The Supreme Court of Texas Rules in Producer's Favor in Royalty Case Involving Fuel Gas

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In *Carl v. Hilcorp Energy Co.*, -- S.W.3d --, 2024 WL2226931 (Tex. May 17, 2024), the Supreme Court of Texas answered two questions certified by the Fifth Circuit concerning the payment of royalty on gas used in off-lease post-production activities. The *Carl* lease provided for a market-value-at-the-well royalty on gas "sold or used off the [leased] premises" and limited free-use to gas used on the leased premises. Texas's high court agreed with the other Texas courts to consider the issue and concluded that the value of the gas used in off-lease post-production activities was a post-production cost that could be shared with the royalty owner.

Background:

It is settled law in Texas that, when a lease provides for royalty to be valued "at the well," the royalty bears its share of postproduction costs. For many years, the consensus in the industry has been that, when gas is used for fuel in postproduction activities, the value of that gas can be properly accounted for as a postproduction cost when calculating wellhead value. *Carl* and other recent cases challenged that position.

Integral to understanding *Carl*, however, is a brief overview of another recent Supreme Court of Texas fuel gas case, *BlueStone Natural Resources II, LLC v. Randle*, 620 S.W.3d 380 (Tex. 2021). *Randle* concerned whether a lessee owed royalty on gas used off the leased premises for compression and plant fuel. *See id.* at 384. The lease's addendum provided for royalty based on the "gross value received" by the lessee at a downstream sales point without deduction for postproduction costs. *Id.* The lessee, BlueStone, argued that it owed no royalty on gas used off-lease under the lease's free use clause: "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*." *Id.* at 394. Deciding an issue of first impression, the Supreme Court of Texas held that the free-use clause was limited to gas used on the leased premises, meaning that BlueStone owed royalty on the off-lease use prior to the point of sale and calculation of gross proceeds. *Id.* at 384.

In the wake of *Randle*, royalty owners with market-value-at-the-well leases filed numerous cases alleging underpayment of royalty associated with off-lease gas use. One such case was *Carl v. Hilcorp Energy Co.*, a putative class action filed in the Southern District of Texas. 2021 WL 5588036 (S.D. Tex. Nov. 30, 2021).[1] The *Carl* lease contained a free-use clause substantively identical to the one in *Randle*. *See id.* at *1. And the lessor argued that the lessee, Hilcorp: (1) owed royalty on gas used off the leased premises; and (2) was prohibited from considering the value of that gas in calculating the wellhead value of the gas. *Id.* Hilcorp moved to dismiss, asserting that the lease's "at the well" valuation point meant that the royalty bore its share of postproduction costs, and that neither the free-use clause nor *Randle* changed that structure. *Id.* at *1, 4. The district court agreed with Hilcorp and dismissed the case, finding that *Randle* was inapposite because it did not interpret a lease containing a market-value-at-the-well royalty clause. *Id.* at *4.

After the lessor appealed, the Fifth Circuit certified two questions to the Supreme Court of Texas:

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1. "After *Randle*, can a market-value-at-the well lease containing an off-lease-use-of-gas clause and free-on-lease use clause be interpreted to allow for the deduction of gas used off lease in the post-production process?"
2. "If such gas can be deducted, does the deduction influence the value per unit of gas, the units of gas on which royalties must be paid, or both?"

Carl as Co-Trustee of Carl/White Trust v. Hilcorp Energy Co., 91 F.4th 311, 317 (5th Cir. 2024).

Opinion:

Question One: The Supreme Court of Texas began by highlighting a point it has made time and again—"[m]inerals that have already been processed or transported are generally more valuable than the same minerals taken straight from the ground." *Carl*, -- S.W.3d --, 2024 WL2226931, at *1. Accordingly, where a lease provides for royalty to be valued "at the well," the lessor would receive a windfall if paid royalty based on a downstream sales price without accounting for postproduction costs. *Id.* The Court emphasized that the workback method accounts for this disparity between the value of gas "at the well" and at a downstream sales point. *Id.*

The Court next determined that Hilcorp had properly accounted for the value of the gas used off-lease by subtracting that volume from "the total volume of gas on which it calculated the royalty." *Id.* at *2. The Court found "no fault" with such a method, explaining that the "'sold or used off the [leased] premises'" language "does not alter [Carl's] obligation to bear the 'usual share of postproduction costs' as the holder of an 'at-the-well' royalty." *Id.*

Finally, the Court clarified that *Randle* had no "particular impact on the outcome" of the case because it involved a gross-proceeds lease with anti-deduction language, not a market-value-at-the-well lease, and "amounted to a distraction from the real issue between these parties, which is post-production costs." *Id.* at *3. However, the Court did note that Randle "reiterates the longstanding rule that an 'at-the-well' royalty 'bears its usual share of postproduction costs.'" Id. In summary, the Court answered "Yes" to the first certified question. *Id.*

Question Two: In a single paragraph, the Court declined to definitively answer the second certified question, explaining that "[t]he parties appear to agree that the question is primarily one of accounting and that it does not impact their legal rights[.]" *Id.* at *4. The accounting methods at issue are best demonstrated through an example. Assume a lessee produces 100 mcf of gas, uses 20 mcf of gas in postproduction activities, and then sells 80 mcf of gas at a downstream location. Under the first method, the lessee adjusts the volume included in its netback calculation to account for the 20 mcf of used gas. Under the second method, the lessee includes the value of the 20 mcf of used gas as a postproduction cost in its netback calculation. In *Carl*, the Supreme Court of Texas concluded that these two accounting methods would yield the same royalty payment and declined to offer further thoughts on the issue. *Id.* The Court expressed no preference for any particular method of royalty accounting, so long as it "results in [Carl] being paid what he is lawfully owed." *Id.*

Takeaway:

The Supreme Court of Texas confirmed that a royalty owner with a market-value-at-the-well lease must bear its share of all postproduction costs, including the value of gas used for off-lease postproduction activities. The Court expressed no preference as to the accounting method used to calculate royalty in this context.

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[1] Other such cases were *Fitzgerald as Trustee for Jackson Family Mineral Trust v. Apache Corp.*, 2021 WL 5999262 (S.D. Tex. Dec. 20, 2021) and *EnerVest Operating, LLC v. Mayfield*, 2022 WL 4492785 (Tex. App.–San Antonio Sept. 28, 2022, no pet.). Both *Apache* and *EnerVest* contained lease language substantively identical to that in *Carl*, and the courts in both cases determined that the free-use clause did not impact the royalty owners' obligation to share in postproduction costs.

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