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NO. 14-0302

In the Supreme Court of Texas

CHESAPEAKE EXPLORATION, L.L.C., ET AL.
Petitioners,

v.

MARTHA ROWAN HYDER, ET AL.
Respondents.

On Petition for Review from the Fourth Court of Appeals at San Antonio, Texas No. 04-13-00769-CV

BRIEF OF AMICUS CURIAE CHESAPEAKE BARNETT SHALE ROYALTY OWNERS

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IDENTITY AND INTEREST OF AMICUS CURIAE

Amicus Curiae consist of more than 20,900 Barnett Shale royalty owner plaintiffs in over 430 separate lawsuits filed in Johnson and Tarrant County against Chesapeake-affiliated entities for systematically underpaying royalties owed under various Barnett Shale leases. These cases were consolidated this year into a single Multidistrict Litigation Pretrial Court ("MDL No. 1") now pending for pre-trial purposes before the Honorable Dana Womack, of the 348th District Court, Tarrant County, Texas.[1] Collectively these Amicus Curiae will be referred to as "Erben Partnership, et al.," "Chesapeake Royalty Underpayment Plaintiffs," or "MDL No. 1 Plaintiffs."

The Court's holding in *Hyder* relates to what post-production costs should not be deducted in connection with an overriding royalty interest (ORRI), under a vigorously negotiated oil and gas lease. The Chesapeake Royalty Underpayment Plaintiffs have an interest in that issue. While many of the MDL No. 1 Plaintiffs' leases expressly prohibit deduction of post-production costs (or at least affiliate post-production costs), others allow the deduction of post-production expenses. Under

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[1] The MDL Panel created two Barnett Shale Royalty owner MDLs, one consisting of all clients represented by the undersigned firms, and another consisting of multiple royalty underpayment suits against Chesapeake by other firms. That Order is attached hereto as Exhibit A.

Heritage and subsequent decisions, even those deductions must be "reasonable."[2] The large majority of the Chesapeake Royalty Underpayment Plaintiffs' leases are "proceeds" leases, and most calculate royalty "at the wellhead." Most of these amici are legally unsophisticated lessors who own small royalty interests in connection with their homesteads, and certainly did not have the attorney firepower the Hyders and Chesapeake brought to the table in negotiating the *Hyder* lease. For these reasons, it is even more important that the fundamental rules of contract construction involving plain meaning and expressed intentions be the touchstone for lease interpretation.

The two undersigned law firms are bearing their own costs of preparing and submitting this brief, as part of their contingent fee arrangements with their royalty underpayment clients suing Chesapeake.

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[2] *See Heritage Resources v. NationsBank*, 939 S.W.2d 118 (Tex. 1996); *see also Warren v. Chesapeake Exploration, L.L.C.*, 759 F.3d 413, 417 (5th Cir. 2014) ("Chesapeake Exploration was entitled to deduct from sales proceeds the *reasonable* cost of post-production costs incurred…") (emphasis added); *Potts v. Chesapeake Exploration, L.L.C.*, 760 F.3d 470, 474-75 (5th Cir. 2014) ("…'subtracting *reasonable* post-production marketing costs,' such as transportation and processing expenses.") (emphasis added) (citations omitted).

INTRODUCTION

Over 20,900 Chesapeake Royalty Underpayment Plaintiffs file this brief in support of the majority opinion. The Motion for Rehearing (and supporting amici) are the latest to highlight the confusion created by the *Heritage* opinion decided twenty years ago by a deeply divided, 4-4 Court.[3] Chesapeake seeks to expand the reach of *Heritage* so that any language prohibiting post-production costs becomes unenforceable "surplusage." Unfortunately, Chesapeake and others have on occasion been successful in their efforts to expand the scope of *Heritage*. But the majority opinion here deftly avoided the more extreme industry views of *Heritage*. The Court applied a plain text reading of the *Hyder* ORRI's "cost-free" language. This is neither remarkable, nor grounds for rehearing, since consistent with over a century of Texas jurisprudence that "[a contract's] terms are to be taken and understood in their plain, ordinary and popular sense." *Mutual Life Ins. Co. v. Simpson*, 88 Tex. 333, 337 (1895).

