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The Energy Dispatch, the IEL’s Young Energy Professional newsletter, contains substantive articles on trending legal issues in the energy industry, interviews, and professional development.

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Young Energy Professional Highlight: Chauntelle R. Wood

Interview by Katherine Raunikar, Jordan, Lynch & Cancienne PLLC

Chauntelle R. Wood is a Senior Associate at Baker Botts L.L.P., in their Houston, Texas office. For this Highlight, Katherine interviews Chauntelle about her extensive trial experience, how that assists in her career as an energy litigator, and advice for young lawyers seeking to follow a similar career path.

KR: What was your path to becoming a lawyer?

CW: While in college, I was unsure what I wanted to do next. I was in the Air Force Reserve at the time, and I thought of going on active duty. But I still was not completely sure whether that was the career path I wanted to take. I then met a political science professor, who is also an attorney. She got to know me and encouraged me to consider law school based on my interests. While those interests were primarily based on liking crime shows and novels, I followed her advice and applied—and it has been one of the best decisions I have made to date. And as a result of following this path, I am the first lawyer in my family.

KR: How would you describe your practice?

CW: Varying. I'm a litigator, but my practice areas depend on several factors, including what is happening generally in the oil and gas market. Examples of the more common practice areas that feature in my cases are traditional commercial disputes, oil and gas lease matters, internal investigations, some tax controversy work, and standard breach of contract issues.

KR: Given that you have gone to trial over forty times, I imagine you must enjoy trial work. If so, what about it do you enjoy the most?

CW: Over time, I have developed the skill of being quick on my feet; while in the courtroom, I can take an argument, find its weaknesses, and break it down all before responding to an issue posed to me. The whole process is a lot of fun, and that fun continues to keep me interested in what I do.

KR: As a trial lawyer, how does energy litigation feature in your practice?

CW: Over half of my practice is focused on energy litigation. In fact, that is how I would best describe myself: an Energy Litigator.

KR: Have you had any mentors in your career that helped you reach where you are today?

CW: Absolutely. Mentors have featured heavily in my career. They continue to help me navigate the legal landscape and have helped me advance my career to this point. It is not an exaggeration to say that I would not have gotten to where I am without the help of many mentors.

KR: Do you have any tips or advice for other young lawyers seeking a career in litigation or the energy space?

CW: Figure out the reason you want to do it and remember that as you progress. Always keeping that reason in mind is what keeps you going and supports a continued eagerness to learn and grow. Doing so has successfully carried me throughout my career so far, and I am sure that it has for many other attorneys out there as well.

KR: What do you like to do when you are not working?

CW: I like to travel with my soon-to-be husband and experience other cultures. For instance, on our honeymoon, we will be traveling to Fiji.

KR: Thank you for fitting us into your busy schedule, Chauntelle!

Interview with Robert Sanders, CFA, CFE, APA

Interview by Travis Cox, Copeland & Rice LLP

Mr. Sanders is a partner at Capstone Forensic Group LLC where he routinely assists clients in calculation of economic damages for businesses and individuals in litigation, investigation of suspected fraud, business valuation, and other financial and accounting analysis. Mr. Sanders works closely with clients in all aspects of his engagements. In addition to obtaining his B.S. in Mathematics from Duke University and MBA, Finance and Asset Management from the University of Virginia Darden Graduate School of Business, Mr. Sanders has also passed multiple certification examinations relevant to his work in financial analysis and fraud investigation. Mr. Sanders has authored expert reports and provided testimony in state and federal courts and arbitrations.

TC: Tell us about your work as an expert.

RS: I provide a variety of financial expert services, including offering lost profits and lost earnings expert testimony, business valuations, investigation of suspected fraud, and other forensic accounting and damages calculations. My practice covers a broad range of industries, but I do focus on energy given the significant footprint here in Houston. To further enhance serving energy clients, I became an Accredited Petroleum Accountant through COPAS last year.

TC: How did you get into doing expert work?

RS: I have enjoyed valuation and financial analysis for a long time. After business school, I was fortunate to be connected with a seasoned damages expert who got me really interested in expert witness work. I started working for him and really enjoyed it. I believe that having a mentor in the field was critical – I found that in addition to getting exposure to a variety of cases and one-on-one training, it helped me to see the finesse of an expert in action. After several years, he decided to slow down his workflow, and so some colleagues and I decided to start a new firm, Capstone Forensic Group LLC, to continue the tradition of high quality expert work.

TC: In what types of cases are you usually retained?

RS: We work on cases in state court, federal court, and arbitration. The work covers many types of litigation, including employment disputes, commercial contract disputes, injury claims, and class actions. We also undertake pre-litigation investigations and help develop potential damage models, as well as take on business interruption insurance claims. I seek out potential testifying expert engagements but also enjoy providing consulting services. In the energy space, our work runs from reviewing operator expenses under JOAs, analyzing forecasts and deliveries in supply contracts, determining lost profits for renewable energy providers, to assessing lease operating and post-production expenses in royalty disputes.

TC: What's the most interesting case you've worked on?

