CASE NO. 13-10601

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

GORDON POTTS; BRANDY WEST,

Plaintiffs – Appellants

v.

CHESAPEAKE EXPLORATION, L.L.C.,

Defendant – Appellee

Appeal from Civil Action No. 3:12-CV-1596-O
In the United States District Court for the
Northern District of Texas, Dallas Division
Honorable Reed C. O'Connor, Presiding

PETITION FOR REHEARING EN BANC

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CERTIFICATE OF INTERESTED PERSONS

The undersigned counsel of record certifies that the following listed persons and entities as described in the fourth sentence of Fifth Circuit Rule 28.2.1 have an interest in the outcome of this case. These representations are made in order that the judges of this Court may evaluate possible disqualification or recusal.

Gordon Potts
Brandy West
Appellants

Chesapeake Exploration, L.L.C.
Appellee

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Chesapeake Operating, Inc.
Chesapeake Energy Marketing, Inc.
Related Chesapeake Entities

/s/ Robert E. Aldrich, Jr.
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RULE 35(b)(1) STATEMENT

The Panel's opinion in this case conflicts with prior opinions of this court and the Supreme Court of Texas. *See Piney Woods Country Life School v. Shell Oil Co.*, 726 F.2d 225 (5th Cir. 1984); *Heritage Res., Inc. v. NationsBank*, 939 S.W.2d 118, 121 (Tex. 1996). Moreover, this case involves a question of exceptional importance to this Circuit, which is whether lessees such as Chesapeake may, without any input from or control by lessors such as Appellants, use affiliate sales and other similar legal fictions to manipulate the location of a "point of sale" and thereby through sleight of hand emasculate negotiated contractual provisions that prohibit lessees from charging post-production costs. This Court rejected such shenanigans in *Piney Woods* under analogous circumstances when Shell Oil and its gas purchasers attempted to avoid state regulations by contractually defining the passage of title to be "in the fields" as opposed to downstream where physical possession of the gas actually changed. As written, the Panel's opinion permits lessees to manipulate the circumstances after the fact to avoid the consequences of the leases to which they agreed. Because this question is of such importance, and because it contradicts state court holdings, Lessors alternatively ask the Court to certify the interpretation of the Lease language at issue to the Supreme Court of Texas.

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ISSUE MERITING EN BANC CONSIDERATION[1]

Issue 1. The Lease[2] provides that royalties on gas shall be based on the market value at the point of sale, that royalties be paid based on arms-length, negotiated sales to unrelated third parties, and that, notwithstanding anything to the contrary in the Lease, all royalties shall be free of all costs and expenses, but the Panel's opinion misplaces the point of sale and renders critical Lease language meaningless. If not corrected, the Panel's interpretation of the Lease and unwarranted expansion of an inapplicable Supreme Court of Texas opinion will negatively affect royalty owners throughout this Circuit who have now, through the Panel's opinion, had their agreements judicially rewritten.

COURSE OF PROCEEDINGS AND DISPOSITION

1. This is an oil and gas case involving the interpretation of the subject Oil, Gas and Mineral Lease (the "Lease").[3] The District Court granted Chesapeake's Motion for Summary Judgment in part and denied Appellants' (jointly, "Lessors") Motion for Partial Summary Judgment.[4] The District Court also denied Lessors' motion for reconsideration.[5] The Panel affirmed the District Court's judgment on July 29, 2014.

[1]Lessors do not waive the other issue raised in their Appellants' Brief and Reply Brief.
[2]Capitalized terms not already defined are defined in the body of this petition.
[3] ROA 26.
[4] ROA 440.
[5] ROA 480, 730, 739.

STATEMENT OF FACTS

A. The Lease

2. Chesapeake is the successor lessee under the Lease.[6] Since the date of first production, Chesapeake has "sold" the subject gas to its affiliate, Chesapeake Energy Marketing, Inc. ("CEMI"), with the "sale" purportedly occurring at the wellhead.[7] The first sale to a non-affiliate occurs when CEMI sells the gas at a downstream location.[8] Chesapeake admits the price it is paid by CEMI, and on which Lessors' royalties are paid, is calculated as the weighted average sales price received by CEMI at the downstream point of sale, *net of the post-production costs* CEMI incurred in moving the gas to the point of sale.[9]

3. Paragraphs 11 and 37 of the Lease provide as follows:

> 11. The royalties to be paid by [Chesapeake] are:
>
> ***
>
> (b) on gas, including casing head gas or other gaseous substances produced from said land or sold or used off the premises or for the extraction of gasoline or other products there from, the *market value at the point of sale* of ¼ of the gas so sold or used. However, in no event shall the royalty paid to [Lessors] be less than [Lessors'] royalty share of the actual amount realized by [Chesapeake] from the sale of oil and/or gas. *Notwithstanding anything to the contrary herein contained, all royalty paid to [Lessors] shall be free of all costs and expenses* related to the exploration, production and

[6] ROA 207.
[7] ROA 395.
[8] Appellee's Brief at 3.
[9] ROA 395; Appellee's Brief at 4.

