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Current Issues in Oil and Gas

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Cases

Statutes

CURRENT ISSUES IN OIL AND GAS[1]

I.
RECENT CASE LAW

A. SUPREME COURT CASES

Chesapeake Exploration v. Hyder, No. 14-0302, 2016 WL 352231 (Tex. January 29, 2016). This was a suit alleging breaches of contract in connection with post-production costs and expenses. The Plaintiffs own overriding royalty interest. Generally, these rights bear no share of production costs but must bear their share of post-production costs. That arrangement can, however, be altered by contract. The lease in question had several cost allocation provisions. For example, it provided that royalty was "free and clear of all production and post-production costs and expenses." It also called for "a perpetual, cost-free (except only its portion of production taxes) overriding royalty of five percent (5.0%) of gross production obtained" for directional wells drilled on the lease but bottomed on nearby land. The lease also had a disclaimer: "Lessors and Lessee agree that the holding in the case of *Heritage Resources, Inc. v. NationsBank*, 939 S.W. 118 (Tex. 1996) shall have no application to the terms and provisions of this lease." The *Heritage Resources* decision noted that royalty is free of production expense but is usually subject to post production cost including taxes.

The Court noted that oil royalty bore post-production costs because it was paid on the market value of the oil at the well. Because post-production costs are incurred after the well-head, the commercial market value necessarily included the sales price less processing and transportation expenses incurred before the oil reached market. Conversely, the gas royalty did not bear post-production costs because it was based on the price Chesapeake actually received for the gas. The Court found that the overriding royalty provision was not as clear as either of these two provisions. The overriding royalty owners contended that the term "cost-free" necessarily meant they were not liable for post-production costs. The Supreme Court rejected that, finding that the term "cost-free" may simply emphasize that the overriding royalty is free of production costs. Chesapeake, on the other hand, argued that because the Parties clearly expressed an intent not to hold gas royalty responsible for post-production costs, the Parties necessarily knew how to express that intent and their failure to do so meant the overriding royalty was responsible for post-production costs. The Supreme Court disagreed with that argument as well. The Court analogized the overriding royalty owners' liability for post-production cost to their ability to take their gas in kind and concluded that "cost-free" as used in this provision, included post-production costs. The Court found, therefore, that Chesapeake was not entitled to deduct those costs from the overriding royalty owners' revenue. The Court also noted that the Parties' referenced to the

[1] I wish to acknowledge the work of Richard F. Brown. Mr. Brown is a shareholder in the firm of Brown & Fortunato, P.C. in Amarillo. He has for the last several years summarized recent oil and gas cases for the Oil, Gas, and Mineral Law Section's Quarterly Report, and he is a frequent seminar speaker. I've relied on Mr. Brown's work to help identify some of the cases discussed in this paper.

Heritage Resources decision indicated an intent to depart from the general rule that a royalty owner was subject to post-production costs.

Railroad Commission of Texas v. Gulf Energy Exploration, NO. 14-0534 2016 WL 363771 (Tex. January 29, 2016). This case held that the Texas Railroad Commission can raise a good faith defense in response to suit over a wrongfully plugged well. In this case, the Railroad Commission agreed to postpone plugging several abandoned off-shore wells to give Gulf Energy Exploration an opportunity to take over operation of four of those wells. Because of a mistake by a Railroad Commission employee, one of the four wells was accidentally plugged. Gulf Energy Exploration obtained the Legislature's consent to file suit against the Railroad Commission. It filed suit against the Commission and the company that the Commission hired to plug the wells. The jury found that the Commission failed to comply with its agreement to postpone plugging and abandoning the well in question. The trial court overruled the Commission's objection to the absence of a question on the Commission's good faith under Texas Natural Resources Code § 89.045 and also refused the Commission's requested good faith question.

The Texas Supreme Court held that this was error and that the Commission was entitled to assert a good faith defense. The Court held that good faith in this instance requires conduct that is honest in fact and is free of both improper motive and willful ignorance of the facts at hand.

Apache Deep Water v. McDaniel Partners, No. 14-0546, 2016 WL 766731 (Tex. February 26, 2016). The issue in this case was the proper calculation of a production payment that was reserved in the assignment of four oil and gas leaseholds. The four leases were assigned in one instrument. Prior to complete payment of the production payment, two of the leases terminated and a dispute arose between the parties over the effect of that termination on the production payment.

A production payment is a share of production from the described premises, free of production costs at the surface, that terminates when a given production volume has been paid or when a specific sum from its sale has been realized. For example, parties might agree to a production payment of $X or a percentage of the first X number of barrels of oil sold. In this instance, the production payment was to continue until net proceeds from the reserved interest amounted to $3.55 million and 1.42 million barrels of oil.

A production payment is in some ways similar to an overriding royalty. Just as with overriding royalty, a production payment ceases when the underlying lease terminates absent some contrary contractual provision.

The Court held that under this general rule the burden was calculated on each lease separately and that when one lease terminated, the burden was not shifted to the remaining leases. Thus, if the assignee was entitled to a 1/16th interest of the assignors' estate, then that 1/16th would be measured by what was conveyed under each lease separately.

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