RS: One of the things I love about working as a financial expert is the variety of interesting cases I get an opportunity to work on. That being said, there is one that stands out. I worked on a case centered around the financing and ownership of international oil and gas exploration activities and LNG infrastructure. The case involved reconstructing joint billing statements over many years, and required tracing transactions through numerous entities and bank accounts in relation to AFEs and assignments of working interests. It was research and document intensive, requiring detailed review and analysis of many types of information including public company filings with the SEC, drilling participation agreements, joint operating agreements, purchase and sale agreements, division of interests, and net profits interest guidance from COPAS. What I really liked about the case was the opportunity to use many specific areas of our expertise and synthesize them into a comprehensive analysis that could be easily understood by attorneys and eventually a judge or jury. I enjoy taking complex analyses and presenting them in a clear and concise manner.

TC: What can the lawyers do to help you with your expert work in any given case?

RS: Great question. It is really important to me to develop a good working relationship with the lawyers on any case I am engaged with. Lawyers can help with my expert work in several ways. Provide us with documents. Don't hold back unfavorable documents; it's better we know about them earlier on so we can prepare, versus being surprised at a deposition or trial. Keep us up to date on relevant case activities, like if you learn about who the opposing expert might be, hints about the other side's damage model, or likely criticisms. We love feedback and being challenged by the attorneys who engage us for expert work. We appreciate rigorous deposition and trial preparation.

Focus on the DO, not the DREAD: Taking Action is the Secret to Successful Business Development and Client Service!

Rachael Schilling, Liskow
Laura Meherg, Wicker Park Group

Wicker Park Group has interviewed thousands of in-house counsel and studied top rainmakers from a variety of law firms to uncover what specific habits, motivators and traits make top performers distinct from their average-performing colleagues. It should come as no surprise that while the rainmakers all have very different styles and approaches to business development, they all focus on building long-lasting and trusted advisor relationships with their clients.

Rainmakers spend 50% more time out of the office and with their clients and twice as much of their non-billable time on business development than the average billing lawyers in their firms. They dedicate time for focused business development activity daily regardless of how much billable work they have on their plates. Most importantly, they focus on solving their clients' most pressing problems, making life easier and building personal relationships.

Historically only the "name partners" and most senior partners in law firms were expected to develop business and manage client relationships. The associates were often told to keep their heads down, focus on producing quality work product and not worry about anything else. That unfortunately created a culture in many law firms where associates did not learn the necessary skills to generate business or successfully manage client relationships. Today we're seeing a shift in culture, and leading law firms are recognizing the importance of this critical skill set and investing in business development and client service skills training at all levels of the firm. For example, Liskow works with Wicker Park Group and has designed a customized program for its younger lawyers that not only provides business development and client service training but also encourages team building and collaboration.

By focusing on business development much earlier in their careers, attorneys are equipped to deliver a far better client experience. Also, most find greater fulfillment in their own careers, which helps law firms retain talent in a highly competitive environment. The clients, individual attorneys, and firms all benefit!

To hone your client development and client relationship management skills, focus on these 10 critical areas:

1. Communicate concisely, directly and in a language and format that is easy for your client to understand. Most challenges in the firm/client relationship (and any relationship) result from miscommunication and failure to manage expectations. Ask how each individual prefers to communicate (email, phone call, text, bcc, etc.) and what you can specifically do to make their life easier. We all have different communication styles, and it's up to us to adapt to our client's preferred style.
2. Develop an area of expertise or niche in a specific practice or industry. 35% of clients interviewed by Wicker Park Group in 2022 name expertise as the top criteria they evaluate when hiring outside counsel. Write, speak, blog and post on social media about topics related to your expertise to demonstrate credibility and increase your visibility.
3. Maintain connections across your network of contacts. Your peers may not be decision makers today, but they will be some day. If you stay in touch with college and law school classmates, former coworkers, social and civic contacts, and new professional connections, you will be in a much better position to get hired in the future and not scrambling to build a network later in your career.
4. Recognize that persistence pays off and that it can take years to cultivate a new client relationship. Look at business development time as an investment in your future success.
5. Demonstrate empathy. Put yourself in your client's shoes when you are making decisions about how to spend your time and their money.
6. Maximize time at conferences and other in-person meetings. Seek out multiple opportunities for meaningful and intentional interactions with clients and prospects before, during, and after the event.
7. Create good business development habits. Prioritize business development activities regardless of billable workload. Put time on your calendar daily to focus on building your network, understanding your client's business, raising your visibility, and honing your skills. You can move it, but you can't cancel it.
8. Be a connector. Learn as much as you can about your firm's capabilities and expertise to help connect client needs to resources across the firm.
9. Be proactive and solutions oriented. Proactive attorneys differentiate themselves in a crowded marketplace.
10. Be intellectually curious. Ask questions to uncover opportunities and connections.

