Texas Supreme Court Holds in *BlueStone* that Gathering Costs Can Sometimes be Deducted as Post-production Costs

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On February 4, 2022, the Texas Supreme Court, issued its decision in *Nettye Engler Energy, LP v. BlueStone Nat. Res. II, LLC*, No. 20-0639, 2022 WL 333368, at *10 (Tex. Feb. 4, 2022) ("*BlueStone*"), which concerned the oft-litigated question of whether and to what extent a royalty interest bore a proportionate share of postproduction costs, including gathering costs. The deed in issue required delivery in kind of the grantor's fractional share "free of cost in the pipe line, if any, otherwise free of cost at the mouth of the well or mine[.]" The parties agreed that a gas pipeline existed and that royalty was free of production costs and postproduction costs incurred before delivery into that pipeline, but disagreed about where the "pipeline" began for purposes of determining delivery under the terms of the deed in question.

Relying primarily on the plain language of the deed and the Texas Supreme Court's 2019 decision in *Burlington Resources*, the grantee (BlueStone) argued that delivery occurred in the gathering pipelines at the wellsite, which burdened the royalty interest with all postproduction costs from that point until the gas was sold. The grantor (Engler) argued that delivery occurred downstream of the wellsite at the transportation pipeline because (1) a gas gathering pipeline was not a pipeline as that term was used in the deed and (2) use of the term "otherwise" to introduce an alternative delivery point "at the mouth of the well" precluded construction of "the pipe line, if any" from including any pipeline at or near the wellhead. Engler also pointed out that for years, BlueStone's predecessor valued production at the point of sale to the gas purchaser's transportation pipeline (not at the gathering pipeline). Engler also offered expert testimony from an oil and gas lawyer to the effect that (1) the deed's reference to "pipe line, if any" referred only to the long-haul transportation pipeline and (2) the language "free of cost in the pipe line" meant that Engler's royalty was free of cost until title transferred to a third-party purchaser. BlueStone objected to Engler's expert testimony on the basis that it was conclusory and opined on pure questions of law.

The trial court agreed with Engler, but the court of appeals in Fort Worth reversed and entered judgment in BlueStone's favor.

The Texas Supreme Court criticized as too narrow the court of appeals' characterization of *Burlington Resources* as establishing a bright-line rule that "into the pipeline" language is always equivalent to an at-the-wellhead valuation. Nevertheless, the Court ultimately agreed that the court of appeals reached the right result and affirmed the judgment in BlueStone's favor. In doing so, the Court disregarded Engler's proffered expert testimony because it said nothing about the industry meaning of "pipe line" at the time the deed was executed in 1986, but merely opined that "most" gas was "usually" processed and sold under "traditional" gas gathering agreements at that time. Taking a pragmatic, plain language approach, the Court then held that a gathering pipeline—as understood through contemporaneous dictionaries and treatises, applicable portions of Texas statutes, and caselaw—"is a pipeline in the ordinary, industry and regulatory meaning of the term" and nothing in the deed excluded such a pipeline from the usual meaning of the term or specified a particular type of pipeline, such as long-haul transportation only, as Engler argued. The

Court further observed that construing the deed as referring to a particular pipeline (or one located off premises) would require the Court to add words of limitation to the deed that did not exist, which the Court refused to do.

This holding has both immediate effects and possible future implications for upstream and midstream companies.

1. The Texas Supreme Court Once Again Affirms That Where Contracts Are Unambiguous, Plain Language Rules The Day, And Each Contract Must Be Separately Analyzed.

While BlueStone has important implications for the oil and gas industry (discussed below), businesses and their counsel should not overlook the Court's emphasis in this case on two hallmarks of its approach to contract interpretation. First, the Court reiterated that where contracts are unambiguous, it will not consider extrinsic evidence like expert testimony that purports to vary, limit or contradict the contract's plain language. This serves as a helpful guide to practitioners when considering whether and how to use "industry experts" in contract interpretation disputes — particularly where there are few or no disputes about the underlying facts. Second, the Court cautioned against characterizing Burlington Resources as a bright-line rule establishing an at-the-well valuation for all postproduction cost disputes involving lease language to the effect of "into the pipeline." This was at least the second time the Court cabined the reach of *Burlington Resources* in a postproduction cost dispute since that case was first issued (the prior instance being in *another* BlueStone dispute decided last year, *BlueStone Nat. Res. II, LLC v. Walker Murray Randle, et al.*, 620 S.W. 3d 380 (Tex. 2021)). In short, the Court reminded litigants and practitioners alike that Texas law requires courts to analyze contract disputes, above all else, on the parties' specific chosen language.

2. Postproduction Costs Associated With Gathering Services May Be Deducted From Royalties In Certain Circumstances.

While at first blush *BlueStone* may appear to be a decision about what does and does not qualify as a pipeline, what lurks beneath is a decision that could have major implications for how upstream companies pay royalties. Depending on the specific deed or lease language in issue, there may be opportunities for upstream companies to deduct postproduction costs associated with gathering pipelines when calculating royalties. For example, if the deed or lease in issue provides for delivery "into the pipeline" or "in the pipe line" without specifying the type of pipeline, whether it must be on or off premises, or whether it must be the pipeline by which title to product is transferred to the ultimate buyer, it is possible that postproduction costs back to such pipeline (regardless of whether it is a gathering pipeline or some other type of pipeline) may be deducted from royalties.

Upstream and midstream companies alike will want to take another look at the royalty provisions in their leases and at their gathering arrangements to determine whether *BlueStone* impacts whether gathering costs can, or should be, deducted. For upstream companies, this decision may require new strategies for determining where and when the first sale of production occurs, and when wells are producing in paying quantities. For midstream companies, this decision may encourage a reconsideration of how gathering rates are structured and new-build investment decisions are made; and it may be worthwhile for them to request review of producer deeds and leases as part of their normal pre-investment decision and pre-commercial negotiation diligence.

Of note, however, *BlueStone* carefully limited its holding to the particular lease language at issue, and noted that it has not "fashion[ed] a rule" "equat[ing] certain language specifying an 'into the pipeline' delivery point with an 'at the mouth of the well' valuation." As always, an upstream company should therefore closely analyze the particular deed or lease language at issue before changing its current royalty calculation process to deduct gathering costs as postproduction costs.