

Gas Royalty Ruling Follows Texas Contract Scrutiny Trend

By **Brooke Sizer** (March 23, 2022)

The Texas Supreme Court has once again tackled the heavily contested issue of postproduction costs in royalty calculations. In *Nettye Engler Energy LP v. BlueStone Natural Resources II LLC*, the court was tasked with determining whether a nonparticipating royalty interest bore its share of natural gas postproduction costs.



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Postproduction costs are usually referring to the costs incurred by an operator in moving the gas from the wellhead to the sales point, such as the costs related to the treating, processing, compressing, gathering and transporting of gas.

Ultimately, the decision came down to the meaning of a single word: "pipeline." The court held in favor of the defendant lessee, BlueStone Natural Resources II, and confirmed that in this instance, a gas gathering pipeline is a pipeline under the terms of the contract.

In doing so, the court further solidified what has been the definite trend in royalty litigation: Texas courts will closely parse every single word of a royalty instrument to ascertain the parties' intent with respect to the proper allocation of postproduction costs.

Background

The underlying dispute concerned the interpretation of a 1986 mineral deed reserving an in-kind, nonparticipating royalty interest — or a royalty consisting of a fractional share of the actual minerals in place. The deed further required delivery of this fractional share "free of cost in the pipeline, if any, otherwise free of cost at the mouth of the well or mine."

For a number of years, BlueStone's predecessor lessee valued Nettye Engler Energy's share of production free of postproduction costs. However, when BlueStone assumed operatorship, it began deducting postproduction costs, which significantly reduced Engler's royalty payments.

Engler shortly thereafter sued BlueStone for improper payments. Both parties agreed that the royalty is free of production costs, and postproduction costs that are incurred prior to delivery into the pipeline. However, the parties could not agree on the location of delivery.

Specifically, the parties could not agree on what constituted the proper pipeline within the meaning of the deed. The dispute over the meaning of "pipeline" hinged on the mechanics of a gas well.

Gas is often produced and accumulated by a smaller pipeline network known as a gathering system. The gathering system then transports the gas to a larger pipeline network that moves the gas downstream to a refinery.

BlueStone argued that the delivery of the gas occurred at the entrance to the gathering pipelines on the wellsite, and the royalty interest was therefore burdened by all of the postproduction costs incurred thereafter.

Engler argued that the delivery did not occur until at least downstream at the transportation

pipeline, after passing through the gathering system; thus, the interest was burdened only with some, but not all, postproduction costs.

The Decision and Takeaways

In finding for BlueStone, the court analyzed the specific language used in the deed, declining to entertain expert testimony offered by Engler as to the meaning of the term.

Relying in part on dictionary, industry manuals and similar sources, the court affirmed that a gathering system is a pipeline within the plain meaning of that term, and that nothing in the deed prohibited the relevant pipeline for delivery of Engler's royalty from being located at or near the well.

The court found that, as the deed is to be construed based on its terms, the deed required delivery to be free of cost into the pipeline, and the first pipeline was the gas gathering system, BlueStone met its obligations. BlueStone was thus permitted to deduct postproduction costs incurred after delivery into the gas gathering system located on the wellsite.

Perhaps more interesting than the court's specific interpretation of the term "pipeline" is the overall message from the court on how it will continue to review cases concerning the interpretation of royalty clauses.

This is exemplified by the extra time the court took to clarify its holding in a related 2019 case, Burlington Resources Oil & Gas Co. v. Texas Crude Energy LLC, on which the appellate court had principally relied.

The court went out of its way to highlight that in Burlington it had not set forth any hard and fast rule that "into the pipeline," or similar language, always means an "at the well" valuation point, but rather had merely confirmed that "all contracts ... are to be construed as a whole to ascertain the parties' intent from the language they used to express their agreement."

This emphasis by the court should serve as a warning to practitioners and parties against reliance on any supposed "magic words," or on a "check the box" level of review when analyzing royalty clauses.

Instead, as with many postproduction royalty suits, Texas courts have made it abundantly clear that the rules are not absolute, but rather focused on the specific language chosen in the context of the four corners of the instrument.

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