Oil and gas leases are contracts, and courts must give effect to the plain terms expressed by the parties in those lease contracts. *Rutherford v. Randall*, 593 S.W.2d 949 (Tex. 1980); *City of Pinehurst v. Spooner Addition Water Co.*, 432 S.W.2d 515

[3] *See Heritage Resources v. NationsBank*, 939 S.W.2d 118 (Tex. 1996); *see also Warren v. Chesapeake Exploration, L.L.C.*, 759 F.3d 413, 417 (5th Cir. 2014); *Potts v. Chesapeake Exploration, L.L.C.*, 760 F.3d 470, 474-75 (5th Cir. 2014); *Comm'r of the Gen. Land Office of Tex. v. Sandridge Energy, Inc.*, 454 S.W.3d 603 (Tex. App.—El Paso 2014, pet. pending).

(Tex. 1968); *Smith v. Liddell*, 367 S.W.2d 662 (Tex. 1963); *Woods v. Sims*, 273 S.W.2d 617 (Tex. 1955). Whenever a royalty owner has tried to posit a favorable reading of lease terms, the industry has argued vociferously—often successfully—that such heresy cannot be allowed; the lease must be enforced precisely as written.[4] But a peculiar double standard has crept into Texas oil and gas jurisprudence—at the behest of some, and under the auspices of *Heritage*, explicit lease language benefitting royalty owners regarding post-production costs, like "cost-free" or "no deductions for post-production expenses"—is sometimes ignored.

This is not the case to overrule *Heritage*, nor is it the proper case to expand *Heritage*, as Chesapeake urges. That *Heritage* should cause such problems is especially odd given that its precedential value should have been limited. As the dissent on rehearing by Justice Gonzalez in *Heritage* notes:

> Because 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. Med. Brand at Galveston v. York*, 871 S.W.2d 175, 176-177 (Tex. 1994).

Heritage Res. v. NationsBank, 960 S.W.2d 619, 620 (Tex. 1997) (Gonzalez, J. dissenting on motion for rehearing) (emphasis added). Other pending cases may

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[4] *See Heritage*, 939 S.W.2d at 131 ("We cannot re-write the agreement for the parties."); *see also Sun Oil Co. v. Madeley*, 626 S.W.2d 726, 727, 733-34 (Tex. 1981) (over 40-year course of conduct in lessor's favor not allowed to vary express terms of lease); *Exxon Corp. v. Middleton*, 613 S.W.2d 240, 244 (Tex. 1981) (explaining that the parties' express contractual language prevails over the parties subjective intent).

soon present the opportunity to address the abuses of *Heritage* by Chesapeake and others and the resulting impact on Texas contract law, where parties' plainly expressed intent is ignored as mere "surplusage."[5]

But because Chesapeake and its industry amici spend so much time touting apocalyptic impacts on *Heritage* from the majority opinion in this case, this Brief takes those *Heritage* arguments head on. *Heritage*, according to Chesapeake, allows courts to disregard express lease terms about royalty—such as a "no deductions" provision or the "cost-free" language here—in favor of an artificial "netback" construct that was theoretically posited to yield "market value," based solely on party stipulations unique to that case, very different from the stipulations and undisputed facts here. The netbacks in practice often do not yield "market value," or anything close.

The *Heritage* "netback" paradigm is sometimes abused, to utilize insider sales of gas to affiliates at the wellhead in order to "deduct" greatly-inflated affiliate-charges far above the reasonable charges for gathering and transportation.[6] A rogue

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[5] *See e,g, Comm'r of the Gen. Land Office of Tex. v. Sandridge Energy, Inc.*, 454 S.W.3d 603 (Tex. App.—El Paso 2014, pet. pending).