"Adding Back" to Precedent: The Supreme Court of Texas's Decision in *Devon v. Sheppard* Interprets "Proceeds-Plus" Royalty Clause

Garrett Martin and Matthew Thomas
Haynes and Boone, LLP

Introduction

On March 10, 2023, the Supreme Court of Texas issued an opinion in *Devon v. Sheppard*, the Court's most recent foray into what the court termed a "perennial problem" of lease interpretation and royalty calculation. *Devon Energy Prod. Co., L.P. v. Sheppard*, No. 20-0904, 2023 WL 2438927, *1 (Tex. Mar. 10, 2023). The much-watched case concerns one version of a so-called "add back" or "proceeds plus" royalty clause in an oil and gas lease. The Court's task was to interpret this unique clause and determine whether it required royalties to be paid on (1) the proceeds the lessee received in an unaffiliated sale or (2) on some value over and above what the lessee received, including costs incurred by subsequent purchasers. In a 7-1 opinion, Texas's high court held the lessee was required to make royalty payments based on the latter option, requiring the lessee to include in its proceeds calculation the additional post-production costs incurred by its buyer—at least when such costs were readily determinable.

The direct outcome in the *Devon v. Sheppard* holding firmly counts as a victory in the lessors' column. Nevertheless, it remains to be seen how impactful the case will ultimately prove in the long history of Texas royalty law.

Background and Lower Court Proceedings

During a period from 2007 to 2010, Devon Energy executed a series of oil and gas leases in the Eagle Ford with Mr. Sheppard and his co-plaintiffs. *Devon Energy Prod. Co., L.P. v. Sheppard*, 643 S.W.3d 186, 189 (Tex. App.—Corpus Christi–Edinburg 2020), *aff'd*, No. 20-0904, 2023 WL 2438927 (Tex. Mar. 10, 2023).

The base royalty provision in these leases is a standard "greater-of" clause, requiring royalties to be paid on the higher of "(1) the market value at the wellhead of such gas, paid to Lessor free of all costs and expenses, or (2) the gross proceeds realized from the sale of such gas, free of all costs and expenses, to the first non-affiliated third party purchaser under a bona fide arms-length sale or contract." *Id.* at 189–90. Such "greater-of" provisions are common in oil and gas leases since the shale boom of the mid-2000s, and present little trouble in interpretation. *See Sheppard (SCOTX)*, 2023 WL 2438927 at *2 (calling the "greater-of" provision "standard fare in the industry"). The first part of this base clause is essentially the same provision at issue in the seminal case of *Heritage Resources v. NationsBank*. *See* 939 S.W.2d 118, 120–21 (Tex. 1996) (where the lease calls for royalty to be based on a percentage of "market value at the well"). Further, the Court's more recent opinion in *BlueStone Natural Resources II, LLC v. Randle* provides concrete understanding of the gross-proceeds obligation in the second part of the clause. *See generally* 620 S.W.3d 380, 383 (Tex. 2021) (interpreting gross proceeds addendum). If Mr. Sheppard's lease had stopped there, this case would likely never have captured the attention of the state's highest court.

However, the relevant lease form did not stop at the base royalty clause, but continued on with this unique provision:

> If any disposition, contract or sale of oil or gas shall include any reduction or charge for the expenses or costs of production, treatment, transportation, manufacturing, process or marketing of the oil or gas, then such deduction, expense or cost shall be added to the market value or gross proceeds so that Lessor's royalty shall never be chargeable directly or indirectly with any costs or expenses other than its pro rata share of severance or production taxes.

Sheppard (SCOTX), 2023 WL 2438927 at *2. The parties applied competing nomenclature for this provision, with plaintiffs using "proceeds plus" and Devon preferring to call it an "add back" clause. *Id.* at *5, *11. Semantics aside, this clause proved to be the center of the dispute. In addition to this unique clause, the lease included an addendum stating that the royalty would not "bear or be charged with, either directly or indirectly" post-production costs, including "gathering, dehydration, compression, transportation, manufacturing, processing, treating, post-production expenses, marketing or otherwise making the oil or gas ready for sale or use." *Id.* at *2.

Following the execution of the leases, Devon marketed the gas produced from wells on those leases pursuant to a series of gas sales contracts. How the sales price under these contracts would be determined varied greatly, as the following examples demonstrate:

1. Some called for Devon to receive payment on an index price minus a fixed percentage of that price, either explicitly stating the fixed reduction related to certain post-production costs like processing or transportation or simply stating a reduction without an express post-sale basis.
2. Others stated that the sales price would be derived after considering the purchasers' own express post-sale costs, including for transportation and other post-production services.
3. Still others included reductions in the sales price for lost and unaccounted for gas or gas used by the purchaser in its own operations.

In all instances, Devon paid royalty on the proceeds it received in the relevant sales contracts from its purchasers, making no deduction from those proceeds in calculating payments to plaintiffs. *Id.* at *4–5. Devon did not calculate what additional costs may have been incurred by its purchasers that could have affected Devon's sales price and did not add those costs to its payment of royalties. *Id.*

The plaintiffs sued Devon for royalty underpayment in 2012, arguing that Devon's calculation of royalties based on the proceeds it received failed to account for the proceeds plus/add back component of the relevant leases. The trial court agreed with the plaintiffs, granting them summary judgment and ruling that Devon had failed to properly calculate royalties under all of the pertinent sales contracts. *Id.* at *5.

