Another Bite at the Post-production Cost Apple

By: M. Ryan Kirby and Timothy Truong

BlueStone Nat. Res. II, LLC v. Randle

No. 19-0459, 2021 Tex. LEXIS 206 (Macr. 12, 2021)

This case concerns: 1) the deduction of postproduction costs from royalties, and 2) the ability of a lessee to utilize the free-use clause of an oil and gas lease.

Quicksilver Resources ("Quicksilver") obtained leases from a variety of lessors. The leases were substantially similar, consisting of a form lease ("Printed Lease") and an addendum ("Addendum"). The language in the Printed Lease states that gas royalties would be paid based on "market value at the well." However, the Addendum states that royalties would be paid on the "gross value received" with no deductions or postproduction costs.

BlueStone Natural Resources II, LLC ("BlueStone") acquired the leases from Quicksilver. Quicksilver had paid gas royalties based on "gross value received" without deducting any postproduction costs. After BlueStone acquired the leases, it began paying the gas royalties using "at the well" computation, less the postproduction costs. Due to the substantial reduction in the royalty being received, four groups of lessors (collectively "Lessors") sued BlueStone. The Lessors alleged that the leases required payment on the "gross" receipt "without deductions," and BlueStone was improperly deducting postproduction costs.

The Lessors also discovered that BlueStone was not paying royalties on (1) commingled gas used as Plant Fuel or (2) on Compressor Fuel gas the fuel processor returned to BlueStone, each of which were being used both on and off the leased premises. BlueStone argued that its use of gas was allowable under the "free-use" provision of the leases, and further argued that its use of the gas was not limited to the leased premises so long as its use of gas benefited and furthered lease operations.

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Postproduction Costs

The Supreme Court of Texas affirmed the lower courts in determining that BlueStone's deduction of postproduction costs was improper. The Addendum had explicit language that resolved conflicts in favor of the Addendum over the Printed Lease, therefore requiring the use of the gross value received for the calculation of royalties.

BlueStone unsuccessfully argued that the "gross value received" language could be harmonized with "at the well" to produce a net-proceeds calculation. The Court disagreed, citing to *Judice v. Mewbourne Oil Co*., 939 S.W.2d 133 (Tex. 1996), which determined that "at the well" language is a net-proceeds calculation, which is the direct opposite of a gross value calculation and that the two were mutually exclusive methods of calculation.

Additionally, BlueStone argued that the Court's decision in *Burlington Resources Oil & Gas Co. LP v. Texas Crude Energy, LLC* 573 S.W.3d 198 (Tex. 2019) gave deference to "at the well" language, which superseded "amount realized" language, allowing BlueStone to deduct postproduction costs from royalty. However, the Court rejected BlueStone's argument, and distinguished *Burlington* on the grounds that the lease in Burlington did not contain conflicting royalty provisions or a provision to resolve conflicting royalty provisions, unlike the Addendum in the present case. The Court specifically noted,

> **[n]othing in *Burlington Resources* can reasonably be viewed as repudiating the notion that "gross" and "net" are opposite calculations or as favoring one over the other when both are present. Here, the parties expressly agreed to resolve the conflict in favor of a royalty free of postproduction costs, and courts must enforce unambiguous contracts as written.**

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The “market value at the well” in the Printed Lease here was in clear conflict with “gross value received” in the Addendum, with the Addendum having controlling language. The Court recognized that standing alone, “at the well” language as in *Burlington* was sufficient to allow postproduction cost deduction stating,

> [w]e expressly recognized that an “amount realized” valuation, viewed in isolation, would be sufficient to prohibit deduction of postproduction costs under our precedent, but under our precedent, contract language cannot be construed in isolation. Examining the parties’ agreement as a whole, we interpreted language requiring royalties to be delivered ’into the pipelines, tanks or other receptacles with which the wells may be connected’ as equivalent to calculating royalties "at the well," which produced a "net amount realized" royalty formula. But unlike the lease here, *Burlington Resources* did not involve conflicting royalty formulas, "gross" valuation language, or a provision directing how to resolve conflicts. The contract terms *Burlington Resources* evaluated did not inherently conflict, but the terms used in BlueStone's lease do.

The Court found that BlueStone incorrectly deducted postproduction costs from royalties paid to Lessors.

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On vs. Off –Premise Use

BlueStone argued that it had a right to utilize leasehold gas free of royalty so long as its use benefited or furthered operations of the lease. The oil and gas lease included a "free use" clause as follows:

> ***Lessee shall have free from royalty or other payment the use of … gas … produced from said land in all operations which Lessee may conduct hereunder, including water injections and secondary recovery operations, and the royalty on . . . gas . . . shall be computed after deducting any so used.***

The Court agreed with the court of appeals that the lease limited free use to operations conducted on the leased premises. The plain language of the lease limited free use to the leased premises and did not allow for BlueStone's broad interpretation of any use that "benefited" or "furthered" lease operations. Given the language, BlueStone was required to pay royalty on gas used for off-lease operations.

In regards to Plant Fuel, both parties have stipulated that it is used off-premises by a third-party processor and royalties were due on it. The Compressor Fuel is used on-premise but it is processed off-premises and commingled. BlueStone accounted for the lessor's fractional share but gave no evidence relating the fractional share to its use on each of the leases and failing to demonstrate whether gas was used on the lessor's leases or leases owned by others. The Court affirmed the Court of Appeals ruling that the free use clause allowed BlueStone to utilize the compression gas on-premises free of royalty, but that gas consumed off-premises had royalty due.

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However, the Court reversed the Court of Appeals on the issue of calculated damages based on the entire value of Compressor Fuel, as at least some of the Compressor Fuel was used on the lease for the benefit of the lease. The Court remanded this issue to the trial court to determine the correct amount due, if any, for Compressor Fuel.

The holding in this case demonstrates that operators should continue to utilize caution in deducting postproduction costs from royalty payments as such analysis is based upon the specific lease language. Furthermore, the Supreme Court of Texas has now shown a trend in ruling in favor of lessors and restricting free-use clauses to use on-premises, as well as restricting lessees from using lease resources in too broad of a manner with vague justifications.

ABOUT THE AUTHORS

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M. Ryan Kirby is a founding Partner and Timothy Truong is a Law Clerk with Kirby, Mathews & Walrath, PLLC, a firm founded on the idea that oil and gas operators are best served by individuals that understand the needs of the industry, as well as fulfilling those needs in an efficient, cost-effective and timely manner, all the while establishing a relationship and a dialogue with the client. In addition to his legal practice, M. Ryan Kirby is also a frequent speaker at seminars for various Landmen's organizations; he also serves as an Adjunct Professor at South Texas College of Law, where he teaches the Texas Oil, Gas and Land Titles course. Timothy Truong is currently a 2L at South Texas College of Law.