> marketing of oil and gas production from the lease including, but not limited to, costs of compression, dehydration, treatment and transportation.[10]
>
> 37. After initial production is established, payment of royalty to Lessor[s] shall be made within 120 days. All payments of royalty thereafter are to be paid 60 days after the end of the production month for oil, and 90 days after the end of the production month for gas. *Payments of royalties to Lessor[s] shall be made monthly and shall be based on sales of leased substances to unrelated third parties at prices arrived at through arms length negotiations.* Royalties to Lessor[s] on leased substances not sold in an arms length transaction shall be determined based on prevailing values at the time in the area. [Chesapeake] shall have the obligation to disclose to Lessor[s] any information pertinent to this determination.[11]

4. In short, paragraph 11 requires that Lessors' royalties be based on the market value at the point of sale and be cost free. Paragraph 37 confirms that, irrespective of who initially purchases the gas, Lessors' royalties are to be calculated based on the sale to an unrelated third party at a price arrived at through arm's length negotiation. The Panel's opinion vitiates these bargained-for terms.

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[10] ROA 213(emphasis added).

[11] ROA 217 (emphasis added).

B. Chesapeake Originally Agreed with Lessors

5. Shortly after Mr. Potts wrote Chesapeake in June 2011 regarding shortfalls in his royalty payments and Chesapeake's violation of the favored nation provision,[12] he received a letter and a check in the amount of $141,607.37, the

amount Chesapeake conceded it improperly deducted from Mr. Potts' royalty payments.[13] Chesapeake later took the opposite position.

6. Chesapeake initially paid royalties to Ms. West free of costs,[14] but it withheld her royalty check in July 2012[15] and advised that it would also withhold future royalty payments.[16]

ARGUMENT AND AUTHORITIES

A. Standard of Review and Lease Interpretation Rules

7. The Court should "review [the] grant of summary judgment *de novo*, applying the same standard as the district court."[17] In construing an unambiguous oil and gas lease, this Court's task is to ascertain the parties' intentions as expressed in the lease.[18] To do so, the Court must examine the entire document

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[12] ROA 221. Lessors addressed the issues regarding the favored nation provision in their Appellants' Brief and do not abandon it here.

[13] ROA 208, 223.

[14] ROA 232.

[15] *Id.*

[16] *Id.* Chesapeake also conceded that it had violated the favored nation clause as to Ms. West's interest, but it withheld the $34,096.53 owed under that provision. ROA 233, 240.

[17] *U.S. v. Caremark, Inc.*, 634 F.3d 808, 814 (5th Cir. 2011) (citations omitted); *see also* FED. R. CIV. P. 56(a).

[18] *Heritage*, 939 S.W.2d at 121 (citing *Sun Oil Co. v. Madeley*, 626 S.W.2d 726, 727-28 (Tex. 1981); *McMahon v. Christmann*, 303 S.W.2d 341, 344 (Tex. 1957)).

and consider each part with every other part so that the effect and meaning of one part on any other part may be determined.[19] It is presumed that parties to a contract intend every clause to have some effect.[20] The Court must enforce the unambiguous document as written.[21] The Panel's opinion regrettably fails to give effect to all language in the Lease.

8. Royalty is commonly defined as the landowner's share of production, free of expenses of production.[22] While royalty is typically subject to post-production costs, the parties may, as they did in this case, modify this general rule by agreement.[23] The specific language of each lease therefore controls.[24]

B. The Panel's Opinion Contradicts the Lease's Plain Language and Places Lessors at the Mercy of Lessees' Post-Contract Conduct

9. Paragraph 11 of the Lease provides that royalties are to be paid on the "market value at the point of sale," that royalties "shall be based on sales of leased substances to unrelated third parties at prices arrived at through arms length negotiations," that "all royalty paid to Lessor shall be free of all costs and expenses," and that the restriction against costs and expenses controls over all

[19] *Id.* (citing *Steeger v. Beard Drilling*, 371 S.W.2d 684, 688 (Tex. 1963)).
[20] *Id.* (citing *Ogden v. Dickinson State Bank*, 662 S.W.2d 330, 331 (Tex. 1983)).
[21] *Id.* (citing *Sun Oil*, 626 S.W.2d at 728).
[22] *Heritage*, 939 S.W.2d at 121-22 (citing *Delta Drilling Co. v. Simmons*, 338 S.W.2d 143, 147 (Tex. 1960)).
[23] *Id.* at 122.
[24] *Id.* at 124.

other language in the Lease.[25] Despite all of this language, the Panel's opinion interprets the Lease to permit the assessment of costs and expenses against Lessors' royalties by accepting the legal fiction of an affiliated "sale" at the wellhead and then calculating "market value at the well" instead of "market value at the point of sale," which actually occurs downstream of the well. Stated differently, the Panel's opinion disregards the Lease language requiring that royalties be free and clear of all costs and based on sales to unrelated third parties and instead places the point of sale at the place where Chesapeake "sells" the gas to itself (*i.e.*, its affiliate CEMI). That holding not only misinterprets the express language of the Lease, it conflicts with a prior opinion of this Court.