[6] *See* http://www.forbes.com/sites/christopherhelman/2014/03/17/[mistreating]-royalty-owners-means-chesapeake-is-stealing-cash (last visited Nov. 4, 2015); *see also* http://www.propublica.org/article/chesapeake-energys-5-billion-shuffle (last visited Nov. 4, 2015); http://www.wsj.com/news/articles/SB10001424052702304071004579407572017346590?mg=reno64-wsj (last visited Nov. 4, 2015).

portion of the industry ignores Justice Baker's admonition that *comparable sales* are the preferable way to determine "market value," in favor of a complex and opaque deduction process that fosters bizarre incentives for operators and producers to get ***below*** "market value," and certainly not the "highest" or "best price reasonably available."[7] This case's record references a couple of the devices Chesapeake used to reduce the proceeds of production from leases, including sales at the wellhead to an "affiliate" and deductions of "affiliate" post-production costs, like gathering charges. *See Chesapeake Exploration, L.L.C. v. Hyder*, 2015 Tex. LEXIS 554 (Tex. June 12, 2015). At least one Texas court has appropriately acknowledged that these types of "affiliate" arrangements are "inherently suspect." *Parker v. TXO Prod. Corp.*, 716 S.W.2d 644, 646 (Tex. App.—Corpus Christi 1986, no writ).

Interpreting the "cost-free" language is even easier here, since a sole exception to the "cost-free" arrangement is delineated in the *Hyder* lease: "…cost-free (except only its portion of *production **taxes***)…" (emphasis added). This exception clears up any possible confusion. "Production" taxes only accrue *after* gas is produced and saved from the lease, i.e., "extracted from the ground"— gas as and after it leaves

[7] Justice Baker was relying on *Exxon Corp. v. Middleton*, 613 S.W.2d 240, 244 (Tex. 1981). Chesapeake and its industry comrades seek to dangerously dilute the implied covenant that accompanies every "proceeds" lease: The operator has a duty to reasonably market, which includes the obligation to obtain the "best price reasonably possible" in the field. *Union Pac. Res. Grp. v. Hankins*, 111 S.W.3d 69 (Tex. 2003); *Yzaguirre v. KCS Res., Inc.*, 53 S.W.3d 368, 373 (Tex. 2001); *Amoco Prod. Co. v. First Baptist Church of Pyote*, 579 S.W.2d 280, 285-87 (Civ. App.—El Paso 1979, writ ref'd n.r.e.).

the wellhead. *Exxon Corp. v. Middleton*, 613 S.W.2d 240, 244 (Tex. 1981); *Monsanto Co. v. Tyrrell*, 537 S.W.2d 135 (Tex. Civ. App. – Houston 1976, writ ref'd n.r.e.); Tex. Tax Code §201.001 (defining "production" or "gas produced" as "gross amount of gas taken from the earth"). "Production taxes" are only incurred and due **post**-production. *See Heritage*, 939 S.W.2d at 122 (identifying taxes as post-production costs). There can be no "production taxes" assessed before the gas exits the mouth of the well, i.e. pre-production. *See* Tex. Tax Code § 201.201 ("The tax imposed by this chapter for *gas produced* and saved is due . . . .") (emphasis added); *see also* Tex. Tax Code § 201.001. If "cost-free" was *not* meant to exclude all costs incurred after production, there would be no need to mention an exception for *post-production* taxes. The exception to "cost-free" cannot be ignored here —Texas contract interpretation requires that every clause be given meaning if possible. *J.M. Davidson, Inc. v. Webster*, 128 S.W.3d 223 (Tex. 2003) (Courts must "harmonize and give effect to all the provisions of the contract so that none will be rendered meaningless"). Chesapeake and the industry are wrong in arguing that *Heritage* somehow should trump the plain text of the *Hyder* lease.

