Texas Supreme Court Interprets "INTO THE PIPELINE" with Regard to Post-Production Costs

New Case Update: *Burlington Resources Oil & Gas Co. v. Texas Crude Energy, LLC*

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Quick Summary

In a 9-0 opinion, delivered on March 1, 2019, the Texas Supreme Court in *Burlington Resources Oil & Gas Company LP v. Texas Crude Energy, LLC* ("*Burlington*") equated the lease language on royalties delivered "into the pipeline" with "at the well" effectively expanding its previous jurisprudence on the deductibility of post-production costs from a royalty stream.

In-Depth Analysis

Amber Harvest, an affiliate of Texas Crude Energy, owns overriding royalty interests in oil and gas leases operated by Burlington Resources. For several years, Burlington made royalty payments after charging Amber Harvest its proportionate share of the post-production costs. Texas Crude later sued Burlington, alleging that the parties' contracts prohibit Burlington from charging post-production costs to the overriding royalty interest holder.[1]

"Post-production costs" means the costs incurred by a lessee in order to make the oil and/or gas marketable. These costs can include transportation, processing and fractionation and all other costs that are associated with increasing the price received. While Texas law recognizes that a royalty generally bears its share of post-production costs, there is nothing that precludes parties from contracting otherwise under the lease. Specifically, where a royalty is based upon "the market value at the well" post-production costs are generally deductible, despite other language that may be contained in the lease to the contrary.

This general understanding was first recognized in *Heritage Resources, Inc. v. NationsBank* ("*Heritage*") in which the Texas Supreme Court recognized that a royalty is generally chargeable with post-production costs, as opposed to production costs, and that a royalty based upon "market value at the well" can be calculated by subtracting post-production costs from the market value at the point of sale. Despite the fact that the lease contained explicit language that, "there shall be no deductions from the value of the [l]essor's royalty by reason of any required processing, cost of dehydration, compression, transportation, or other matter to market such gas," the Court in *Heritage* decided that such costs were in fact still deductible from the lessor's royalty.

In *Burlington*, the Court was asked to interpret "into the pipeline" which is another phrase commonly used to specify where a royalty interest will be delivered, and therefore valued. The Court looked to the entirety of the granting and valuation clauses in reaching its decision.

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[1] Although this case is based upon an overriding royalty interest, the Court's reasoning should apply to other types of oil and gas royalties, as the Court acknowledged in *Chesapeake Exploration LLC v. Hyder.*

The granting clause provides in pertinent part:

> [Assignor] does hereby ASSIGN, TRANSFER AND CONVEY unto [Assignee], … those certain overriding royalty interests, as set out below.... [s]aid overriding royalty interests shall be delivered to ASSIGNEE into the pipelines, tanks or other receptacles with which the wells may be connected, free and clear of all development, operating, production and other costs. … (emphasis added)

The valuation clause provides in pertinent part:

> The overriding royalty interest share of production shall be delivered to ASSIGNEE or to its credit into the pipeline, tank or other receptacle to which any well or wells on such lands may be connected, free and clear of all royalties and all other burdens and all costs and expenses … or ASSIGNOR, at ASSIGNEE's election, shall pay to ASSIGNEE, for ASSIGNEE's overriding royalty oil, gas or other minerals, the applicable percentage of the value of the oil, gas or other minerals, as applicable, produced and saved under the leases. "Value", as used in this Assignment, shall refer to (i) in the event of an arm's length sale on the leases, the amount realized from such sale of such production and any products thereof, (ii) in the event of an arm's length sale off of the leases, the amount realized for the sale of such production and any products thereof, and (iii) in all other cases, the market value at the wells. (emphasis added)

While the valuation clause specifies that the royalty payment shall be calculated based on the "amount realized" from the sale, it and the granting clause also specify that the royalty interest shall be delivered "into the pipelines, tanks, or other receptacles with which the wells may be connected."

Burlington argued that "into the pipeline" should be interpreted in the same way that the Court has historically interpreted "market value at the well" and post-production costs should therefore be deductible despite the use of the phrase "amount realized." The Court agreed.

The Court's opinion equates "into the pipeline" with "at the wellhead or nearby" as the royalty's valuation point. The Court concluded that this gives Burlington the right to subtract post-production costs from the amount realized in the sales prices in order to calculate the royalty's value as the product flows "into the pipelines, tanks or other receptacles with which the wells may be connected" thus expanding the Court's previous jurisprudence on the subject and providing clarity to operators whose leases call for delivery and valuation of royalty interests "into the pipeline."

Looking Ahead: What Does This Mean for You?

While Texas Crude still has a few days to ask for a rehearing from the Texas Supreme Court, RR&A recommends that operators of Texas oil and gas leases review their leases for "into the pipeline" or similar phrases in light of the Court's opinion so that you are aware of the potential effect this case may have on your business.

If you have any questions or concerns regarding the cases mentioned in this newsletter or any other matters, do not hesitate to reach out to RR&A at (832) 831-2289 or RReese@RReeseandAssociates.com.