



How Custom Provisions in Oil and Gas Leases Can Impact Reserve Value

RR&A provides outside general counsel services, including transactions, commercial contracting, corporate compliance and land and business development services to upstream E&P operators and non-operators located in the U.S.



OVERVIEW

1. Royalties

- Greater of 3 Method
 - Market Value
 - Posted Price
 - Index Pricing
- Volume Paid On
- Post Production Costs
- Pricing Differentials

2. Acreage

- Depth Severance
- Retained Acreage

3. Continuous Drilling

- Commitment Based on Price

4. Additional Items of Interest

- First Lien
- Hedging
- Assignment
- Tolling



ROYALTIES GREATER OF THREE

Traditional Method – Price received by Lessee

Lessor Issue

- Lessees selling to affiliates for less, make money back downstream
- Lessors no longer trust Lessee's marketing efforts

Custom Provision - Lessor's royalty shall be 25% of the greater of:

1. The price received by Lessee in the first sale to a non-affiliated purchaser
2. The market value of such gas (or posted price for oil)
3. Price based on index



ROYALTIES MARKET VALUE

“**Market Value**” - being defined as the highest current market price reasonably obtainable under new gas contracts made at or near the time that the contract for sale of gas produced hereunder is made in the county for the sale of gas of substantially the same quantity and quality



ROYALTIES POSTED PRICE

Posted Price – “the highest price posted price, plus premium, paid for oil (adjusted for grade and quality) in the field where the leased premises are located”

“Posted Price ... in the field” is a term of art in our industry:

- Was the price that 3-4 major purchasers would actually post in field locations for oil exchanges declaring what they were willing to pay for oil based on quality and location
- See *North Cent. Airlines, Inc. v. Continental Oil Co.*, 574 F.2d 582, 588 (D.C. Cir. 1978) for a description of the historical practice.
- Lessors claiming index prices (highest one they can find) or spot market prices are the “posted price”



ROYALTIES INDEX PRICING

Oil

The average of the daily per barrel settlement prices for:

- NYMEX Division Light, Sweet Crude Oil published by CME Group
- Oil Arbitrage Wire published by Platts, a Division of McGraw Hill Financial (now called North American Crude and Products Scan)
 - Eagle Ford Postings Average
- Crude Oil Postings published by Flint Hill Resources
 - Eagle For Light
 - Permian Sweet



ROYALTIES INDEX PRICING

Natural Gas

- Inside FERC's Gas Market Report published by Platts, a division of McGraw-Hill
 - Houston Ship Channel/Beaumont, Texas
 - El Paso Natural Gas – Permian Basin
 - East Texas

- Natural Gas Intelligence Gas Price Index (“NGI”), published by Intelligence Press, Inc.,
 - South Texas Regional Average
 - Houston Ship Channel
 - East Texas Regional Average
 - West Texas Regional Average

ROYALTIES GREATER OF 3

Effect(s) –

- Increased administrative / accounting burden
- Hard to determine highest market value in real time
- “Market Value” and “Posted Price” = audits & litigation
- Lessor only gets upside
- Raise in price = effective higher royalty %

ROYALTIES VOLUME PAID ON

Traditional Method –

- Produced, Saved and Sold – royalties paid only on amounts sold
- Produced and Saved – royalties paid on gas sold and used (Most common)
- Produced and Saved (but including flared gas) – royalties also paid on flaring

Lessor Issue –

- Lessees flaring marketable gas
- Lessees intentionally venting large quantities of gas
- Lessors want payment for all benefits derived from lease



ROYALTIES VOLUME PAID ON

Custom Provisions

“Produced”, “Gross Production,” - royalties paid on gross volume from wellhead

Effect(s) –

- Increased measurement requirements
- Allocation Issues
- Higher volume than sold = effective higher royalty %

ROYALTIES

POST PRODUCTION COSTS

Traditional Method – Lessor bears its share of post-production costs

“Post-production costs” – costs incurred off the lease such as transportation, processing, fractionation, etc to make the gas marketable (usually to increase the price received)

Lessor Issue – current market is that Lessors do not share in post-production costs

Effect(s)

- Cost free royalty = effective higher royalty %



ROYALTIES

POST PRODUCTION COSTS – HERITAGE & HYDER

Heritage Resources, Inc. v. Nationsbank, 939 S.W.2d 118 (Tex. 1996).