SUMMARY OF ARGUMENT

Though review of the *Heritage* opinion is unquestionably necessary, this case does not present the best opportunity to address *Heritage*'s resulting confusion, other than perhaps to acknowledge *Heritage's* limited precedential value. The parties'

intent here to prohibit the deduction of post-production costs from the ORRI is evidenced in three separate ways: (1) by specifying "cost-free" in reference to an ORRI, which is already inherently free of production costs; (2) by excluding "production taxes" (a quintessential *post*-production cost) as the sole exception to the ORRI "cost-free" language; and (3) by including a blanket *Heritage* disclaimer (which the Court helpfully held is not required to effectuate the "cost-free" language). Rehearing should be denied; if granted, this Court should confirm the limited precedential value of *Heritage*, reinforce the basic principle of Texas contract law requiring that all contractual provisions be given effect, and interpret lease language as plainly written so as to properly honor the parties' intent. Any rehearing of this case should not disturb the Court's proper construction of the ORRI as being free of both production and post-production costs.

ARGUMENT

A. The Majority *Hyder* Opinion Applied the Plain Language of the Overriding Royalty Provision to Determine the Intent of the Parties.

The Court's ruling is not remarkable or extraordinary in any way. It merely reinforces a bedrock principle of Texas law that requires that all provisions of a contract be given effect so as to honor the express intentions of the parties. *Tawes v. Barnes*, 340 S.W.3d 419, 425 (Tex. 2011); *EOG Res. v. Hanson Prod.*, 94 S.W.3d 697, 701 (Tex. App. San Antonio 2002) (holding that courts "presume that the parties to a contract intend every clause to have some effect"). The relevant language

reads: "Lessee shall . . . convey to Lessors a perpetual, cost-free (except only its portion of production taxes) overriding royalty of five percent (5.0%) of gross production obtained from each such well payable to Lessors. . . ."

The majority carefully examined the language and properly noted that overriding royalties are generally not subject to production costs. *Hyder*, 2015 Tex. LEXIS 554 at 5; *see also MacDonald v. Follett*, 180 S.W.2d 334 (1944); *Alamo Nat'l Bank of San Antonio v. Hurd*, 485 S.W.2d 335, 339 (Tex. Civ. App.—San Antonio 1972, writ ref'd n.r.e.). Thus, the issue boils down to whether the parties' use of "cost-free" in reference to an overriding royalty interest referenced ***post***-production costs or redundantly referenced the already-excluded pre-production costs. The Court, as it must, properly assigned meaning to every phrase in the lease agreement, and declined to interpret the term "cost-free" as superfluous (or as "surplusage," in *Heritage* parlance). The clause's sole exception for post-production taxes removes all doubt that "cost-free" meant free of post-production costs (except post-production taxes like severance taxes).

The cases that Chesapeake relies on to support its position that "cost-free" applies only to production costs are inapposite. *See* Chesapeake's Motion for Rehearing, p. 9. Not one of these cases addresses the meaning of the term "cost-free"—standing alone—in reference to an ORRI. *See, e.g.*, *Danciger Oil & Refineries, Inc. v. Hamill Drilling Co.*, 171 S.W.2d 321, 322 (Tex. 1943) (cost-free

clause merely said "free and clear of *operating expenses*") (emphasis added); *Delta Drilling Co. v. Simmons*, 338 S.W.2d 143, 147 (Tex. 1960) (narrowly stating "free and clear of all cost of development, except taxes" interpreted to mean "expense-free" except for taxes—post-production expenses were not squarely at issue); *Martin v. Glass*, 571 F. Supp. 1406 (N.D. Tex. 1983) (ORRI narrowly specified "free and clear of *all cost of drilling, exploration, development, completion and operating*") (emphasis added). These cases all involved language that clearly identified the exclusion of identified production costs, in considerable contrast to the broader "cost-free" language in the *Hyder* lease.

