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NO. 14-0302

IN THE SUPREME COURT OF TEXAS

CHESAPEAKE EXPLORATION, L.L.C
AND CHESAPEAKE OPERATING, INC., Petitioners

v.

MARTHA ROWAN HYDER, ET AL., Respondents

ON PETITION FOR REVIEW
FROM THE FOURTH COURT OF APPEALS, SAN ANTONIO, TEXAS
COURT OF APPEALS NO. 04-12-00769-CV

BRIEF OF AMICI CURIAE TEXAS LAND AND MINERAL OWNERS ASSOCIATION AND NATIONAL ASSOCIATION OF ROYALTY OWNERS-TEXAS, INC. ADDRESSING MOTION FOR REHEARING

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IDENTITY AND INTEREST OF AMICUS CURIAE TEXAS LAND AND MINERAL OWNERS ASSOCIATION

Texas Land and Mineral Owners Association ("TLMA") is a statewide advocacy association whose members are farmers, ranchers, and royalty owners. TLMA's charter is to support a business and legal environment that accommodates the continued exploration for and production of oil and natural gas and also protects the property rights of mineral owners.

The National Association of Royalty Owners-Texas, Inc. ("NARO-Texas") is a non-profit trade association organized under Texas law, representing a statewide membership of oil and gas royalty owners and landowners. NARO-Texas seeks to protect the economic interests and promote the legal rights of oil and gas royalty owners throughout Texas.

TLMA and NARO-Texas previously filed an amicus brief in this case.

TLMA and NARO-Texas are paying the fees for preparation and submission of this brief.

INTRODUCTION

Texas Land and Mineral Owners Association and the National Association of Royalty Owners-Texas, Inc. (collectively, "TLMA-NARO") file this brief urging the Court to deny Chesapeake's motion for rehearing. The Court held that the Hyder lease, unlike many other leases, prohibits the lessee from shifting post-production costs (except for taxes) to the lessor's gas royalties. This conclusion was reached after a careful, reasoned consideration of all of the language of the lease and is the only interpretation that gives meaning to the plain language in the lease. Amici in support of Chesapeake concede as much, asking the Court to disregard the "cost free" language in the overriding royalty Paragraph 10 of the lease as "surplusage." Texas Oil & Gas Association (TXOGA) Br. at 6, 10; BP America Prod. Co. *et al*. (BP) Br. at 17, 18; Texas Independent Producers & Royalty Owners (TIPRO) Br. at 11. These amici essentially assert that the sky will fall unless the Court gives no meaning to this language. Giving meaning to all provisions whenever possible, however, is what this Court has consistently required Texas courts to do.

"Parties to a lease may allocate costs, including post-production or marketing costs, as they choose." *Heritage Resources, Inc. v. NationsBank*,

939 S.W.2d 118, 124 (Tex. 1996) (Owen, J., concurring). That is what occurred here. This Court should not change the terms of the parties' agreement merely because it is different from how most lessees pay overriding royalties.

TLMA-NARO responds to the following arguments raised by the Chesapeake amici TXOGA, BP, TIPRO and Sandridge Exploration and Production, LLC (Sandridge):

(A) Chesapeake amici argue that an overriding royalty based on gross production is a royalty based on the "market value at the well" and, under *Heritage*, post-production costs are deductible, regardless of any "cost free" language in the lease;

(B) BP et al. argue that the Court's characterization of this lease as a proceeds lease could be interpreted to mean that payment is not based on the price actually received by the lessee but, rather, on the price received by lessee's purchaser, who resells the gas;

(C) Chesapeake amici contend that "production taxes" are not "post production costs;" and

(D) Chesapeake amici argue that the value of a royalty should not change based on whether it is taken in kind or in cash.

ARGUMENT

A. The Hyders' overriding royalty is based on a percentage of gross production, not on the value of production "at the well." "Gross production" does not mean "value at the well."

TXOGA and TIPRO argue (at 4 and 8 respectively) that an overriding royalty based on "gross production" "necessarily refers to production at the well" and, therefore, can only mean that the royalty on that production must be based on its value "at the well." Amici Sandridge similarly argues (at 2-3) that the Hyders' overriding royalty must be valued "at the well." Amici are reading words into the Hyder lease that are simply not there.

