - "Generally speaking, an overriding royalty on oil and gas production is free of production costs but must bear its share of postproduction costs unless the parties agree otherwise."
  - BUT…"cost-free" means free of all costs
    - "Cost-free" language indicated "agreement otherwise."
    - "Cost-free" language "literally refers to all costs."

CHESAPEAKE EXPLORATION, L.L.C. V. HYDER
POST-PRODUCTION DEDUCTIONS

- **Supreme Court's Holding**
  - Proceeds Lease
    - "[T]he price-received bases for payment in the lease is sufficient in itself to excuse the lessors from bearing postproduction costs."
  - Anti-*Heritage* Clause
    - A disclaimer of the *Heritage* holding "cannot free a royalty of postproduction costs when text of the lease itself does not do so."

MARKETABLE CONDITION
NORTH DAKOTA

North Dakota

- Approved the netback method to determine value when no comparable sales exist.
  - *Bice v. Petro-Hunt, L.L.C.*, 768 N.W.2d 496 (N.D. 2009).
    - "We join the majority of states adopting the 'at the well' rule and rejecting the first marketable product doctrine."
    - Noted the problem in the minority states of determining when gas has become marketable.

MARKETABLE CONDITION
NORTH DAKOTA REJECTS *HERITAGE* RULE

Recent Decision: *Kittleson v. Grynberg Petr. Co.*

- February 22, 2016 Supreme Court of North Dakota
  - The more specific "no deductions" language qualifies and prevails over "market value at the well."
  - Under the "no deductions" language of the royalty clause, a producer may not deduct from royalty the post-production costs required to make gas marketable.
  - **The ten-year limitation period applies to breach of contract actions for underpayment of royalties under an oil and gas lease.**

MARKETABLE CONDITION
EMERGING SHALE PLAYS

Pennsylvania

- Guaranteed Minimum Royalty Act
  - Lease must "guarantee the lessor at least one-eighth royalty of all oil, natural gas or gas of other designations removed or recovered from the subject real property." 58 PA. STAT. ANN. § 33.3
  - *Kilmer v. Elexco Land Servs.*, 605 Pa. 413 (2010).
    - Held: Leases allowing deductions of post-production costs do not violate the GMRA. The Court rejected arguments predicated on the marketable condition rule.

MARKETABLE CONDITION
OTHER MAJORITY RULE STATES

Mississippi

- *Piney Woods Country Life Sch. v. Shell Oil Co.*, 726 F.2d 225 (5th Cir. 1984) (Piney Woods II).
  - "Market value at the well" means lessor and lessee share in post-production costs.

MARKETABLE CONDITION
OTHER MAJORITY RULE STATES

Louisiana

- *Columbine II Ltd. Partnership v. Energen Resources Corp.*, 129 F. App'x 119 (5th Cir. 2005).
  - "At the wellhead" lease that also contained "no deduction of post-production costs" provision.
  - Recognized general rule under Louisiana law that "at the well" means post-production costs are shared, but held that express lease provision that prohibited such costs trumps.
  - Cf. *Heritage*.

MARKETABLE CONDITION
MINORITY: MARKETABLE CONDITION RULE

- Minority rule: "First Marketable Product"
  - Rooted in the implied covenant to market
  - Requires lessee to bear costs to render the gas "marketable"
- Commentators have been critical
  - Difficult to define (not "workable")
  - Meaningless without a clear definition
  - "Marketable" when and where? … components of the stream may be "marketable" at different points

MARKETABLE CONDITION
MINORITY: MARKETABLE CONDITION RULE

Kansas

- "First marketable product" is rooted in Kansas law
- *Gilmore v. Superior Oil Co.*, 388 P.2d 602 (1964).
  - Compression on the lease
  - Leases provided for proceeds or market value "at the mouth of the well."
  - Court discussed duty to market and purpose of the compression (to make the gas marketable by enabling it to enter the pipeline).
  - Lessee required to bear the expense because such preparation was necessary to make the gas marketable.

MARKETABLE CONDITION
MINORITY: MARKETABLE CONDITION RULE

Kansas

- *Coulter v. Anadarko Petroleum Corp.*, 296 Kan. 336 (2013).
  - Lessee must bear the entire cost of putting the gas in condition to be sold.
  - Once the gas is in marketable condition, regardless of whether a market actually exists at that point, the lessor can be charged with a proportionate share of post-production costs.