Chesapeake, and others in the industry who vigorously oppose this decision, claim it "may have altered the course of oil and gas jurisprudence in Texas." Brief of Amici from Industry supporters, p. 1.[8] Such an excessive response can only be explained by their concern that *Hyder* represents a roadblock in a series of decisions that endorsed their overreaching efforts to expand *Heritage*. The majority opinion in *Hyder*, however, is far from groundbreaking: it aligns lease interpretation with the requirements of Texas contract interpretation.

Heritage muddied the waters of contract interpretation, as construed by

[8] The firm filing the Amicus brief for TIPRO does not disclose to the Court that it also represents Chesapeake's co-defendant Total E & P in hundreds of royalty underpayment cases, including in all of the royalty underpayment cases filed by these 20,900+ amici. TIPRO certainly speaks for *none* of the almost 21,000 royalty owners represented by the undersigned.

operators. Despite a provision expressly prohibiting certain post-production deductions, the *Heritage* Court determined that deductions of post-production expenses from royalty payments were appropriate. *See Heritage*, 939 S.W.2d at 123 (concluding the "no deductions" language was "mere surplusage as a matter of law"). This put into doubt basic principles of contract interpretation under Texas law. *See, e.g., Rutherford v. Randall*, 593 S.W.2d 949 (Tex. 1980); *City of Pinehurst v. Spooner Addition Water Co.*, 432 S.W.2d 515 (Tex. 1968); *Smith v. Liddell*, 367 S.W.2d 662 (Tex. 1963); *Woods v. Sims*, 273 S.W.2d 617 (Tex. 1955). As a direct result of *Heritage's* singular exception to contractual interpretation of oil and gas leases in Texas, some royalty owners (who could afford experienced oil and gas counsel) have been wary to simply trust that a "no deductions" provision will be interpreted to prohibit all post-production deductions, and have included specific lease provisions disclaiming *Heritage*. *See, e.g., Chesapeake Exploration, LLC v. Hyder*, 427 S.W.3d 472, 479 (Tex. App.—San Antonio 2014, pet. granted).[9] The majority opinion correctly held that this disclaimer language is not necessary to enforce explicit lease provisions—though here it clearly reinforced the parties' intent. But that a disclaimer of Texas Supreme Court precedent came to be perceived as necessary speaks volumes about how some producers sought to abuse *Heritage*.

[9] The majority opinion here did not rely on the *Heritage* disclaimer in reaching its opinion. This alarms the industry, since it means that "cost free"/"no deducts" language could be enforced going forward without the peculiar "*Heritage* disclaimer."

B. <u>This is Not the Case to Expand *Heritage*; If Anything, *Heritage* Should be Severely Limited to its Peculiar "Market Value" Lease and Stipulated Facts.</u>

Due to the unique history underlying the *Heritage* decision, it has limited precedential value. Justice Baker delivered the opinion of the Court in *Heritage*, joined by Chief Justice Phillips and Justices Cornyn, Enoch and Spector. *Heritage*, 939 S.W.2d at 120. The opinion also contained a concurrence by Justice Owen, in which Justice Hecht joined, and a dissent by Justice Gonzalez, which was joined by Justice Abbott. *Id*. at 124-131. After *Heritage* was decided, NationsBank filed a motion for rehearing. The response in opposition to the *Heritage* opinion was overwhelming; numerous organizations filed amicus curiae briefs asking the Court to withdraw the former *Heritage* opinion and grant NationsBank's motion for rehearing. *Heritage*, 960 S.W.2d at 619. The amici supported Justice Gonzalez's view that the majority and concurrence erred by ruling that the "no deductions" provision in the lease was surplusage. *Id*.

In his rehearing opinion, Justice Gonzalez disclosed that Justices Cornyn, Spector and Abbott joined him in voting to grant NationsBank's motion for rehearing. *Id*. at 620. Justice Gonzalez further stated that Justice Enoch had recused himself and Justice Phillips had "switched his position and now agrees with Justice Owen's concurrence." *Id*. This left Justice Baker "as the lone remaining supporter" of his original majority opinion. *Id*. So the Court was equally divided on the proper

disposition of the case, and rehearing was denied. *Id*.