Paragraph 10 of the Hyder lease does not say that the royalty paid on production is based on the value of the gas "at the well." In fact, Paragraph 10 does not refer to value at all. Instead, it directs that the royalty paid under Paragraph 10 shall be "cost free," except for production taxes. As the Court noted, the reference to "cost free" is the only indicator in Paragraph 10 regarding how the royalty owed under that provision is to be calculated. The Court properly gave meaning to that phrase.

The Court also properly examined the entire Hyder lease to confirm that the meaning it found in Paragraph 10 was consistent with the rest of the lease. To discern intent, courts "'examine and consider *the entire writing*

in an effort to harmonize and give effect to *all the provisions* of the contract so that none will be rendered meaningless.'" *Seagull Energy E & P, Inc. v. Eland Energy, Inc.*, 207 S.W.3d 342, 345 (Tex. 2006) (emphasis in original, quoting *Coker v. Coker*, 650 S.W.2d 391, 393 (Tex. 1983)). "'No single provision taken alone will be given controlling effect; rather, all provisions must be considered with reference to the whole instrument.'" *Id.* (again quoting *Coker*).

TXOGA agrees (at 15-16) that the gas royalty clause in Paragraph 5 of the lease requires the lessee to pay royalty based on the proceeds received, without deduction of post-production costs, because the gas royalty clause does not provide for gas royalties based on the value "at the well." But neither does the overriding royalty ("ORRI") clause provide for royalties based on the value "at the well." There is nothing in the lease to support TXOGA's argument that "gross production," "cost-free," means "value at the well."

TIPRO argues (at 1) that the Court's review of Paragraph 5 of the lease "as a tool to interpret the ORRI clause found in paragraph 10 is inconsistent with the intent of ORRIs and how they are to be paid." TIPRO's position is contrary to the well-established contract construction

principles discussed above and is a misreading of the Court's opinion. The Court did not hold that the pricing provisions in Paragraph 5 dictated the pricing in Paragraph 10. On the contrary, the Court accurately observed that the royalty owed in Paragraph 10 "is not as clear as either of the other two royalty provisions" in Paragraph 5. *Chesapeake Exploration, L.L.C. v. Hyder*, No. 14-1302, 2015 WL 3653446 at *3 (Tex. June 12, 2015).

But the Court properly examined Paragraph 5 in the context of determining what Paragraph 10 provides. Paragraph 5 does not tie the gas royalty to its "value" at the well but, instead, to the price the lessor receives, and has detailed language regarding the "cost free" nature of that royalty. The oil royalty, in contrast, is determined under Paragraph 5 by "the market value at the well" and therefore bears postproduction costs. *See id.* at *2. The "cost free" language in Paragraph 10, while not as detailed as the cost-free language for the gas royalty in Paragraph 5, is fundamentally the same as the cost-free language applicable to the gas royalty in Paragraph 5. The oil royalty provision in Paragraph 5 shows that the parties knew how to refer to "market value at the well" when they intended that to be the basis for calculating a royalty. The absence of such language in Paragraph 10 is significant. Courts find significance not only

in what the parties said "but also what they did not say." *Americo Life, Inc. v. Myer*, 440 S.W.3d 18, 24-25 (Tex. 2014). If the parties had meant the royalty in Paragraph 10 was to be based on "market value at the well," they knew how to say that and they chose not to.

TXOGA argues (at 6-7) that the Hyder lease must be interpreted to mean the same thing as the lease in *Heritage*—*i.e.*, market value at the well. But the lease in *Heritage*, unlike the overriding royalty provision here, *does* say that lessee is to "pay the Lessor 1/4 of the market value at the well for all gas." *Heritage*, 939 S.W.2d at 120. Moreover, the "no deduction" language in *Heritage* prohibited deductions from the "value of the Lessor's royalty." *Id.* at 121. This qualifying "value" language is absent from Paragraph 10 of the Hyder lease, which simply says "cost-free (except only its portion of production taxes)." The Court correctly looked to the particular language in the Hyder lease in construing it to provide for a different calculation of the overriding royalty than was required by the lease in *Heritage*.

B. The Court's opinion does not require all proceeds leases to be based on the price paid by the first non-affiliated entity; Chesapeake's particular lease terms and its stipulations regarding its obligations require this.