MARKETABLE CONDITION
MINORITY: MARKETABLE CONDITION RULE

Kansas

- *Fawcett v. Oil Producers, Inc. of Kansas*, 325 P.3d 1032 (2015)
  - "At the well" leases
  - Sales at the wellhead
  - ***Held that lessee could deduct post-production costs based on "at the well" standard***
  - ***Rejected lessor's argument that "marketable condition" = interstate pipeline quality***

MARKETABLE CONDITION
MINORITY: MARKETABLE CONDITION RULE

Kansas

- *See also*
  - *ROCO, Inc., et al. v. EOG Resources, Inc.*, Case No. 14-1065-JAR-TJJ in the U.S. District Court for the District of Kansas (November 2016 order granting summary judgment on breach of lease claim in light of *Fawcett*)
  - *Thelma Jean Lambert Living Trust, et al. v. Chevron U.S.A., Inc., et al.*, Case No. 14-1220-JAR-TJJ in the U.S. District Court for the District of Kansas (same).

MARKETABLE CONDITION
MINORITY: MARKETABLE CONDITION RULE

Colorado

- *Rogers v. Westerman Farm Co.*, 29 P.3d 887 (Colo. 2001).
  - Goal was a "workable definition of marketability."
  - "At the well" leases (4 lease types).
  - Deductions for gathering, compression, and dehydration (also addressed transportation).
  - "At the well" is "silent" on allocation of post-production costs.
  - Must look to the implied covenant to market and when gas becomes "marketable."

MARKETABLE CONDITION
MINORITY: MARKETABLE CONDITION RULE

Colorado

- *Rogers*
  - Looked to "first marketable product" for guidance.
  - Developed two components of "marketable"
    - Condition … "when it is in the physical condition such that it is acceptable to be bought and sold in a commercial marketplace"
    - Location … "in the location of a commercial marketplace such that it is commercially saleable in the oil and gas marketplace"
  - Question of Fact
  - Query: How is that "workable"?

MARKETABLE CONDITION
MINORITY: MARKETABLE CONDITION RULE

Colorado

- *Savage v. Williams Prod. RMT Co.*, 140 P.3d 67 (Colo. App. 2005)
  - "One-eighth of the proceeds from the sale of gas"
  - Court held leases were silent
  - Single offer or purchaser does not conclusively establish the existence of a market

MARKETABLE CONDITION
MINORITY: MARKETABLE CONDITION RULE

Oklahoma

- Lessees bear post-production costs and carry the burden of showing:

  (1) that the costs enhanced the value of an already marketable product;

  (2) that such costs are reasonable; and

  (3) that actual royalty revenues increased in proportion with the costs assessed against the royalty interest owners.

  - *Mittelstaedt v. Santa Fe Minerals, Inc.*, 954 P.2d 1203 (Okla. 1998).

MARKETABLE CONDITION
MINORITY: MARKETABLE CONDITION RULE

Oklahoma

BUT…

- Numerous Supreme Court decisions talk in terms of determining wellhead values or values in the field, which is inconsistent with the royalty owners' theory that gas is to be valued at the tailgate of the plant.
- The court in *Mittelstaedt* rejected the argument that a producer is obligated to deliver gas into a distant market and to pay royalty on the price received there.

MARKETABLE CONDITION
MINORITY: MARKETABLE CONDITION RULE

Oklahoma

- "At the Well" negates Marketable Condition Rule
  - *Naylor Farms, Inc. v. Anadarko OGC Co.*, No. CIV-08-0668-R, 2011 WL 7053787 (W.D. Okla. July 14, 2011).
- "At the Well" does not negate Marketable Condition Rule
  - *Fankhouser v. XTO Energy*, No. CIV-07-0798-L, 2012 WL 601415, at *2 (W.D. Okla. Feb. 23, 2012) (explicitly disagreeing with *Naylor*).

MARKETABLE CONDITION
MINORITY: MARKETABLE CONDITION RULE

Wyoming

- Statutory Framework: The Wyoming Royalty Payment Act ("WRPA") (Wyo. Stat. Ann. § 30-5-301 et seq.)
- *Cabot Oil & Gas Corp. v. Followill*, 93 P.3d 238, 242 (Wyo. 2004).
  - "The Act was enacted in 1982 to stop oil producers from retaining other people's money for their own use."

MARKETABLE CONDITION
MINORITY: MARKETABLE CONDITION RULE

Wyoming

- § 30-5-304(a)(vii) defines "royalty" as "the mineral owner's share of production, free of the costs of production."
- § 30-5-304(a)(vi) defines "costs of production" to include "gathering, compressing, … dehydrating, separating, storing or transporting the oil to the storage tanks or the gas into the market pipeline."
- "Costs of production" do not include "the reasonable and actual direct costs associated with transporting the oil from the storage tanks to market or the gas from the point of entry into the market pipeline or the processing of gas in a processing plant."