The Thirteenth Court of Appeals affirmed in part and reversed and rendered in part. *See Sheppard (COA)*, 643 S.W.3d at 205–11. First, the court agreed that Devon had failed to properly calculate royalties in paying on the proceeds it received without deduction from unaffiliated purchasers because Devon had failed to include in its royalty calculation post-production costs incurred after its sale. *Id.* at 201. Following that component of its decision, the intermediate court affirmed summary judgment for the gas sales contracts that explicitly referenced post-production costs and allowed Devon to determine how its sales price was impacted by transportation, processing, or other services. *Id.* at 205–11. But for contracts where it was unclear whether or how Devon's sales price was impacted by its purchaser's own post-production cost, the court of appeals reversed summary judgment and rendered judgment for Devon—finding the lease did not require Devon to include those potential, unknown costs back into its royalty calculation. *Id.* Devon appealed the Thirteenth Court's ruling to the Supreme Court of Texas, which granted review.

The Supreme Court of Texas Weighs In

In its appeal to the high Court, Devon lodged two central arguments against the lower courts' royalty clause interpretations in its appeal to the Supreme Court. First, Devon argued that the lease's principal royalty clause required payment on gross proceeds with significant language emphasizing that "gross" really means all of Devon's proceeds but nothing more. *Sheppard (SCOTX)*, 2023 WL 2438927 at *3–4, 9. In that context, the only reasonable interpretation of the proceeds plus/add back clause was to further emphasize that any costs whatsoever that occurred before Devon's sales point could not be shared with the plaintiffs. *Id.* at *4. Devon stressed that this interpretation complied with the fundamental tenets of the Supreme Court of Texas's case law, starting with the *Heritage Resources* concept that there are no deductions after the royalty-valuation point. *Id.* at *5.

Devon's second argument was that payment of royalties on non-proceeds—*i.e.*, post-production costs borne by unaffiliated third parties—is "so at odds with the usual expectations that it cannot be required when the leases do not state such an intent 'plainly and in a formal way.'" *Id*. *9. Devon specifically challenged the intermediate court's dismissal of basic lease interpretation as "legalese" and industry "jargon" when the Supreme Court of Texas has repeatedly held that lease interpretation is necessarily formal and subject to common-law established expectations.

The Supreme Court of Texas rejected both of Devon's arguments, and affirmed the lower courts' decisions. The Court found unpersuasive that the proceeds plus/add back clause simply restated the lease form's gross-proceeds obligation, holding instead that Devon's reading of the clause rendered it meaningless. *Id.* The Court largely focused on the perceived breadth of the requirement that Devon add back in "charges" or "costs" of any kind, including "indirect" ones. *Id.* Given that the lease form already barred Devon from passing on any pre-sale deductions, the Court reasoned that the proceeds plus/add back clause had to function to prohibit something else—*i.e.*, sharing post-sale costs. *Id.* at *10. As to Devon's argument about usual expectations, the Court recognized that lease language was subject to Texas's long history of common-law interpretation—whether or not legalese or jargon. *Id.* But the Court nevertheless found that the plaintiffs' proceeds plus/add back clause was a clear expression of an effort to go beyond the Court's prior interpretations, which the Court has repeatedly said parties could choose to do. *Id.* at *10–11.

Justice Blacklock issued a lone dissent. In his view, both the Court and the lessors misinterpreted the effect of the proceeds plus/add back clause (paragraph 3(c)). *Id.* at *12. Justice Blacklock reads paragraph 3(c) as "an attempt to ensure that neither a clever lessee nor a wayward court will deprive the royalty owner of the full benefit of its cost-free 'gross-proceeds' royalty." *Id.* Under Justice Blacklock's view, paragraph 3(c) is relevant *only* if the lessee attempts to reduce or charge the lessor with any of the enumerated post-production costs. *Id.* Because Devon did not attempt to do so, paragraph 3(c) did not control the dispute. *Id.*

Implications of *Devon v. Sheppard*

The *Devon v. Sheppard* decision is certainly a positive outcome for the lessors. It is also a reminder that the Supreme Court of Texas does not uniformly take industry-friendly positions, despite its strong history of promoting oil and gas development—and with it, economic growth—in Texas. That is assuming anyone needs such a reminder in light of the recent decision in *BlueStone*, 620 S.W.3d 380 (Tex. 2021), and the still relatively fresh opinion in *Hyder*. *See Chesapeake Expl., L.L.C. v. Hyder*, 483 S.W.3d 870 (Tex. 2016). Beyond those immediate takeaways, however, it is difficult to forecast the opinion's ultimate effect on Texas's already well-developed royalty jurisprudence.

But, there are several reasons to question the scope of the high court's opinion. As a threshold matter, proceeds plus/add back clauses of any sort remain relatively uncommon in Texas oil and gas leases—a point the Supreme Court of Texas repeatedly highlighted in characterizing the plaintiffs' leases as "bespoke," "unusual," and "unique." *Sheppard (SCOTX)*, 2023 WL 2437827 at *1, *3, *11. They are typically only found in leases prepared by sophisticated lawyers working directly for landowners, as opposed to the still-more-common practice of direct lease negotiations between a landowner and a producer's landman using a standard lease form. As such, proceeds plus/add back clauses are far more likely to be found in "super leases"—so named for their lengthy and multifaceted terms typically prepared for sophisticated landowners by a small subset of law firms.

