Oil And Gas Contract Drafting Lessons From Texas Ruling

By **Kenneth Held and Brent Hanson** (April 1, 2021, 4:35 PM EDT)

Kenneth Held

Brent Hanson

On March 12, the Supreme Court of Texas issued a unanimous opinion that clarifies when a lessee is entitled to deduct post-production costs from royalties paid to the lessor under oil and gas leases.[1]

Construing a lease and an addendum to the lease, the court in BlueStone Natural Resources II LLC v. Randle held that the "gross value received" language in the addendum constitutes a valuation point at the point of sale — which does not allow deduction of post-production costs — that conflicted with the form lease's "at the well" provision — which generally allows such deductions.

Because the addendum provided that it would control in the event of a conflict, the lessor BlueStone was not permitted to deduct post-production costs from royalties paid to the lessor. The court referenced but distinguished its 2019 decision in Burlington Resources Oil & Gas Co. LP v. Texas Crude Energy LLC,[2] which held that at-the-well valuation points permit deduction of post-production costs.

Burlington did not dictate the result in BlueStone because the "value received" clause in the lease in Burlington did not have a modifier, whereas the phrase "value received" in the BlueStone lease was modified by the word "gross" — which, the court found, "gives rise to 'an in inherent conflict'" with an at-the-well royalty provision.[3]

The court emphasized that traditional rules of contract construction apply to oil and gas leases. And the decision makes it clear that when drafting oil and gas leases, parties should make sure to explicitly state contract terms, rather than relying on generally understood industry terms — and should take care to avoid creating contradictory terms through amendments or addenda.

Overview of Royalty Provisions: Market Value at the Well Leases Versus Proceeds Leases

Courts in Texas employ standard contract construction rules to construe oil and gas leases, beginning with the express language of the contract and examining the entire writing to harmonize the provisions in the contract.[4] At the same time, however, certain background principles affect Texas courts' interpretation of the language in oil and gas leases.

For example, royalty owners generally do not pay production costs, such as for geophysical surveying and drilling wells, but usually are required to pay post-production costs, such as for transportation, processing and compression that are incurred to bring gas from the wellhead downstream to market.[5]

This typical allocation of costs between the royalty owner and the lessee is often reflected in a "market value at the well" lease provision. The market value at the well can be thought of as the commercial market value less the expenses incurred to get the oil or gas from the well to the market.

[6]

As stated by the court in Burlington, however, parties may "contract for a royalty calculated based not on the value of the oil and gas at the well but on its value at the point of sale."[7] If a royalty is based on the amount realized from a sale, the lessee generally cannot deduct post-production costs from the royalty payment.[8] This is called a proceeds lease,[9] and it can have a huge impact on the amount of royalties a royalty holder receives — because the value of oil or gas increases as it is processed and moved from the wellhead downstream.

In Burlington, the court clarified that royalty provisions in oil and gas leases can have a separate valuation point and valuation method.[10] The leases in Burlington provided that the royalty payments were calculated based on the amount realized from the sale, i.e., the actual amount of money received for the sale instead of the typical market value.[11]

But the leases also included what the court concluded was an at-the-well provision.[12] The court read the provisions together to create a valuation point at the well based on the valuation method of the amount realized from the downstream sale.[13]

The court concluded that Burlington had "the right to subtract post-production costs from the 'amount realized' in downstream sales price in order to calculate the product's value" at the wellhead.[14] In other words, Burlington held that there can be a valuation point at the well tied to a valuation method based on the amount realized at the downstream sale.

The Dispute in BlueStone: Whether BlueStone May Deduct Post-Production Costs From Royalty Payments

A primary issue in BlueStone was whether the lessee was entitled to deduct post-production costs from its royalty payments to lessors. The original lessee, Quicksilver, did not deduct post-production expenses for almost a decade. After BlueStone acquired the leases, it began deducting post-production costs from its royalty payments.

The royalty holders sued BlueStone.[15] At issue was the interplay between a form lease — the printed lease — and an addendum to that lease.

The printed lease contains a royalty provision for "market value at the well of one-eighth of the gas so sold or used." The addendum states that it controls over contrary provisions in the printed lease and includes a clause that states the "Lessee agrees to compute and pay royalties on the gross value received."[16]

If the at-the-well clause in the printed lease is not superseded by the gross value received clause in the addendum, then BlueStone is permitted to deduct reasonable post-production costs from royalty payments to the royalty holders. But if the gross value received clause is both a valuation method and a valuation point, then the addendum controls over the printed lease, and BlueStone would not be permitted to deduct post-production costs from royalties.

The trial court and the Fort Worth Court of Appeals both held that the superseding clause in the addendum governed, resulting in a "pure-proceeds" royalty calculation that did not allow BlueStone to deduct post-production costs from its royalty payments.[17] BlueStone appealed.

