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San Antonio Court of Appeals Issues Important Opinion In Chesapeake Royalty Dispute

By Richard A. Rohan
214.855.3043 | rrohan@ccsb.com

The San Antonio Court of Appeals recently issued an important opinion in a royalty dispute between a prominent Fort Worth family and Chesapeake Exploration L.L.C. and its affiliate, Chesapeake Operating, Inc. ("COI"). In *Chesapeake Exploration LLC v. Hyder,* the Hyders successfully advanced the argument that Chesapeake was not entitled to deduct post-production expenses from the royalties reserved by them out of an oil and gas lease entered into in 2004. Hyder leased approximately 1,000 acres of land in Johnson and Tarrant Counties to Four Sevens Oil Company, Ltd., which lease was later assigned to Chesapeake and COI. The royalty clause that applied to wells located on and producing from the leased premises granted Hyder a 25% royalty and provided "the royalty reserved herein by [Hyder] shall be free and clear of all production and post-production costs and expenses . . . or any other costs and expenses incurred between the wellhead and [Chesapeake's] point of delivery or sale of such share to a third party." (Opinion, p. 4) At trial, both parties stipulated that Chesapeake incurred unaffiliated third-party transportation costs of $1.75M between the point of delivery and point of sale.

In its suit, Hyder argued that the "free and clear" language precluded Chesapeake from deducting these transportation costs from Hyder's royalty. Chesapeake countered that the language "any other costs and expenses incurred between the wellhead and [Chesapeake's] point of delivery or sale of such share to a third party" was disjunctive and allowed Chesapeake to deduct costs and expenses incurred after the point of delivery but before the point of sale to a third party. The trial court disagreed with Chesapeake following a bench trial, and the San Antonio Court of Appeals affirmed the trial court's ruling.

In its discussion, the Court of Appeals noted that a royalty is normally subject to post-production costs, including transportation costs, but that parties were free to modify this general rule by agreement, citing the landmark case of *Heritage Resources, Inc. v. NationsBank*, 939 S.W.2d 118, 121-22 (Tex. 1996). Applying traditional contract rules of construction, the court rejected Chesapeake's interpretation because it ignored the "free and clear" language in the royalty clause and was therefore contrary to the plain reading of that clause. To the extent the general rule permitted deduction of post-production expenses from an oil and gas royalty, the court found the parties had modified the general rule in their agreement by expressly excluding post-production costs and expenses.

A second royalty provision in the lease reserved for Hyder "a perpetual, cost-free (except only its portion of production taxes) overriding royalty of five percent (5%) of gross production obtained" from wells that, while drilled on the leased premises, were producing from land adjacent to or near the leased premises ("off-lease wells"). The parties disagreed as to the meaning and scope of the term "cost-free." Chesapeake again contended that "cost-free" applied to production costs, but not to post-production costs, which under the general rule in Texas were deductible from the payment of overriding royalties. Hyder countered that "cost-free" referred to all costs, including post-production costs.

As to this claim as well, the court sided with Hyder and held that "cost-free" meant free of all costs, including post-production costs. The court began its analysis recognizing that post-production costs are normally borne proportionately by both the operator and the royalty interest owners, citing *Martin v. Glass,* 571 F. Supp. 1406, 1415 (N.D. Tex. 1983), *aff'd*, 736 F.2d 1524 (5th Cir. 1984). Again, however, the court noted that under *Heritage*, parties to an oil and gas lease were free to modify the general rule by agreement. Chesapeake argued that the trial court erred by failing to take account of the general rule when construing the royalty at issue, and that the term "cost-free" must be construed in light of the general rule that an overriding royalty, while free of production costs, is subject to post-production costs. Chesapeake cited a number of state court cases from Texas and Oklahoma in support of its position. The Court of Appeals, however, distinguished them based upon differences in the royalty language found in each of those cases from the overriding royalty language in the Chesapeake-Hyder lease. The court concluded that Chesapeake's proffered interpretation would render the term "cost-free" meaningless and would require it to, in effect, rewrite the parties' agreement.

The court's rulings on the two royalty provisions provide comfort to royalty owners that they may, through express royalty language, effectively exclude post-production costs notwithstanding the general rule that royalties are subject to such costs. Perhaps more significant is the court's ruling in connection with a cross-appeal point brought by Hyder to claim a royalty on gas that was lost and unaccounted for. Such gas is lost between the wellhead and the point of sale. Although such gas is produced, it is not sold, because it never reaches the point of sale to the third party. Nevertheless, Hyder sued for royalties on this lost gas. In support of its argument, Hyder contended there was a transfer of gas at the wellhead between COI and another Chesapeake affiliate, Chesapeake Energy Manufacturing, Inc. ("CEMI"). As a result, Hyder argued, the wellhead is the point at which Chesapeake actually received a price for its gas, thereby triggering Hyder's entitlement to a royalty thereon.

The court rejected Hyder's argument. In doing so, the court concluded that even if production were measured at the wellhead, because COI and CEMI were affiliates, this transfer of gas between affiliates "does not constitute a sale to a 'third party.'" (Opinion at 14) (Significantly, Hyder and Chesapeake stipulated that COI and CEMI are affiliated companies. As a consequence, the questions whether they were affiliates, and whether a transfer among them constituted a transfer to a third party, were not litigated to the court.) Without a third-party sale, Chesapeake owed no royalty obligation to Hyder.

It is important to note that the Hyder lease contained a lease royalty clause that is more explicit than most leases, in terms of describing the type of post-production costs and their deductibility, as well as the treatment of sales to affiliates. Nevertheless, this ruling by the Court of Appeals may prove significant in other litigation matters pending against Chesapeake, and in other royalty cases, where the issue in dispute is where and when in the production/post-production process ought a sale to be counted for purposes of calculating the price paid for minerals and the resulting royalty to be paid to royalty owners. Claims asserted by litigants against Chesapeake, and in other royalty litigation generally, often pertain to affiliate transfers of petroleum products, and the impact such transfers have on royalties owed. One recurring contention is that the price utilized by the lessee to calculate royalties is the result of a transfer to an affiliated entity at an artificially low price, and that a downstream purchase by an unaffiliated party must be used in order to calculate the correct royalty (sometimes after adjusting for costs to get the oil or gas to the point of sale downstream). In the *Hyder* opinion, the court recognizes the distinction between an affiliate "sale" and one to an unaffiliated third party. As alluded to above, the court's observation that COI and CEMI are affiliated may not in itself carry much if any precedential value in other Chesapeake litigation, since that affiliation was stipulated to by the parties. But the differential treatment afforded by the court to affiliated vs. non-affiliated sales may prove to be a significant point in subsequent royalty litigation.

The principle holdings from the *Hyder* opinion, therefore, are that parties to an oil and gas lease are free to modify the general rule in Texas that royalties are subject to post-production expenses. The court also provides examples of language that successfully accomplish such a modification. A corollary pronouncement by the court, that transfers of oil and gas between affiliates did not create a third-party sale sufficient to trigger a lessee's obligation to pay a royalty, may find its way into other royalty lawsuits going forward. ■