BP asserts (at 1) that the Court's opinion could be read to require royalties in a proceeds lease "to be paid not on the price actually received by the lessee but, rather, on the price received by the lessee's purchaser if the lessee's purchaser resells the gas." The opinion neither states nor implies this. The requirement here that the price be based on the price received by Chesapeake's marketing affiliate – which resold the gas to a non-affiliated third party – is dictated by Chesapeake's own stipulation that its affiliate sales would be ignored for purposes of calculating royalties. *See* the Hyders' response to Chesapeake's motion for rehearing at 12.[1] Pursuant to this stipulation, the price received by Chesapeake's marketing affiliate is considered the price received by Chesapeake. Chesapeake never contended, in the trial court, the court of appeals, or before this Court, that the "proceeds" on which its royalties must be paid should be the proceeds received by Chesapeake from its marketing

[1] The Hyder lease prohibits the lessee from selling production to an affiliate. "Lessee shall not sell hydrocarbons to entities owned in whole or in part by Lessee or to entities affiliated with Lessee in any way, without the express written consent of Lessors." Hyder Lease, ¶ 5.

affiliate. The Court's opinion properly notes these special circumstances in footnote 1 of its opinion.

TXOGA argues (at 18) that the Court's opinion erroneously holds that, for a proceeds lease, the price-received basis for payment is enough to excuse the lessors from bearing postproduction costs. The Court, however, did not make such a general holding but, instead, based its ruling on the specific language of the Hyder lease, which contains an express "cost-free" provision.

C. Paragraph 10's exclusion of production taxes from the "cost free" requirement indicates an intent that the lessor not bear post-production costs.

In its initial amicus brief, TXOGA did not dispute that production taxes were post-production costs. Instead, it argued (6/10/2014 Br. at 11-13) that "cost-free (except only its portion of production taxes)" means free of production costs, not *post*-production costs. TXOGA argued (6/10/2014 Br. at 11) that the phrase "cost free," when associated with an overriding royalty, is "understood in the industry" to make the overriding royalty free of *production* costs that must be paid by the working interest. TXOGA cited no authority or evidence for such an "industry understanding" and this

Court properly rejected this argument (which was also made by Chesapeake).

Now, TXOGA says (at 6, 10) that the term "cost-free" must be disregarded as surplusage. BP and TIPRO (at 17-18 and 11, respectively) make similar "surplusage" arguments and further argue (at 15-17 and 9-12, respectively) that production taxes are not post-production costs.

TXOGA, BP and TIPRO are wrong on both counts. Treating "cost-free (except only its portion of production taxes)" as mere surplusage violates the fundamental rule that, in construing contracts, courts strive to give "effect to *all the provisions* of the contract so that none will be rendered meaningless." *Seagull Energy*, 207 S.W.3d at 345 (emphasis in original). The "cost free" provision is the only provision in Paragraph 10 that directly addresses whether costs may be deducted from the overriding royalty. If that provision is disregarded, there is nothing in Paragraph 10 that speaks to whether post-production costs may or may not be deducted. As the only provision in Paragraph 10 addressing the deductibility of costs, this provision can and should be given meaning.

This Court has never described production taxes as anything other than post-production costs. *See Heritage*, 939 S.W.2d at 122 (referring to

"post-production costs, including taxes"); *French v. Occidental, Permian Ltd.*, 440 S.W.3d 1, 8 n.24 (Tex. 2014) (same).

Under the Texas Tax Code, a severance tax is imposed on the "gas produced and saved in this state by the producer." Tex. Tax Code § 201.052(a). The tax is due "on the 20th day of the second month *following* the month of production." Tex. Tax Code § 201.201 (emphasis added). Thus, the tax is not owed unless production occurs and is not due until more than two months after the gas is produced. The tax is therefore an expense incurred post-production. *See* Williams & Meyers Manual of Oil and Gas Terms (9th ed.) at 828 (giving as the synonym for post-production costs the term "Subsequent-to-Production Costs"). That this expense is a tax does not change the fact that it is a cost.