- 3 Leases
- Royalty to be paid on gas shall be the market value at the well “however, that there shall be no deductions from the value of Lessor’s royalty by reason of any required processing, cost of dehydration, compression, transportation, or other matter to market such gas.”
- “Royalty” and “market value at the well” have well defined meanings in our industry

Decision – post-production costs are deductible



ROYALTIES

POST PRODUCTION COSTS – HERITAGE & HYDER

Chesapeake Exploration LLC v. Hyder, 483 S.W.3d 870 (Tex. 2016).

- Oil – “the market value at the well of all oil and other liquid hydrocarbons.” – royalty bears post-production costs
- Gas - “25% of the price actually received by Lessee for all gas produced from the leased premises and sold or used.” – royalty does not bear post-production costs
- Overriding royalty – “a perpetual, cost-free (except only its portion of production taxes) overriding royalty of five percent (5.0%) of gross production obtained” -
????



ROYALTIES

POST PRODUCTION COSTS – HERITAGE & HYDER

Chesapeake Exploration LLC v. Hyder, 483 S.W.3d 870 (Tex. 2016).

- “Lessors and Lessee agree that the holding in the case of *Heritage Resources, Inc. v. NationsBank*, 939 S.W.2d 118 (Tex. 1996) shall have no application to the terms and provisions of this Lease.”
- “lease drafters are not always driven by logic”
- “As long as “market value at the well” is the benchmark for valuing the gas, a phrase prohibiting the deduction of **post-production** costs from that value does not change the meaning of the royalty clause....”

Decision – post-production costs are not deductible from the overriding royalty interest



ROYALTIES

PRICING DIFFERENTIALS

Traditional Method – Lessee is paid and pays Lessor’s royalty on Houston Ship Channel + or - #

- This # is based on a number of factors but especially location of the lease so is often termed “transportation”
- “Post-production costs” – costs incurred off the lease such as transportation, processing, fractionation, etc to make the gas marketable

Lessor Issue – Lessor believes that this is a post-production cost for which they should be reimbursed. Lessee believes this is just a component of the price received.

ROYALTIES

PRICING DIFFERENTIALS

Custom Provision – If any contract entered into by Lessee includes any adjustment for any cost or expense, including the cost or expense of producing, gathering, dehydrating, compressing, transporting, manufacturing, processing, treating or marketing of oil or gas, or if any such expenses are deducted by Lessee or the purchaser for purposes of arriving at a price or value for oil or gas, then such adjustments or deductions shall be added to the value, price or proceeds realized, so that Lessor's royalty shall not be chargeable, directly or indirectly, with any of such allocations, costs or expenses

Lessee shall directly reimburse Lessor for any charges, expenses or price differentials occasioned by allowance for such costs and withheld by any purchaser, gatherer, processor, pipeline company, Lessee or others.

Effect(s) –

- Lessees who believe they are complying with their leases are getting audit claims
- Raise in price = effective higher royalty %

ACREAGE DEPTH SEVERANCE

Traditional Method – All depths, sometimes deep severance

Lessor Issue – low production fields holding newly productive depths without a new lease or lease bonus

Custom Provision – at the expiration of (0-10 years) years following the primary term as extended herein, this lease shall expire as to all depths and formation except those formations actually producing oil or gas in paying quantities

- Some leases sever on a rolling basis where deep rights are released first and shallow rights are released a number of years thereafter
- Others will restart continuous drilling on shallow depths after a certain number of years or require release

Effect(s) –

- Loss of up the hole potential



ACREAGE

RETAINED ACREAGE

Traditional Method – Retained well tracts/ production units each holding enough acreage for 2 or more PUD locations