10. Instead of enforcing the Lease as written, the Panel's opinion puts a stamp of approval on Chesapeake's post-contract corporate shell game designed to pass on impermissible post-production costs to lessors who bargained for cost-free royalties. Writing for this Court in 1984, Judge Wisdom saw through and prevented similar gamesmanship by Shell Oil.[26] In that case, Shell's leases required royalty payments based on "market value at the well" if the gas was not sold at the well and based on the "amount realized" for the sale of gas at the well.[27] Shell decided to process sour gas itself at a plant off the premises before selling

[25] ROA 213, 217.

[26] *See Piney Woods Country Life School v. Shell Oil Co.*, 726 F.2d 225 (5th Cir. 1984). *Piney Woods* originated from Mississippi, but Judge Wisdom cited many Texas cases as authority for the interpretation of the leases in that case.

[27] *Id.* at 228.

it.[28] Shell's contracts with its downstream purchasers contradicted this reality and provided that title to the gas passed in the field before the gas had been processed, even though the purchaser did not take control of the gas until the gas had been "processed and 'redelivered.'"[29] Shell calculated and paid royalties based on the "amount realized," relying on the language in its third-party contract that title to the gas had passed in the field.[30]

11. Rejecting Shell's arguments, this Court appropriately held that "the gas sold by Shell was not 'sold at the well,' within the meaning of the lease, even though the sale contracts provide[d] that title to the gas passe[d] on or near the leased premises."[31] Shell wanted to include its production costs under the "amount realized" calculation, but it had to have sold the gas at the well for the amount realized calculation to be appropriate.[32] Explaining why the leases could only be interpreted to mean that the gas had *not* actually been sold at the well, Judge Wisdom wrote,

> To interpret the leases otherwise *would place the lessors at the mercy of the lessee*. The lessors had no say in Shell's choice of where to put the passage of title. Their interests were either irrelevant or adverse to Shell's. Shell and its buyers wanted to avoid state pipeline regulations; but their decision to do so had the effect of placing the "point of sale" on the lease, thereby avoiding Shell's obligation to pay

[28] *Id.* at 229.
[29] *Id.*
[30] *Id.* at 229.
[31] *Id.* at 231.
[32] *Id.* at 228 (quoting applicable lease language).

> royalties on market value. *The opportunity for manipulation is apparent*.[33]

12. A very similar thing happened here, but instead of rejecting the legal fiction as Judge Wisdom did, the Panel's opinion condones it. Like Shell fabricated, or at least manipulated, the point of sale in *Piney Woods* to suit its purposes, Chesapeake inserted its affiliate, CEMI, into the chain of production and marketing in this case so that it could create the legal fiction that the "point of sale" occurred at the wellhead rather than downstream in an arms-length transaction with an unrelated third party. Chesapeake's post-contract conduct here is really no different than what this Court refused to allow in *Piney Woods*, yet the Panel's opinion allows this manipulation even though its opinion confirms that the result in this case would be different if Chesapeake had not inserted its affiliate into the chain of production to create the fiction of "selling" the gas at the wellhead and even though the Lease specifically provides that "[p]ayments of royalties to Lessor[s] shall be made monthly and shall be based on sales of leased substances to unrelated third parties at prices arrived at through arms length negotiations."[34]

13. The Panel's opinion states:

> [W]hen gas is sold at the wellhead, there are typically no costs of compression, dehydration, treatment or transportation. When there are no such costs at the wellhead, the market value at the wellhead is "free of all costs and expenses," as contemplated by the above-quoted

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[33] *Id.* at 232 (emphasis added).
[34] Panel Op. at 6; ROA 217.

> paragraph, and there is nothing in the royalty clause "contrary" to the "[n]otwithstanding" sentence. If the gas is sold by the lessee downstream of the wellhead, then both the sentence providing for a ¼ royalty and the "[n]otwithstanding" sentence contemplate that costs incurred by the lessee between the point of production and the point of sale are to be borne by the lessee.[35]

Counsel for Chesapeake also confirmed during oral argument that the result would change without Chesapeake's affiliate "sale" at the wellhead.[36] Both the Panel's holding and Chesapeake's concession ignore that the Lease requires royalties to be paid "based on sales of leased substances to unrelated third parties at prices arrived at through arms length negotiations."[37]

14. If not corrected, the Panel's opinion will encourage other lessees throughout this Circuit to adopt similar legal fictions so that they too can pass along transportation and other post-production costs to lessors, even when the applicable lease would require otherwise. The only reasonable construction of the Lease in this case, consistent with its plain language and this Court's holding in

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[35] Panel Op. at 6.

[36] During oral argument, counsel for Chesapeake stated as follows:

> If for instance the point of sale was at a different point downstream, then you could give effect to that notwithstanding clause. If Potts and West had negotiated for and included a "no affiliates sale," that is "you may not sell my gas to an affiliate," then whatever the next point of sale is in the chain of commerce as this gas moves downstream toward the [inaudible], then there would be a practical effect for this "no deductions" clause set out in the Lease.