Justice Gonzalez stated:

> Because 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. Med. Brand at Galveston v. York*, 871 S.W.2d 175 (Tex. 1994). Cases relying on the new rule of law pronounced in the Court's April 25, 1996 opinion are similarly restricted. *See, e.g., Judice v. Mewbourne Oil Co.*, 939 S.W.2d 133, 135-136 (Tex. 1996).

Heritage, 960 S.W.2d at 620 (emphasis added).

As was anticipated by NationsBank's amici, *Heritage* creates confusion over the deductibility of post-production costs. *Heritage* prevents some from enforcing lease terms prohibiting deductions, as such terms can be deemed "surplusage as a matter of law."

C. *Heritage* Should Apply, If at All, Only to "Market Value at the Well" Leases.

The leases in *Heritage* provided that Lessor's royalty would be based on "market value at the well," "provided, however, that there shall be no deductions from the value of Lessor's royalty by reason of any acquired processing, cost of dehydration, compression, transportation or other matter to market such gas." *Heritage*, 939 S.W.2d at 120-21. This Court identified two methods to calculate "market value at the well": (i) gas sales that are comparable in time, quality, quantity, and availability of marketing outlets; or (ii) the netback method: subtracting

"reasonable" post-production marketing costs from what was uniquely stipulated to be point of sale market value. *Id*. at 122. Comparable sales is the preferred method, according to Justice Baker; net back is used *only* when information about comparable sales is not available. *Id*. Operators often disregard the "preferred" comparable sales in favor of the netback method because it provides an elaborate, complex and opaque deduction process, which can penalize royalty owners and foster incentives for operators to get below market value (at the wellhead) for production.

Because information about comparable sales was uniquely not available in that case, the *Heritage* Court determined "market value at the well" using the netback method, and upheld the deductions, finding the "value of Lessor's royalty" was not affected. *Id*. at 123. By reconstructing the lease to apply the "no deduction" language to the "net" value of the royalty, not to the phrase as written ("there shall be no deductions from the value of lessor's royalty…"), the Court engrafted a term ("net") found nowhere in the lease, while ignoring the no deductions language. *Id.* ("the post-production clauses [are] *surplusage* as a matter of law") (emphasis added); *see also id*. at 132 (J. Gonzalez, dissenting) ("[T]he Court errs by ignoring the clear intent of the parties.").

The *Heritage* opinion was clear that the Court's analysis was limited to market value leases, stating: "The critical clause in all three leases is the requirement that

Heritage pay the royalty interest owners their fractional interest of '*the market value at the well*' of the gas produced." *Id*. at 121. The Court's analysis of the deductions permitted in market value leases becomes entirely unworkable when applied to "proceeds" leases.[10] Therefore, *Heritage* should only apply, if at all, to "market value at the well" leases. And certainly not to the Hyder ORRI.

D. ***Heritage* Should Not Be Applied to "Proceeds" Leases.**

An oil and gas proceeds lease imposes duties on the lessee which extend beyond the terms of the lease itself. *Yzaguirre*, 53 S.W.3d at 373. These implied duties include the covenant to develop the premises, protect the leasehold, and manage and administer the lease. *Id*. (citing *Amoco Prod. Co. v. Alexander*, 622 S.W.2d 563, 567 & n.1 (Tex. 1981). Subsumed in the implied covenant is the duty to market the oil and gas reasonably, meaning the oil and gas producer must receive the "best price" obtainable in marketing the lessor's gas. *See Cabot Corp. v. Brown,* 754 S.W.2d 104, 106 (Tex. 1987).

As such, a royalty based on "proceeds" depends not only on "market value," but primarily on the "highest" or "best" price a producer can and does receive; it does not, by its very nature, contemplate the deduction of post-production costs.[11]

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[10] *But see Warren v. Chesapeake Exploration, L.L.C.*, 759 F.3d 413, 417 (5th Cir. 2014) (holding that the lessee was entitled to deduct from sales proceeds the reasonable post-production costs incurred in delivering marketable gas from the mouth of the well to the actual point of sale).