The Supreme Court's Holding

The Supreme Court of Texas determined that the gross value received clause in the addendum conflicted with the at-the-well provision in the printed lease, affirming the decision of the appellate court.[18]

The court started with a restatement of basic contract interpretation, noting that Texas courts "construe the mineral lease as a whole and interpret the language according to its plain, ordinary, and generally accepted meaning."[19] The court concluded that "when proceeds are valued in 'gross' ... the valuation point is necessarily the point of sale because that is where gross is realized or received."[20]

The court rejected BlueStone's argument premised on Burlington that at-the-well language acts as a trump card that supersedes the gross amount realized language.[21] The court distinguished the lease at issue in Burlington, which did not use gross language to modify the amount realized valuation in the lease.

The addendum at issue in BlueStone, however, included a gross value received clause. The terms, the court concluded, cannot be reconciled: "'gross' and 'net' terms do not peaceably coexist."[22]

The court held that the lease was unambiguous, the gross value received clause in the addendum was controlling, and it provided (1) a valuation method of the royalty based on the amount the lessee receives under its sales contract for the gas, and (2) a valuation point that is necessarily the point of sale because of the modifier, "gross."[23] As a result, BlueStone was not permitted to deduct post-production costs.[24]

Key Takeaways

When drafting contracts in general — and oil and gas leases specifically — drafters should take care to explicitly state the contract terms, and not rely on generally understood industry terms. Drafters should carefully note that the valuation method is distinct from the valuation point, and both should be explicitly detailed in leases.

Furthermore, drafters must be careful when using the terms "gross value received" — which will prohibit post-production deductions from royalty payments — and "at the well" — which permits those deductions.

Parties to, or acquirers of, oil and gas leases should review existing leases to determine whether those agreements contain conflicts between gross value received and at-the-well clauses, and whether any superseding clauses might affect interpretation.

Many form contracts are governed with riders or addendums, similar to the printed lease and addendum at issue in BlueStone. For example, the Edison Electrical Institute master contract, which is a commercially oriented, standard power purchase and sale agreement, includes optional annex provisions, and provides in its cover sheet the ability to identify any customized contract riders that modify the terms of the master agreement.[25]

The North American Energy Standards Board Inc. also provides a base contract for the purchase and sale of natural gas, which is modified by the cover sheet, special provisions and transaction confirmations.[26]

While BlueStone's holding concerns oil and gas royalties, it provides insight into the ways the Supreme Court of Texas views contract modifications through riders or addenda. Drafters should be mindful of the potential for creating contradictory terms through amendments or addenda, and draft to address such contradictions.

Kenneth Held is a partner and Brent Hanson is an associate at Skadden Arps Slate Meagher & Flom LLP.

[1] BlueStone Natural Resources II LLC v. Randle , No. 19-0495.

[2] Burlington Resources Oil & Gas Co. LP v. Texas Crude Energy LLC , 573 S.W.3d 198 (Tex. 2019).

[3] BlueStone slip op. at 15 (quoting Judice v. Mewbourne Oil Co. , 939 S.W.2d 133, 136 (Tex. 1996) (Owen, J.) (plurality op.)).

[4] Burlington, 573 S.W.3d at 202-03.

[5] See Burlington, 573 S.W.3d at 203.

[6] See Chesapeake Expl. LLC v. Hyder , 483 S.W.3d 870, 873.

[7] See Burlington, 573 S.W.3d 204.

[8] See Burlington, 573 S.W.3d 204.

[9] Chesapeake Exploration LLC, 483 S.W.3d at 873.

[10] Burlington, 573 S.W.3d at 211.

[11] Id.

[12] Id.

[13] Id. at 205, 211.

[14] Id. at 211.

[15] See BlueStone Nat. Resources II LLC v. Randle , 601 S.W.3d 848, 853 (Tex. App. — Fort Worth 2019, pet. granted).

[16] There is also a dispute about a "free-use" clause that permits BlueStone to use "free from royalty ... oil, gas, and coal produced from said land in all operation which lessee may conduct hereunder." The Supreme Court of Texas in a matter of first impression found that the free use clause was limited to on-lease uses. BlueStone, slip op. at 26.

[17] Id. at 869.

[18] BlueStone, slip op., at 2.

[19] Id. at 8.

[20] Id. at 14.

[21] Id. at 15-16.

[22] Id. at 15.

[23] Id. at 12, 14, 17 (emphasis in original) (quoting Bowden v. Phillips Petroleum Co ., 247 S.W.3d 690, 699 (Tex. 2008)).

[24] Id. at 17.

[25] Andrew S. Katz, Using the EEI-NEM Master Contract to Manage Power Marketing Risks, Energy Law Journal, Vol. 21, 269 & 275 (2000).

[26] See, e.g., 7A William B. Burford, West's Tex. Forms, Minerals, Oil & Gas § 17:10 (4th ed.).