MARKETABLE CONDITION
MINORITY: MARKETABLE CONDITION RULE

West Virginia

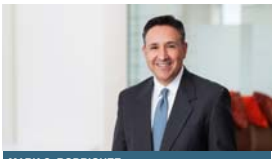
- *Tawney v. Columbia Natural Res., L.L.C.*, 633 S.E.2d 22, 30 (W.Va. 2006).
  - Class suit for deduction of post-production costs
  - Surveyed states' laws but didn't adopt
  - Relied on West Virginia's own "settled law" … royalty based on sales price received

MARKETABLE CONDITION
MINORITY: MARKETABLE CONDITION RULE

West Virginia

- *Tawney*
  - "At the well" – type language is ambiguous and does not permit deduction of costs from wellhead to point of sale.
  - Must expressly provide that lessor will bear some part of the costs, identify "with particularity" the specific deductions, and indicate the method of calculating the deductions.

SPEAKER BIOGRAPHY



MARK C. RODRIGUEZ
PARTNER, ENERGY LITIGATION

1001 Fannin Street
Suite 2500
Houston, TX 77002
+1.713.758.3288
mrodriguez@velaw.com

Education

Harvard Law School, J.D., 1995

Rice University, B.A., Psychology, 1992

Other Language: Fluent in Spanish

Recognition

Selected to the Texas Super Lawyer list, *Super Lawyers*(Thomson Reuters), 2014 – 2016

The Best Lawyers in America© (Woodward/White, Inc.),Commercial Litigation, 2014—2017; Energy Law, 2014—2017

Legal 500 U.S., Energy Litigation Law, 2011 and 2012

Mark is a trial attorney with more than 20 years of experience representing energy industry clients in a broad range of lawsuits and arbitrations, including royalty disputes, class actions, disputes under operating agreements, and other energy-related contract disputes.

In addition, he represents clients in administrative proceedings, audits, and investigations involving claims by state agencies and the federal government concerning royalties, civil penalties, notices of noncompliance, and the False Claims Act. Mark also counsels clients with regard to the calculation of federal and private royalties, including issues related to the handling of post-production costs. His nationwide energy practice includes lawsuits, arbitrations, and administrative proceedings in or involving Texas, Alaska, Colorado, Mississippi, New Mexico, North Dakota, Oklahoma, Utah, and Wyoming. Additionally, Mark represents clients in appeals before the Department of the Interior Office of Hearings and Appeals, and the Office of Natural Resources Revenue.

- Obtained a no liability award in a AAA arbitration involving claims against an operator for royalty underpayment, failure to develop, and improper measurement of carbon dioxide from producing units in southwestern Colorado (lead)
- (N.D. Tex); (5th Cir.) — Won and upheld summary judgment in bankruptcy court, federal district court, and the Fifth Circuit Court of Appeals on behalf of an independent oil and gas company on title claims related to leases and wells in the Barnett Shale (lead)
- (Tex. Dist.) — Obtained summary judgment in South Texas state court on overriding royalty owners' claims against operator for underpayment of royalties (lead)
- (Tex. Dist. – Crockett Cnty.) — Obtained a take-nothing jury verdict in a six-week trial involving royalty owners' claims for more than $70 million based on alleged failure to timely engage in enhanced recovery efforts and alleged royalty underpayment
- (Tex. Dist. – Starr Cnty.) — Obtained summary judgment in South Texas state court on behalf of a multinational energy company against landowner's trespass and conversion claims seeking more than $100 million
- Representing an independent oil and gas producer in appeals of ONRR Orders to Report and Pay additional royalties on Wyoming oil and coalbed methane production (lead)
- Representing multiple producers in various appeals to the Department of Interior Office of Hearings and Appeals from ONRR Notices of Noncompliance and Civil Penalty
- Represented an operator in administrative appeals of ONRR Orders to Report and Pay, and Notice of Noncompliance, alleging underpayment of royalties, improper transportation allowance deductions, and seeking civil penalties; we successfully negotiated favorable settlement of all claims

V&E OFFICES

THANK YOU

Austin T +1.512.542.8400
Beijing T +86.10.6414.5500
Dallas T +1.214.220.7700
Dubai T +971.4.330.1800
Hong Kong T +852.3658.6400
Houston T +1.713.758.2222
London T +44.20.7065.6000
Moscow T +7.495.544.5800
New York T +1.212.237.0000
Palo Alto T +1.650.687.8200
Richmond T +1.804.327.6300
Riyadh T +966.11.250.0800
San Francisco T +1.415.979.6900
Taipei T +886.2.2176.5388
Tokyo T +81.3.3282.0450
Washington T +1.202.639.6500