With that said, producers can expect that proceeds plus/add back clauses will become increasingly common. *Devon v. Sheppard* will certainly contribute to that increase. But at a more basic level, lease clauses like the proceeds plus/add back clauses often spread by word of mouth as neighboring landowners discuss what terms they have been able to negotiate with producers. These landowners sometimes attempt to tack on as many "helpful" clauses as they can in the belief that doing so will provide the "best deal"—sometimes without fully understanding how the various bolted-on components of their royalty clause function together. The result is often more of a "Frankenstein" lease rather than a "super" one, with several seemingly conflicting terms. These authors have already seen "Frankenstein" leases include one type of proceeds plus/add back clause or another.

Moreover, not all proceeds plus/add back clauses are the same. The relevant clause in *Devon v. Sheppard* expressly refenced how royalty should be calculated if the "contract or sale of oil or gas shall include any reduction or charge for" post-production costs, and provided that the "Lessor's royalty shall never be chargeable directly or indirectly with any [such] costs or expenses." *Sheppard (SCOTX)*, 2023 WL 2438927 at *2. Critically, this form of a proceeds plus/add back clause centers on "reductions" and "charges" in relation to sales contracts. *See id.* But certain royalty provisions that have also been referred to as proceeds plus/add back clauses use alternative language that refers to adding back in the lessee's "deductions" to its proceeds in calculating royalty—phrasing that is much more susceptible to being read as "surplusage" in the vein of *Heritage Resources* because the lessee would have no deductions to add back to its proceeds in calculating royalty.

Leases with proceeds plus/add back clauses also often include other clauses that may permit sharing of post-production costs, such as express limits on where royalty should be calculated (*e.g.*, "not more than the price lessee receives") or express allowances for lessee to take certain deductions. In such instances, the Supreme Court of Texas's review of the "highly unique," "unusual" clause at issue in *Devon v. Sheppard* may not—and likely should not—necessarily apply. Indeed, the Supreme Court concluded the reasoning portion of its opinion with a warning:

> If anything is clear from the many Texas decisions dealing with royalty provisions, it is that different royalty provisions have different meanings, and the construction of an oil-and-gas lease must ultimately be based predominantly on the particular clause at issue construed within the context of the lease as a whole. Today, we address only the specific language of the provisions before us as applied to the disputed issues on appeal.

Sheppard (SCOTX), 2023 WL 2438927 at *11 (internal quotations and citations omitted).

A further limitation on the Supreme Court of Texas's decision is that it left undisturbed the court of appeals' reversal and remand of judgment for Devon that it owed no additional royalty obligations for royalty payments tied to gas sales contracts with no express mention of post-production costs. The plaintiffs did not cross-appeal the intermediate court's decision, so the issue was not before the Supreme Court. As such, the Thirteenth Court of Appeals leaves open the possibility that certain gas sales contracts can mute the effect of proceeds plus/add back clauses. Producers who are adversely impacted by the relevant proceeds plus/add back clauses may consider amending their sales arrangements to reduce their risk of claims.

As a final note, the Supreme Court of Texas's opinion stated in dicta that transportation and fractionation or "T&F"—operations that occur in relation to natural gas liquids once separated from the natural gas stream—are post-production costs akin to gathering or processing that may not be shared with certain royalty owners under certain leases. Very few cases across the country have weighed in on T&F in relation to royalties. The Supreme Court's cited only a Southern District of Texas Bankruptcy Court case, which itself provides no citational support and perhaps even less reasoning. *See Petty Bus. Enters., L.P. v. Chesapeake Expl., L.L.C.* (*In re* Chesapeake Energy Corp.), Nos. 20-33233, 20-3433, 2021 WL 4190266, at *7 (Bankr. S.D. Tex. Sept. 14, 2021). In fact, there are physical and historical reasons for recognizing T&F as distinct from standard post-production costs, and approaching T&F as the Supreme Court did may have drastic effects on the economics of certain wells and even fields. Given that the Supreme Court of Texas directly acknowledged that the T&F issue was not preserved, prudence would have suggested it be left for a case where it could have been better developed in briefing and argument. For instance, the Supreme Court's dicta equated fractionation to gas processing, which is simply not the case. Regardless, T&F is likely to take on a greater importance in royalty considerations and discussions in the near-term.

Oklahoma Supreme Court Provides Key Guidance on Production in Paying Quantities Analysis and Cessation of Production Clause

Ryan Pittman and Elizabeth Pursley
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Waves of lease termination cases have hit lessees over the past decade, most of which allege the oil and gas lease at issue has terminated for lack of production in paying quantities (known as "PPQ cases"). One form of PPQ case that has seen some success from lessors and top-lessees alike, at least at the district court level, is the allegation that the well ceased producing in paying quantities beyond the specific period set forth in the cessation of production clause. This is likely because of a lack of clarity in legal precedent, combined with the real-world-realities of oil and gas accounting and marketing that don't fit neatly into any single legal framework.