Lessor Issue – low producing wells holding entire lease indefinitely

Custom Provision – at the expiration of (0-7 years) years following the primary term as extended herein, this lease shall expire as to all acreage contained within each retained well tract less and except the area being drained by each well

Effect(s) –

- Loss of PUDs included in initial valuation
- Litigation over amount of acreage to be released



CONTINUOUS DRILLING COMMITMENT BASED ON PRICE

Traditional Method – Continuous drilling allows for between 60 and 120 days between the completion of each well and the commencement of another well

Lessor Issue – Same number of wells required when prices are high as when they are low

Custom Provision – Number of wells required each year are dependent on hydrocarbons prices (usually range from 0 to 4 per year). Some lease require a payment for each well not drilled, others require a payment if well is drilled during low price environment

Effect(s) –

- Encourages drilling during higher price environment
- Avoids lease extension conversations
- Increases value of lease



ADDITIONAL ITEMS

FIRST LIEN

Traditional Method – Texas Bus. & Comm. Code § 9.343 provides an automatically perfected security interest in amount of Lessor’s royalty interest

Lessor Issue –

- *In re SemCrude, L.P.*, 407 B.R. 112 (Bankr. D. Del. 2009). - Delaware Bankruptcy Court refused to recognize statutory lien based on § 9.343 as a perfected security interest based on first purchaser being out of state and choice of law rules.
- Statute does not protect any additional claims lessor has against lessee over and above % of royalty interest



ADDITIONAL ITEMS FIRST LIEN

Custom Provision – Automatically perfected first lien, sometimes on all production and equipment

Effect(s) –

- Mortgagor will not accept subordination
- Loss of bankruptcy advantage for additional claims



ADDITIONAL ITEMS

HEDGING

Traditional Method – Lessor does not derive any benefit from Lessee’s hedging program

Lessor Issue – Lessors want payment for all benefits derived from lease

Case Law – *Cimarex Energy Co. v. Chastant*, 537 Fed. Appx. 561 (5th Cir. 2013)

“the gains or losses on derivative trading, which do not affect the price at the wellhead or on the lease, are not subject to the lease’s royalty provision.”

Custom Provision – Lessor to receive the benefit of all contracts, including hedging

Effect(s) –

- If don’t hedge 100% of production, did you hedge production from this Lease?
- Additional revenue = higher effective royalty

ADDITIONAL ITEMS ASSIGNMENT

Traditional Method – assignment of lease to another Lessee not to be unreasonably withheld

Lessor Issue –

- Soft consent = no consent
- Assignment to notoriously bad operators or a company they would not have originally leased to

Custom Provision – consent fees, lists of prohibited assignees, lists of factors for which consent can be withheld

Effect(s) –

- Leases less marketable
- Often the lessees specifically disallowed are the target market for divesting the lease

ADDITIONAL ITEMS

TOLLING

Traditional Method – statute of limitations for in Texas for causes of action are generally between 2 years (tort) and 4 years (contract)

Lessor Issues –

- Texas Courts have taken a dim view of lessors that don't exercise their rights to information from lessees.
- Refused to apply the discovery rule in many oil and gas cases.

Case Law –

- HECI v. Neel, 982 S.W.2d 881 (Tex. 1998) – reversing a \$3.7 million judgment in favor of lessors and holding that the discovery rule did not apply
- Exxon v. Emerald, 348 S.W.3d 194 (Tex. 2011) – reversing a \$18.6 million verdict in favor of lessors on basis of limitations based on actual knowledge

ADDITIONAL ITEMS

TOLLING

Custom Provision – Tolling of all statutes of limitations on any express or implied obligations, covenants and conditions imposed upon Lessee under the Lease. Only lifted upon actual knowledge based on information given to Lessor by Lessee in writing, the expiration of the lease in its entirety, or certain # of years

Effect(s) –

- Records retention
- Lessors have no end date to liability

Questions?

Contact:

Rachel Reese

Managing Attorney

R. Reese and Associates LLC

Phone: 832-831-2289

Email: rreese@rreeseandassociates.com