Audio Recording of Oral Argument, March 11, 2014, Docket No. 13010601, www.ca5.uscourts.gov/oralargumentrecordings.aspx (quoted statements run from approximately 31:40 to 32:15).

[37] ROA 217.

Piney Woods, is that the "point of sale" is downstream where CEMI sells the gas to unrelated third parties and that Lessors must receive ¼ of the value of the gas at that point of sale, free and clear of all costs and expenses.

C. The Panel's Opinion Also Conflicts with, or at least Misapplies, *Heritage*

15. The Panel's opinion relies heavily on *Heritage* as if *Heritage* controls the outcome in this case.[38] It does not control for multiple reasons.

16. First, *Heritage* involved three leases, all of which called for royalties to be based on the "market value at the well" with "no deductions from the value of Lessor's royalty" for post-production costs.[39] The Lease here calculates royalties based on the "market value *at the point of sale*" rather than "at the well," requires that the point of sale for the purpose of calculating royalties be downstream at the place of the first non-affiliate sale, and mandates that royalties be "free and clear from all costs and expenses."[40] Then-Justice Owen concurred in *Heritage* and wrote:

> At the outset, it is important to note that we are construing specific language in specific oil and gas leases. Parties to a lease may allocate costs, including post-production or marketing costs, as they choose. Our task is to determine how those costs were allocated under *these* particular leases.[41]

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[38] 939 S.W.2d 118 (Tex. 1996).
[39] *Id.* at 120-21.
[40] ROA 213, 217.
[41] *Heritage*, 939 S.W.2d at 124 (Owen, J., concurring) (emphasis in original) (internal citations omitted).

Heritage's holding based on "market value at the well" and other terms not present in this Lease simply does not apply in this case. The three applicable provisions are contained in paragraphs 11 and 37 of the Lease.[42] It is from those three provisions, not the provisions in the *Heritage* leases, that this Court must determine what formula should be used to calculate Lessors' royalties.

17. *Heritage* also does not apply here because the parties contracted to avoid it by basing royalties on the "market value at the point of sale" rather than the "market value at the well." Then-Justice Owen suggested just that in her concurring opinion in *Heritage*, writing:

> There are any number of ways the parties could have provided that the lessee was to bear all costs of marketing the gas. If they had intended that the royalty owners would receive royalty based on the market value at the point of *delivery or sale*, they could have said so.[43]

In this case, the parties followed that suggestion and based royalties on the market value at the point of sale instead of the market value at the wellhead. They also went further, mandating that royalties be "based on sales of leased substances to unrelated third parties at prices arrived at through arms length negotiations."[44]

18. That market value "at the point of sale" and "at the wellhead" are different is obvious. The *Heritage* majority held that one method of calculating "market value at the well" is to "net back," or subtract reasonable post-production

[42] ROA 213, 217.
[43] 939 S.W.2d at 131 (Owen, J., concurring) (emphasis in original).
[44] ROA 217.

marketing costs from the "market value at the point of sale."[45] If "market value at the point of sale" is but one variable necessary to calculate "market value at the well," they cannot be the same. Moreover, then-Justice Owen's concurrence recommended that lessors avoid "market value at the well" by basing royalties on "market value at the point of sale."[46] The Panel's opinion in this case conflicts with *Heritage* by equating the two terms and judicially rewriting the Lease to whipsaw Lessors (and others like them) who bargained for cost-free royalties by basing them on "market value at the point of sale" as instructed in the *Heritage* concurrence. Even if *Heritage* applies (it does not), the Panel's opinion conflicts with *Heritage*'s recognition that "at the well" and "point of sale" differ.

19. Moreover, if the Court continues to interpret *Heritage* to have some application here, it is important to understand the history of *Heritage* in order to place its precedential value, which is limited, in context. This is particularly important given the Panel's blanket application of *Heritage* well beyond the language of the leases at issue in *Heritage*. The Panel's opinion concludes that "*Heritage* remains binding law,"[47] but that is true only in identical cases. The *Heritage* "majority" opinion was issued by Justice Baker on April 25, 1996.[48] At that time, Justice Baker was joined by Justices Phillips, Cornyn, Enoch and

[45] *Id*. at 122.
[46] *Id.* at 131 (Owen, J., concurring)
[47] Panel Op. at 11.
[48] *Id.* at 118-19.

Spector. Justice Owen wrote a concurring opinion, in which she was joined by Justice Hecht. Justice Gonzalez wrote a dissenting opinion and was joined by Justice Abbott. Thus, the original vote was 5-2-2.

20. On rehearing, much changed as Justices Cornyn and Spector switched their votes and joined the dissent, Justice Enoch recused himself, and Justice Phillips switched his position and joined the concurrence.[49] Thus, only Justice Baker was left supporting the "majority" opinion. The final vote on rehearing was four votes to reverse and four votes to affirm, with one justice recused. Because the Supreme Court of Texas was without majority agreement on the reasons supporting the judgment in *Heritage*, it controls the result only in *identical* cases.[50] This case is anything but identical to *Heritage*.