However, the Oklahoma Supreme Court recently issued a landmark opinion clarifying when "production" under a habendum clause ceases and the cessation of production "savings period" begins. The decision and the clarity it provides should give lessees confidence in the continued validity of their leases despite temporary periods of unprofitability, which is especially important during extended periods of low commodity prices.

Lease Termination Principals under Oklahoma Law

The typical oil and gas lease habendum clause provides for a term of a specified number of years (known as the "primary term") which is extended for so long thereafter as oil or gas is produced (known as the "secondary term"). Under Oklahoma law, satisfaction of the habendum clause to extend the term of a lease into the secondary term does not require actual production, but merely a well *capable* of producing in paying quantities. "Thus, where a well was completed and capable of producing in paying quantities within the primary term, the lease continued, so far as the habendum clause was concerned, as long as the well remained capable of producing in paying quantities, regardless of any marketing of the product." *Pack v. Santa Fe Minerals*, 869 P.2d 323, 326 (Okla. 1994).

The Supreme Court of Oklahoma has defined "paying quantities" as "quantities sufficient to yield a return, however small, in excess of lifting expenses, even though well drilling and completion costs might never be repaid." *James Energy Co. v. HCG Energy Corp.*, 847 P.2d 333, 339 (Okla. 1992). In these cases, courts evaluate profitability over a reasonable period of time, generally a year or longer (sometimes referred to as the "lookback period").

Lessors' Use of the Cessation of Production Clause to Reduce the Lookback Period

PPQ plaintiffs generally argue there is no well on their lease capable of producing in paying quantities, either due to a complete lack of production or an unreasonable period of unprofitable production, and thus their lease is terminated. As previously mentioned, courts generally assess profitability over a "reasonable period of time" considering all the circumstances in the case, which is typically a year or longer.

However, many leases contain express cessation of production clauses that require operations be commenced to restore production within a specified number of days or the lease will terminate. Utilizing these clauses, lessors have argued that any interruption in profitable production for the period stated in the cessation of production clause serves to terminate the lease. This argument effectively reduces the lookback period from the usual "year or longer," to just a few months.

Plaintiff's position is derived from language contained in the 1980 Oklahoma Supreme Court case of *Hoyt v. Continental Oil Co*, 606 P.2d 560 (Okla. 1980), wherein the Court stated that when a cessation of production clause modifies the habendum clause and the parties have expressly negotiated for a specific period of time during which cessation of production can be allowed, the negotiated provision "will control over the common law doctrine of temporary cessation allowing a 'reasonable time' for resumption of drilling operations." *Hoyt*, 606 P.2d at 563.

Thus, for example, where a lease contains a 60-day cessation of production clause, lessors have argued that any interruption in profitable production for longer than sixty days terminates the lease. This interpretation of the cessation of production clause has led to absurd results and creates unworkable requirements for lessees to maintain their leases. Thankfully, the Oklahoma Supreme Court recently clarified its statement in *Hoyt*, and clearly articulated the appropriate analysis for determining whether a lease has ceased to produce in paying quantities.

The Tres C Decision

On February 14, 2023, the Oklahoma Supreme Court issued an opinion in *Tres C, LLC v. Raker Resources, LLC, Continental Resources, Inc., and Dewblaine Energy, LLC*, 2023 OK 13, which addressed how a court should determine whether production in paying quantities has ceased under a habendum clause, including whether the cessation-of-production clause plays any role in narrowing the window of time that should be considered in making such a determination. The Court held the cessation of production clause cannot be relied upon to define the time for assessing profitability.

The lease at issue in *Tres C* contained a habendum clause with a primary term of 10 years, and "as long thereafter as oil, gas . . . or any of the products covered by this lease is or can be produced." The lease also contained the following 60 day cessation of production clause: "***If, after the expiration of the primary term of this lease, production on the leased premises shall cease from any cause, this lease shall not terminate provided lessee resumes operations for drilling a well within sixty (60) days from such cessation***, and this lease shall remain in force during the prosecution of such operations and, if production results therefrom, then as long as production continues." (Emphasis added).

In October 2016, high line pressure caused the well at issue, the Cowan Well, to quit producing. To remedy this, the operator installed a compressor, and by mid-November 2016 the Cowan Well was producing again. But based on the lessor's calculations, the well did not produce at a profit for at least three months.

Based on this three months of allegedly unprofitable production, Tres C sued the lessees to terminate its oil and gas lease. Tres C argued the 60-day cessation of production clause in the lease required profitable production be restored within sixty days, and since it wasn't, the lease terminated. The district court agreed with Tres C and terminated the lease. The Oklahoma Court of Civil Appeals affirmed the district court, and the Oklahoma Supreme Court granted writ to review the decision.

The unanimous Oklahoma Supreme Court held the district court erred when it relied upon the cessation-of-production clause to establish a three-month period for assessing whether a cessation of production in paying quantities had occurred. The Court explained the appropriate rule of law should be "a time [period] appropriate under all of the facts and circumstances." *See Barby v. Singer*, 1982 OK 49, 648 P.2d 16-17. The Court found that although the well was not producing in paying quantities for a period of three months, that time period is "not an appropriate time period . . . particularly in light of the operator's efforts to remedy the dip in production." *See Tres C, LLC* at ¶37. The court specifically stated that, as a matter of law, the time period of three months is "too short for determining whether a cessation of production in paying quantities has occurred." *Id.* at ¶26.