[11] "At the wellhead" sales point language actually connotes no deductions for gathering, transmission and compression, since it takes none of those things to deliver gas "at the wellhead." *See Bowden*, 247 S.W.3d at 702 (explaining that post-production costs "would ***not be incurred*** in

See Martin v. Glass, 571 F. Supp. 1406, 1416 (N.D. Tex. 1983) (finding that "proceeds" does not allow for deductions of post-production costs); *Warren v. Chesapeake*, 759 F.3d 413, 417 (5th Cir. 2014) (finding that "amount realized" by itself does not contemplate deductions of post-production costs); and *Heritage*, 939 S.W.2d at 120–21 (finding that royalty is calculated from "proceeds" when the royalty provision is based upon "amount realized").

Because of the differences between proceeds leases and market value leases, this Court has developed a trend toward refusing certification of class claims for royalty underpayment when both "market value" and "proceeds" leases are included in the class. *See, e.g., Union Pac. Res. Grp. v. Hankins*, 111 S.W.3d 69, 70 (Tex. 2003). This Court has held that the implied covenant to obtain the best price reasonably attainable in proceeds leases distinguishes them from market value leases, thereby defeating the commonality requirement for class certification. *See, e.g., Bowden v. Phillips Petroleum Co.*, 247 S.W.3d 690, 709 (Tex. 2008). Ignoring the distinctions between the two types of leases—as Chesapeake urges—effectively undermines this body of Supreme Court oil and gas law relating to class certification.

Here, the dissent and Chesapeake (with its amici) attempt to transform the ORRI into a market value provision to make this case fit into the *Heritage* paradigm.

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sales ***at the wellhead***"); *see also Heritage*, 939 S.W.2d at 130 (". . . regardless of how value is proven in a court of law, logic and economics tell us that there are no marketing costs to 'deduct' from value at the wellhead.") (Owen, J., concurring).

See Hyder, 2015 Tex. LEXIS 554 (Tex. 2015) (Brown, J., dissenting) ("Though the overriding royalty may not have been expressed using the familiar market-value-at-the-well language, I read its value as being just that."); *see also* Chesapeake's Motion for Rehearing, p. 5-6. In so doing, Chesapeake hopes to convince the Court that the post-production costs *Heritage* may allow in market value leases—absent comparable sales—nullifies the "cost-free" language. Here, "gross production" is a measure of the volume of gas from which the Hyders' fractional interest is derived. *See Hyder*, 2015 Tex. LEXIS 554 (Tex. 2015).

E. The Exception for Production Taxes (Due and Incurred Only *Post*-Production) Reinforces the Parties' Intent to Exclude *Post*-Production Costs.

This Court and numerous other Texas courts have recognized production taxes as a post-production expense. *See Hyder*, 2015 Tex. LEXIS 554, at *10; *Heritage*, 939 S.W.2d at 122 (identifying taxes, treatment costs, and transportation costs as post-production costs); *Occidental Permian LTD. v. French*, 391 S.W.3d 215, 220 (Tex. App.—Eastland 2012) *aff'd*, 2014 Tex. LEXIS 533 (Tex. June 27, 2014) ("*Postproduction costs include taxes*, treatment costs to render the hydrocarbons marketable, and transportation costs.") (emphasis added); *Blackmon v. XTO Energy, Inc.*, 276 S.W.3d 600, 604 (Tex. App.—Waco 2008, no pet.) (recognizing taxes as a post-production cost under Texas law) (citations omitted); *Cartwright v. Cologne Prod. Co.*, 182 S.W.3d 438, 444 (Tex. App.—Corpus Christi

2006, pet. denied) (identifying taxes, along with treatment costs, compression costs and transportation costs, as postproduction expenses); *Enron Oil & Gas Co. v. Joffrion*, 116 S.W.3d 215, 221 (Tex. App.—Tyler 2003, no pet.) (same).