21. Unfortunately, the Panel's opinion not only misapplies *Heritage* but greatly expands it by giving it blanket application to any oil and gas lease that uses the phrase "market value." The Panel attempts to bolster *Heritage*'s precedential import by noting the cases from the Supreme Court of Texas and this Court that cite it,[51] but the cases listed in the Panel's opinion either involved "market value at the well" leases (identical to *Heritage*, in which instance Lessors agree *Heritage*

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[49] 960 S.W.2d 619 (Tex. 1997).

[50] *Id.* at 620 (stating that "[b]ecause we are without majority agreement on the reasons supporting the judgment, however, the judgment itself has very limited precedential value and controls only this case"); *see University of Tex. Medical Branch at Galveston v. York*, 871 S.W.2d 175, 176-77 (Tex. 1994).

[51] Panel Op. at 11.

controls), or they cited *Heritage* for propositions unrelated to this case.[52] Nothing in those cases suggests that *Heritage* applies here.

CONCLUSION

22. The parties unequivocally modified the general rule that post-production costs are chargeable to Lessors by including the cost-free provision in paragraph 11 of the Lease.[53] It is difficult to imagine how the parties could have made their intent any clearer that *all* royalties paid to Lessors shall be *free* of *all* costs. The words "all" and "free" are not ambiguous.

23. It therefore violates the Lease that Lessors' royalties are based on the price that Chesapeake's afilliate pays to Chesapeake, a number that is net of post-production costs so that Lessors are not realizing the full value of the downstream sale. The Panel's opinion authorizes post-production costs by disregarding the "free and clear of all costs and expenses" language, by equating "market value at the well" with "market value at the point of sale," and by accepting Chesapeake's post-contract manipulation of the supposed point of sale despite the Lease's

[52] *See Ramming v. Natural Gas Pipeline Co. of Am.*, 390 F.3d 366, 372 (5th Cir. 2004) (involving leases identical to the *Heritage* leases in that they called for payment to be made based on the "net proceeds from sale at the mouth of the well" and based on the "market value at the well"); *El Paso Field Servs., L.P. v. Mastec N. Am., Inc.*, 389 S.W.3d 802, 808 (Tex. 2012) (citing *Heritage* for the proposition that the term "due diligence" as used in a pipeline construction contract was to be given its plain, ordinary and generally accepted meaning because it was not defined in the contract); *Union Pac. Res. Grp., Inc. v. Hankins*, 111 S.W.3d 69, 71 (Tex. 2003) (citing *Heritage* for the proposition that "[m]arket value is generally determined by comparing the sale price to other sales 'comparable in time, quality, quantity, and availability of marketing outlets'").

[53] ROA 213.

language that the point of sale for the purpose of calculating royalties must be at a downstream sale to an unrelated third party.

24. The plain meaning of the three applicable clauses in the Lease requires that Lessors' royalties be calculated as a fraction of the market value at the point of sale – where CEMI sells the subject gas to an unrelated third party downstream of the well – and be free of all post-production costs and expenses. Because the Panel's opinion holds otherwise and will put at risk the expectations of royalty owners throughout this Circuit, the Court should rehear this case en banc, reverse the District Court's summary judgment, and render judgment that Chesapeake improperly burdened Lessors' royalties with post-production costs. Alternatively, the Court should certify the question to the Supreme Court of Texas.

PRAYER

Lessors request that this Court grant this Petition for Rehearing En Banc, withdraw the Panel's opinion, reverse the district court's judgment, render summary judgment for Lessors, and remand this case to determine Lessors' damages and attorneys' fees. Alternatively, Lessors pray the Court will certify this matter to the Supreme Court of Texas. Lessors further pray that the Court grant them such other and further relief to which they may be justly entitled.

Respectfully submitted,

/s/ Robert E. Aldrich, Jr.

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CERTIFICATE OF SERVICE

On August 26, 2014, a true and correct copy of the foregoing document was served on the following counsel of record by certified mail, return receipt requested:

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PANEL OPINION

IN THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

No. 13-10601

United States Court of Appeals
Fifth Circuit
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Lyle W. Cayce
Clerk

GORDON POTTS; BRANDY WEST,

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v.

CHESAPEAKE EXPLORATION, L.L.C.,

Defendant–Appellee.

Appeal from the United States District Court
for the Northern District of Texas

Before JONES, SMITH, and OWEN, Circuit Judges.

PRISCILLA R. OWEN, Circuit Judge:

The meaning of royalty provisions in an oil and gas lease are in dispute. Gordon Potts and Brandy West (the lessors) appeal the district court's grant of summary judgment in favor of the lessee, Chesapeake Exploration, L.L.C. (Chesapeake). We affirm.

I

Potts and West are two of the lessors in an oil, gas, and mineral lease in which Chesapeake is the successor-lessee to FSOC Gas Co., Ltd. (FSOC). Three paragraphs of the lease are at issue. Paragraph 11 provides in relevant part:

> The royalties to be paid by Lessee are: . . . on gas . . . the market value at the point of sale of 1/4 of the gas sold or used. . . . Notwithstanding anything to the contrary herein contained, all

> royalty paid to Lessor shall be free of all costs and expenses related to the exploration, production and marketing of oil and gas production from the lease including, but not limited to, costs of compression, dehydration, treatment and transportation.