BP and TIPRO argue (at 16 and 10 respectively) that severance taxes cannot be post-production costs because Texas Tax Code § 201.205 prohibits Chesapeake from agreeing to take on the financial responsibility for the Hyders' share of severance taxes. Section 201.205 does not say this. All it says is that the tax "shall be borne ratably by all interested parties, including royalty interests," and obligates the producers or purchasers of the gas to take responsibility for withholding any sums owed by the

royalty owners and remitting all of the tax owed to the comptroller. Tex. Tax. Code § 201.205. Nothing in the Tax Code prohibits a lessee from agreeing to assume the costs of all severance taxes owed, including those owed by the royalty owners. On the contrary, "tax shifting clauses are relatively common" in oil and gas leases. Ernest E. Smith and Jacqueline Lang Weaver, Texas Law of Oil and Gas § 4.6[C], 4-74.2 (2nd ed.). *See also Enserch Corp. v. Houston Oil & Minerals Corp.*, 743 S.W.2d 654, 657 (Tex. App.—Houston [1st Dist.] 1987, writ denied) (enforcing a contractual allocation of severance taxes).

BP and TIPRO also argue (at 18 and 11, respectively) that only marketing costs are post-production costs – not taxes. The very authorities they cite – *Heritage* and *Martin v. Glass* – undercut their argument. *Heritage* expressly describes post-production costs as "including taxes." 939 S.W.2d at 122. *Martin v. Glass* does not limit post-production costs to marketing costs but, instead, describes them generally as "costs incurred *subsequent* to production." 571 F.Supp. 1406, 1410 (N.D. Tex. 1983), *aff'd*, 736 F.2d 1524 (5th Cir. 1984) (emphasis added).

BP and TIPRO suggest that the Court's opinion will create confusion regarding whether royalty owners with leases generally prohibiting

deduction of post-production costs can shift their share of severance taxes to their lessees. Those facts were not before the Court. This Court's opinion never suggests that, absent the parenthetical "except for taxes," the "cost-free" clause would require the lessees to bear financial responsibility for all of the severance taxes imposed by the Tax Code. The Court considered the provision *excepting* production taxes from the cost-free requirement only as an indication that the cost-free requirement refers to costs incurred *after* production, not before. It may be that severance taxes would not be considered a "post-production cost" in the context of a lease prohibiting deduction of such costs *without* the parenthetical exception for taxes; but it is clear from Paragraph 10's parenthetical that "cost-free" was intended to apply to all post-production costs *other than* taxes.

D. There is nothing unfair or improper in having a meaningful difference in value between a royalty taken in kind and a royalty taken in cash.

Chesapeake and TXOGA argue (at 6-7 and 4, respectively) that the Court's decision violates "long-established Texas oil and gas law" by allowing the royalty owner to receive a better royalty when he chooses to take royalty in cash rather than in kind. Like Chesapeake, TXOGA fails to cite a single case supporting the notion that a royalty owner cannot

negotiate a lease that gives it a meaningful choice between taking royalty in cash versus in kind. Moreover, they overlook the fact that both the majority and the dissent agree that the 25 percent gas royalty provision in Paragraph 5 of the Hyder lease gives the lessor this option. There is nothing unreasonable or improper in giving a lessor the option to choose either a cash or in-kind royalty and to have one option be more valuable than the other.

TIPRO argues (at 2-3) that this kind of option is improper for an overriding royalty because, unlike the lessor's reserved royalty, it is carved out of the lessee's working interest and is paid on production from off-lease premises. Nothing in the language of the Hyder lease supports this notion, and nothing other than TIPRO's *ipse dixit* supports the notion that where the royalty originates makes a legal difference in how it is calculated. Courts look to the language of the lease to determine its meaning, not what others assert is the norm or the general rule. *See Heritage*, 939 S.W.2d at 122 (recognizing that "parties may modify this general rule [that the royalty bears post-production costs] by agreement").

TIPRO also argues (at 7-8) that the Hyder lease does not actually give the Hyders the option to take their overriding royalty in cash but that

Chesapeake merely makes these payments as an "accommodation" to the Hyders. Chesapeake, however, has never made this argument.

Conclusion

The motion for rehearing should be denied.

Respectfully submitted,

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CERTIFICATE OF COMPLIANCE

This brief complies with the type-volume limitation of Tex. R. App. P. 9.4 because it contains 2,782 words, excluding the parts of the brief exempted by Tex. R. App. P. 9.4(i)(l). The undersigned relied on the word count of MS Word, the computer program used to prepare the brief.

/s/ Mary A. Keeney
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I certify that on November 10, 2015, I electronically filed the foregoing document, and on which day I have provided a true and correct copy of the foregoing via the electronic filing service or U.S. First Class Mail to the following attorneys for the parties as follows:

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