Most important for lessees, the Court stated "'[i]t is not the purpose of the cessation of production clause to establish an accounting period for purposes of determining if production is in paying quantities.' . . . Otherwise, leasehold operators subject to a 60-day cessation-of-production clause (like Defendants/Petitioners) would be required to commence drilling operations immediately upon sustaining a slight loss for one month without regard to whether they believed the next month's production might be profitable, because another month of slight loss could result in forfeiture of the lease. Such a result would be wholly unworkable in the oil and gas industry." *Id.* at ¶ 29.

The Court made clear that the cessation of production clause "only comes into play *after* a cessation has occurred." *Id.* at ¶ 28. Thus, before an operator has any requirement under a cessation of production clause to commence operations to restore production, courts must first analyze production and profitability over a reasonable period of time to determine whether production has ceased in the first place. This interpretation harmonizes the common law cessation of production doctrine with the more specific cessation of production clauses.

Implications for Lessees

The *Tres C* opinion provides guidance and consistency to operators while recognizing the realities of oil and gas operations. As acknowledged by the Court, oil and gas are never produced and marketed continuously and without interruption. Moreover, information available to the lessee varies with respect to production months, accounting months, and billing months. For example, operators are not paid in the same month the hydrocarbons are produced. Rather, payment of proceeds from production typically occurs a month (or more) after the "production month." The same is true for operating expenses invoiced to working interest owners. As a result, an operator may not even know a well is unprofitable within a sixty-day period.

The temporary cessation of production doctrine was intended to ensure a lease does not terminate at the slightest interruption of profitable production. The *Tres C* opinion should reassure lessees that their leases will remain in force even if some months prove unprofitable, and that they may continue to rely on the standard "year or longer" look back period to determine profitability.

Virginia Supreme Court Confirms Utility Tariffs are Contracts, and Govern the Relationship Between Utilities and Customers

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On an appeal pertaining to a circuit court's jurisdiction to hear a contract claim arising out of tariff language, the Supreme Court of Virginia once again affirmed that a tariff is a contract. In *Ashland, LLC, v. Virginia-American Water Company*, 878 S.E.2d 378 (Va. 2022), Ashland, LLC ("Ashland"), appealed a circuit court's dismissal of its contract claim against Virginia-American Water Company ("Virginia-American"). The circuit court held that Article IX, Section 4 of Virginia's Constitution deprived it of jurisdiction to adjudicate Ashland's contract claim. The Supreme Court of Virginia reversed and remanded the case.

Ashland, a chemical manufacturer, brought the contract action against Virginia-American, a private utility company that operated water plants, and provides water to local customers, including Ashland. Virginia-American provides water pursuant to a tariff issued by the State Corporation Commission ("Commission").

In 2018, Virginia-American undertook repairs at its water plant located in Hopewell, Virginia—the plant which provides water to Ashland. The repairs resulted in equipment failure and an outage that disrupted water service to Ashland. During the outage, Ashland was unable to manufacture the chemicals it sells, and Ashland brought the lawsuit for the $515,000 in damages it incurred due to lost business and profits.

Ashland relied on Rule 19(c) of the operative tariff, which provides that Virginia-American "will undertake to use reasonable care and diligence in order to prevent and avoid interruption and fluctuations in the service, but it cannot and does not guarantee that such will not occur." Particularly, Ashland alleged that Virginia-American's placement of a bypass line near the electronic equipment during its repairs constituted "a breach of its contractual duty to use reasonable care."

Virginia-American demurred to the complaint and asserted that other provisions of the tariff barred Ashland's claim. Namely, Virginia-American cited tariff Rule 8(f), which provides that Virginia-American "shall not, in any way or under and circumstances, be held liable or responsible to any party . . . for any losses or damage resulting from . . . any deficiency in . . . supply of water due to any cause whatsoever[,]" and Rule 17(a), which states that Virginia-American "does not guarantee a[n] . . . uninterrupted supply of water, and customers are cautioned to provide sufficient storage of water where an absolutely uninterrupted supply must be assured."

The question whether the circuit court had jurisdiction to hear Ashland's breach of contract claim arose during the briefing of and argument about Virginia-American's demurrer. The circuit court inquired whether it had jurisdiction to hear the matter or whether resolution of this dispute was within the jurisdiction of the Commission. The circuit court ultimately issued a letter opinion addressing the jurisdictional issue, concluding that Ashland's "contention that jurisdiction is appropriate because it has brought a contract action fails to properly interpret a 'tariff.'" The circuit court explained "[i]t remains true that 'circuit courts have jurisdiction over common law contract claims' [and that] a tariff 'establishes the contractual relationship between the parties'[; y]et, these two truths do not mean that a dispute over tariff provisions is merely a common law contract claim." It stated that "while the two may appear to be similar, a tariff is not the equivalent of a contract." The circuit court concluded that it lacked jurisdiction because Article IX, Section 4 of the Constitution of Virginia provides that only the Supreme Court may hear appeals of decisions of the Commission and that "'no other court . . . shall have jurisdiction to review, reverse, correct, or annul any action of the Commission or to enjoin or restrain it in the performance of its official duties.'" The circuit court found that the promulgation of a tariff by the Commission is an "action" of the Commission, and held that "[t]o sit for this controversy, [it] must 'review' the [t]ariff" and lacked power to do so.