Paragraph 29 contains a "favored nation" provision, which states:

> Lessee agrees if Lessee or any of its Working Interest Partners has agreed to pay or later agrees to pay a higher royalty or bonus consideration to another landowner, mineral owner or other parties, (in the same drilling unit, spacing unit or pooled or utilized land to which the leased lands are included), then Lessee shall pay to Lessor an amount based on such higher royalty, or bonus consideration retroactive to the effective date of the Lease(s).

Paragraph 37 provides, in pertinent part:

> Payments of royalties to Lessor shall be made monthly and shall be based on sales of leased substances to unrelated third parties at prices arrived at through arms length negotiations. Royalties to Lessor or leased substances not sold in an arms length transaction shall be determined based on prevailing values at the time in the area. Lessee shall have the obligation to disclose to Lessor any information pertinent to this determination.

An affiliate of Chesapeake, Chesapeake Operating, Inc. (COI), operates the lease on Chesapeake's behalf. COI, as agent for Chesapeake, sells gas produced from the lease to Chesapeake Energy Marketing, Inc. (CEMI), another affiliate of Chesapeake, at the wellhead located on the lessors' property. CEMI then transports the gas through a gathering system and resells it to unaffiliated purchasers at gas pipeline hubs that are considerable distances from the wellhead. The sales to unaffiliated purchasers occur at delivery points that include the Houston Ship Channel and locations in Louisiana and Alabama. CEMI pays Chesapeake the weighted average sales price that CEMI receives when it sells the gas downstream, after deducting post-production costs that CEMI incurs between the wellhead and the points at which deliveries to unaffiliated purchasers occur. The royalty that Chesapeake pays to the lessors is 1/4 of the price it receives from CEMI.

Potts protested to Chesapeake that his royalty payments were improperly calculated because post-production costs had been deducted in arriving at the value on which royalty was based. Potts also questioned whether Chesapeake had complied with the favored nation clause and demanded access to Chesapeake's records. Chesapeake initially agreed that it should not have deducted post-production costs in calculating royalties and paid Potts accordingly. However, Chesapeake subsequently changed its position, asserting that its original concession regarding post-production costs was a mistake. Chesapeake conceded that it had failed to pay Potts the amount he was due under the favored nation provision, but in tendering what was owed under that provision of the lease, Chesapeake withheld the amount it contended was an "over-payment" of royalties due to post-production costs that Chesapeake had not, but was entitled to, deduct.

Potts filed suit against Chesapeake in Texas state court, alleging breach of contract and seeking a declaratory judgment that Chesapeake was not permitted to deduct post-production costs in calculating royalty. After Chesapeake removed the case to federal district court on the basis of diversity jurisdiction, West joined the litigation as a plaintiff. West claimed that Chesapeake initially paid her royalties without deductions for post-production costs, but then ceased remitting payments altogether on the ground that she had been overpaid and Chesapeake was recouping the difference out of future payments.

The parties filed cross-motions for summary judgment. The district court granted Chesapeake's motion and denied that of the lessors. Construing the lease under Texas law, the court held that Chesapeake was permitted to calculate "market value at the point of sale" by starting with the market value received from unaffiliated purchases and subtracting reasonable post-production costs incurred between the downstream points of sale to unaffiliated purchasers and the point of sale to CEMI.

The lessors moved for reconsideration, arguing *inter alia* that because royalty payments are to be calculated based on sales to unrelated third parties under paragraph 37 of the lease, the "point of sale" to be considered is the point at which CEMI sold the gas to unaffiliated purchasers. The district court denied the motion. The lessors timely appealed.

II

"We review a district court's grant of summary judgment de novo, applying the same standard as the district court."[1] Under that standard, "[s]ummary judgment is proper 'if the movant shows that there is no genuine dispute as to any material fact and the movant is entitled to judgment as a matter of law.'"[2] "We generally review a decision on a motion to alter or amend judgment under [Federal Rule of Civil Procedure] 59(e) for abuse of discretion. To the extent that a ruling was a reconsideration of a question of law, however, the standard of review is *de novo*."[3]

III

The parties agree that Texas law applies in construing the lease.[4] Under Texas law, "[a]n oil and gas lease is a contract, and its terms are interpreted as such."[5] The parties further agree that the lease in this case is unambiguous. "In construing an unambiguous oil and gas lease our task is to ascertain the

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[1] *10 Ring Precision, Inc. v. Jones*, 722 F.3d 711, 717 (5th Cir. 2013) (citation omitted).

[2] *Id.* (quoting FED. R. CIV. P. 56(a)).

[3] *Miller v. BAC Home Loans Servicing, L.P.*, 726 F.3d 717, 721-22 (5th Cir. 2013) (citations and internal quotation marks omitted).