The tax in this context can only be a post-production expense because it cannot be imposed (or even calculated) until *after* the gas is extracted from the ground. Tex. Tax Code § 201.001 (defining "production" or "gas produced" as the "gross amount of gas taken from the earth . . ."); Tex. Tax Code § 201.201 ("The tax imposed by this chapter for *gas produced* and saved is due . . . .") (emphasis added); *see also Monsanto*, 537 S.W.2d at 13 (noting that "under Texas oil and gas law the clear, well-established, and unambiguous meaning of the term 'production' is 'actual production' or the actual physical extraction of the mineral from the soil").[12] Before gas is "extracted from the ground" no production taxes are, or can be, owed. *See Fleming Oil Co. v. Anco Gas Corp.*, 217 S.W.2d 29, 33 (Tex. Crim. App. 1948) ("At all times pertinent to this suit the law exacted a gross production tax from the producer of gas on the petroleum products extracted from said gas and made it the duty of the first purchaser of said products to deduct the tax from the price paid to the producer and to pay the tax to the State of Texas."); Tex. Tax. Code §201.052 ("A tax is imposed on the market value of ***gas produced*** and saved in the state by

[12] In contrast, "production" expenses, like pipe, drilling, fracking and the like, all occur *before* gas is "produced," and their expenditure does not always mean there will even be gas produced.

the producer.”).

Once correctly categorized as a post-production expense, excluding taxes from the “cost-free” language (i.e., permitting that exclusive post-production deduction from ORRI) further supports the ORRI’s freedom from *all* other post-production costs. The lease states: “Lessee shall . . . convey to Lessors a perpetual, cost-free (except only its portion of production taxes) overriding royalty of five percent (5.0%) of gross production obtained from each such well payable to Lessors. . . .” If the “cost-free” language was meant only to apply to pre-production costs, there would be no logical reason to make an exception for post-production “production taxes,” like severance taxes. The Court aptly stated: “It would make no sense to state that the royalty is free of production costs, except for postproduction taxes (no dogs allowed, except for cats).” *Hyder*, 2015 Tex. LEXIS 554 (Tex. 2015).

The dissent recognizes its “task” to “determine how those costs were allocated under [this] particular lease,” but then relies on what it believes other, unrelated parties have done in other, differently worded leases. *Hyder*, 2015 Tex. LEXIS 554 (Tex. 2015) (Brown, J., dissenting) The Court should not use possible poor draftsmanship in other agreements to misconstrue the lease in *Hyder*. Simply because other parties in other leases *may* have redundantly referenced cost-free specifically in regard to production costs in an ORRI, does not give license to ignore core contract interpretation rules under Texas law. The dissent’s position that it reads

the "cost-free" language as "redundant but not meaningless" actually reads the phrase as redundant *and* meaningless. *Hyder*, 2015 Tex. LEXIS 554 (Tex. 2015) (Brown, J., dissenting). The exclusion of production taxes as the sole exception to the ORRI "cost-free" language unquestionably evidences the intent of the parties: No other post-production deductions are permitted.

CONCLUSION

The majority opinion merely reinforces the longstanding tenet of Texas law requiring that a lease be interpreted so as to give meaning and effect to all lease language. Rehearing should be denied, but if rehearing is granted, this Court should confirm the limited precedential value of *Heritage*, reinforce the basic principle of Texas contract law requiring all contractual provisions be given effect, and still interpret the lease language here as plainly written to properly honor the parties' intent.

Respectfully submitted,

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CERTIFICATE OF COMPLIANCE

This brief complies with the type-volume limitation of Tex. R. App. P.9.4(i)(2)(B) because it contains 4,448 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.

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By my signature below, I hereby certify that a true and correct copy of the above and foregoing document has been sent via electronic filing to the following counsel this the 6th day of November, 2015.

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