In its review, the Supreme Court found that the circuit court erred. The Supreme Court recognized that the authority conferred upon the Commission by both the Constitution and the General Assembly to set the rates for and otherwise regulate water companies is near plenary, subject to review only by the Supreme Court of Virginia. The Supreme Court likewise recognized that Code § 17.1-513 provides the circuit courts with similar authority to adjudicate contract actions. *See Pure Presbyterian Church of Washington v. Grace of God Presbyterian Church*, 296 Va. 42, 56 (2018). The circuit courts may exercise that authority "[u]nless ousted of jurisdiction by law." *Appalachian Power Co. v. John Stewart Walker, Inc.*, 214 Va. 524, 530 (1974).

The Supreme Court agreed with the circuit court that there are differences between a tariff and a traditional commercial contract. Tariffs do not arise out of arms-length negotiations between a company and its customer, as commercial contracts do. Instead, the terms of a tariff, including the rates set forth therein, are imposed on the utility and its customers by the Commission which "is exercising a legislative function delegated to it by the General Assembly." *City of Alexandria v. State Corp. Comm'n*, 296 Va. 79, 94 (2018) (quoting *Old Dominion Comm. for Fair Util. Rates v. State Corp. Comm'n*, 294 Va. 168, 180 (2017)). In the case of a monopoly utility with a defined service territory, a customer's decision is limited to either accepting the terms of the tariff or going without service. The Supreme Court, however, disagreed that these differences change the fundamental nature of the relationship between the utility and its customers—a contractual relationship with the obligations of the parties defined by the tariff. *See Kroger Co. v. Appalachian Power Co.*, 244 Va. 560, 562 (1992); *see also Po River Water & Sewer Co. v. Indian Acres Club of Thornburg, Inc.*, 255 Va. 108, 113-14 (1998).

Having concluded that the contractual obligations stemming from a tariff does not preclude Ashland's action from being one for common law breach of contract, the Court next analyzed Article IX, Section 4. Virginia-American contended that this section prevented the circuit court from hearing this suit because "[i]n order to adjudicate Ashland's claim in the case at bar, the circuit court had to review – interpret, construe – the [Commission]'s action adopting the specific language of the [t]ariff." The Supreme Court has not read "review" as prohibiting a circuit court from reading, interpreting, or applying a tariff provision in common law actions between a utility and its customers. In fact, the Supreme Court has consistently permitted circuit courts to do so, provided that all the circuit court was required to do was read, interpret, and apply the tariff provisions. *See Po River*, 255 Va. at 114 (recognizing that the ability of a circuit court to read and apply the provisions of a tariff to adjudicate a billing dispute between a utility and its customer by "comput[ing] the recipient's liability for payment at the rate set by the Commission for the customer class pertaining to that recipient"); *Kroger Co.*, 244 Va. at 562 (affirming a circuit court's decision to sustain a plea in bar based on "the single issue [of] whether the [t]ariff barred [the customer]'s negligence action against" the utility).

The Supreme Court held that its longstanding understanding of "review" in the context of Article IX, Section 4, prohibits any court other than the Supreme Court from addressing whether the Commission committed error in any action entrusted to the Commission by the Constitution or statute. Circuit courts, therefore, are barred from considering whether the Commission exceeded its authority or otherwise erred in the adoption of a tariff. Circuit courts are not barred from reading and then applying the terms of a tariff as is necessary to resolve a common law dispute. The Supreme Court found that "[t]o hold otherwise would be to preclude any actions for damages between a customer and a utility over the underpayment or overpayment of a utility bill[,]" and the Supreme Court has long allowed circuit courts to adjudicate such cases without running afoul of Article IX, Section 4. *Ashland, LLC*, 878 S.E.2d at 383; *see, e.g., Po River*, 255 Va. at 114; *Chesapeake & Potomac Tel. Co. of Virginia v. Bles*, 218 Va. 1010, 1010 (1978); *Massaponax Sand & Gravel Corp. v. Virginia Elec. & Power Co.*, 166 Va. 405, 407 (1936).

The Supreme Court concluded that circuit courts are free to read and then apply the terms of a tariff as adopted by the Commission as necessary to resolve a common law dispute between a utility and its customer, but lack jurisdiction to resolve actions requiring the circuit court to determine whether the Commission erred in a matter entrusted to it by the Constitution or statute. Because Ashland did not call into question any action of the Commission in its lawsuit, and, in fact, sought to require Virginia-American to comply with a condition imposed by the tariff, the circuit court erred in dismissing this action for lack of jurisdiction. On remand, the circuit court will now hear the demurrer through the lens of a typical common law breach of contract claim.

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