[4] *See Clardy Mfg. Co. v. Marine Midland Bus. Loans Inc.*, 88 F.3d 347, 352 (5th Cir. 1996) ("We look to state law to provide the rules of contract interpretation.").

[5] *Tittizer v. Union Gas Corp.*, 171 S.W.3d 857, 860 (Tex. 2005) (per curiam).

parties' intentions as expressed in the lease."[6] We are to "examine the entire document and consider each part with every other part so that the effect and meaning of one part on any other part may be determined."[7] Additionally, "[w]e give terms their plain, ordinary, and generally accepted meaning unless the instrument shows that the parties used them in a technical or different sense."[8]

A

We begin our analysis of the lease's provisions with the royalty clause in paragraph 11. It provides that royalties on gas are "the market value at the point of sale of 1/4 of the gas sold or used." This unambiguously requires Chesapeake to pay 1/4 of the market value of the gas at the point at which Chesapeake sells the gas. If, as in the present case, the lessee sells the gas at the wellhead, there generally will be no post-production costs incurred by the lessee. If the lessee sells the gas downstream from the wellhead, then the lessee would be required to pay 1/4 of the market value of the gas calculated at that point of sale and could not deduct post-production costs incurred between the wellhead and the point of sale.

The lessors contend that there are other provisions in the lease that modify or override this part of the royalty clause. They rely on the following language, also found in the royalty clause in paragraph 11 of the lease:

> Notwithstanding anything to the contrary herein contained, all royalty paid to Lessor shall be free of all costs and expenses related to the exploration, production and marketing of oil and gas production from the lease including, but not limited to, costs of compression, dehydration, treatment and transportation.

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[6] *Heritage Res., Inc. v. NationsBank*, 939 S.W.2d 118, 121 (Tex. 1996).

[7] *Id.*

[8] *Id.*

The above-quoted language directs that "royalty" is to be "free of all costs and expenses related to the exploration, production and marketing of" gas "including, but not limited to, costs of compression, dehydration, treatment and transportation." As discussed above, when gas is sold at the wellhead, there are typically no costs of compression, dehydration, treatment or transportation. When there are no such costs at the wellhead, the market value at the wellhead is "free of all costs and expenses," as contemplated by the above-quoted paragraph, and there is nothing in the royalty clause "contrary" to the "[n]otwithstanding" sentence. If the gas is sold by the lessee downstream of the wellhead, then both the sentence providing for a 1/4 royalty and the "[n]otwithstanding" sentence contemplate that costs incurred by the lessee between the point of production and the point of sale are to be borne by the lessee. Since it is undisputed that gas sales by Chesapeake have occurred at the wellhead, and since the lessors do not contend that the sales to unaffiliated purchasers were at less than market value, Chesapeake could arrive at the market value at the wellhead by deducting reasonable post-production costs to deliver the gas from the wellhead to the point at which the gas was sold to unaffiliated purchasers.

The district court correctly concluded that Chesapeake's calculation of royalties is consistent with the methodology for calculating market value at the wellhead explained by the Supreme Court of Texas in *Heritage Resources, Inc. v. NationsBank*.[9] In *Heritage*, the royalties to be paid under the leases were a percentage of the gas's "market value at the well."[10] The leases further provided that "there shall be no deductions from the value of [the] Lessor's royalty by reason of any required processing, cost of dehydration, compression,

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[9] 939 S.W.2d 118 (Tex. 1996).

[10] *Heritage*, 939 S.W.2d at 120-21.

transportation, or other matter to market such gas."[11] The Supreme Court of Texas held that the lessee had not breached the lease in arriving at market value of gas at the wellhead by deducting post-production transportation costs from the market value ascertainable at a downstream point.[12] The court explained, "[t]here are two methods to determine market value at the well."[13] "The most desirable method is to use comparable sales" at the well.[14] When information about such sales is not readily available, the market value at the well is determined by taking the market value of the gas at a point downstream where sufficient information is available, and then "subtracting reasonable post-production marketing costs," such as transportation and processing expenses.[15] The "no deductions" clause, the court continued, simply "restate[d] existing law" by providing that the lessors' royalty, which could be calculated using the two methods described, may not be further reduced because of costs.[16]

The lessors insist that that the "[n]otwithstanding" sentence is distinguishable from the "no deductions" clauses at issue in *Heritage* and should be given a different meaning. The clauses in *Heritage* stated that "there shall be no deductions from the value of [the] Lessor's royalty by reason of any required processing, cost of dehydration, compression, transportation, or other matter to market such gas."[17]

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[11] *Id.*

[12] *Id.* at 123-24.

[13] *Id.* at 122.

[14] *Id.*

[15] *Id.*

[16] *Id.*

[17] *Id.* at 120-21.

The lessors contend that, unlike the clauses at issue in *Heritage*, a sentence in their lease provides that *all* royalties shall be *free* of *all* costs. The lessors argue that the lease does not simply prohibit deductions from a given value, but provides affirmatively that the royalty may not be "burdened" with any costs. They maintain that subtracting post-production costs from sales that occur miles from the wellhead to derive the market value at the point of sale, in this case the wellhead, burdens the royalty with such costs.

This argument misunderstands *Heritage* and is mathematically unsound. The *Heritage* court held that the "no deductions" clauses were not in conflict with the royalty provisions. The deduction of post-production costs incurred between the wellhead and a downstream point at which market value could be ascertained was nothing more than a method of determining market value at the well in the absence of comparable sales data at or near the wellhead. The value of the gas, and therefore the value of the royalty, was not reduced. As the concurring opinion stated, "[t]he concept of 'deductions' of marketing costs from the value of the gas is meaningless when gas is valued at the well. Value at the well is already net of reasonable marketing costs."[18]

That reasoning is equally applicable to the clause at issue in this case. The value of the lessors' royalty is a percentage of the market value at the point of sale, which in this case is at the well. A "net-back" method of calculation does not "burden" or reduce the value of the royalty.[19]

B

The lessors contend, however, that the lease prohibits the point of sale from being at the wellhead if Chesapeake sells the gas to an affiliated entity.

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[18] *Id.* at 130 (Owen, J., concurring).

[19] *See also Warren v. Chesapeake Exploration, L.L.C.*, No.13-10619, 2014 WL 3511880, at *3 (5th Cir. 2014).

The lessors rely on paragraph 37 of the lease, which requires that royalty payments be "based on sales . . . to unrelated third parties at prices arrived at through arms length negotiations."

Chesapeake argues that the lessors waived their reliance on paragraph 37 by failing to raise the issue in the district court until the lessors' motion for reconsideration. Even if the lessors preserved their reliance on paragraph 37, a question that we do not reach, it does not support their position. Paragraph 37 says, in pertinent part:

> Payments of royalties to Lessor shall be made monthly and shall be based on sales of leased substances to unrelated third parties at prices arrived at through arms length negotiations. Royalties to Lessor or leased substances not sold in an arms length transaction shall be determined based on prevailing values at the time in the area. Lessee shall have the obligation to disclose to Lessor any information pertinent to this determination.

This section of the lease specifically contemplates that if the lessee sells the gas to an affiliate, the royalty shall "be determined based on prevailing values at the time in the area." Paragraph 37 does not require the point of sale to be the point at which the gas is ultimately sold to a non-affiliated entity.

The lessors argue that construing "point of sale" as the point where Chesapeake sells the gas to CEMI would frustrate the parties' expectations and their reliance on the concurring opinion in *Heritage*. They rely on the following passage from the concurring opinion:

> There are any number of ways the parties could have provided that the lessee was to bear all costs of marketing the gas. If they had intended that the royalty owners would receive royalty based on the market value at the point of *delivery or sale*, they could have said so.[20]

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[20] *Heritage*, 939 S.W.2d at 131 (Owen, J., concurring) (emphasis in original).

The concurring opinion emphasized that the parties to a lease "may allocate costs . . . as they choose" and that courts must examine the specific language chosen in order to "determine how . . . costs were allocated under [the] particular leases" at issue.[21] In this case, the language of the lease, including paragraph 37, make clear that the royalty due the lessors is a percentage of the market value of the gas at the point at which the lessee sells the gas. As discussed above, had Chesapeake sold the gas at a point downstream from the wellhead, then the royalty would be 1/4 of the market value of the gas at that point. Post-production cost incurred between the wellhead and the point of sale could not be deducted in arriving at the market value at the point of sale under either the "1/4" royalty sentence in the royalty clause of paragraph 11, or any other provision in the lease. But Chesapeake has sold the gas at the wellhead. That is the point of sale at which market value must be calculated under the terms of the lessors' lease.

C

The lessors contend that the district court erred by relying on *Heritage,* asserting that the case has limited precedential value. They note that after the opinion in *Heritage* issued, one of the Justices who had joined the majority opinion recused himself. The other members of the Supreme Court of Texas split 4-4 in ruling on a motion for rehearing. An opinion dissenting from the denial of rehearing reflects that two of the Justices who had originally joined the majority opinion had changed position and had expressed their agreement with the original dissenting opinion.[22] The lessors argue that the Texas court

[21] *Id.* at 124.

[22] *See Heritage Res., Inc. v. NationsBank*, 960 S.W.2d 619, 619 (Tex. 1997).

was thus without a majority that agreed on the reasons supporting the judgment in *Heritage*.

Because rehearing was denied, the court's opinion in *Heritage* was not withdrawn. The Texas court's decision in *Heritage* remains binding law, as the numerous cases from both the Supreme Court of Texas and this court citing that decision demonstrate.[23]

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For the foregoing reasons, the judgment of the district court is AFFIRMED.

[23] *See, e.g.*, *Ramming v. Natural Gas Pipeline Co. of Am.*, 390 F.3d 366, 372 (5th Cir. 2004); *El Paso Field Servs., L.P. v. Mastec N. Am., Inc.*, 389 S.W.3d 802, 808 (Tex. 2012); *Union Pac. Res. Grp., Inc. v. Hankins*, 111 S.W.3d 69, 71 (Tex. 2003).