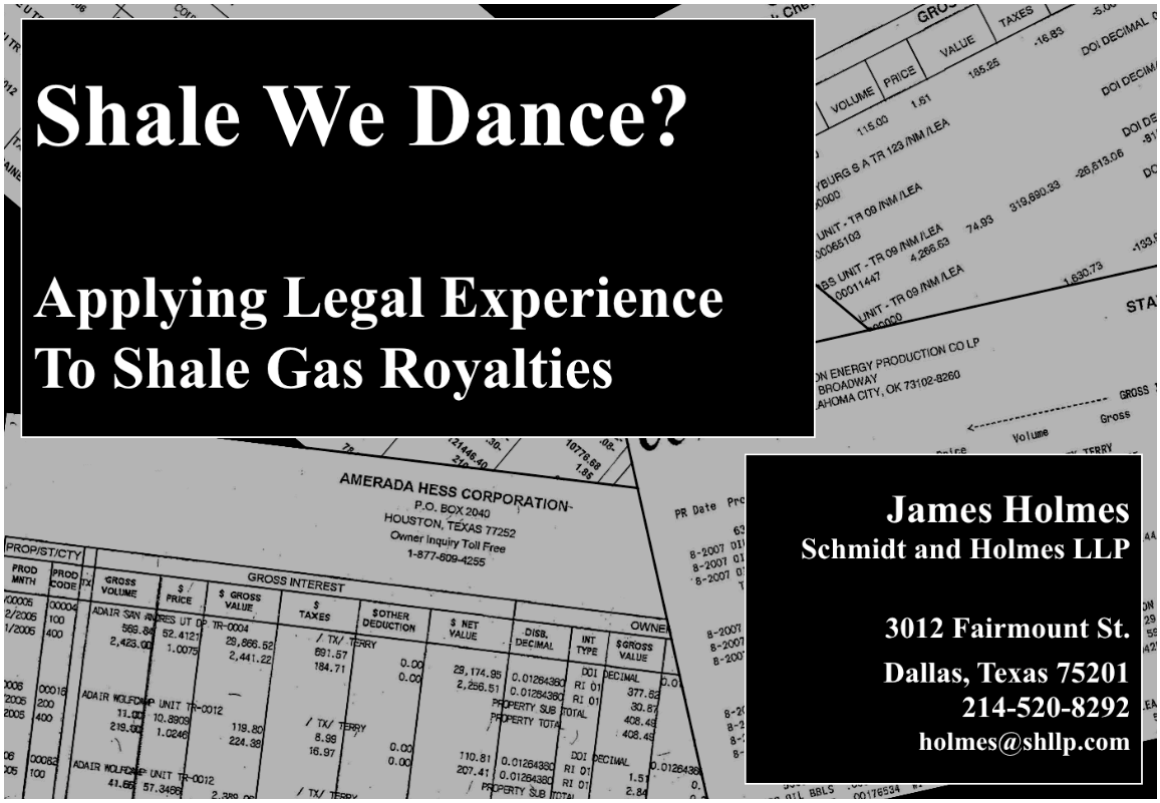


To: Attendees of the 31st Annual NARO Convention, Long Beach, California, October 20-22, 2011

I've spent the better part of the past decade in lawsuits against large oil companies. Most of our disputes have concerned upstream pricing, processing, general production issues, and all aspects of upstream-midstream marketing – specifically, how such activities affect my clients' royalty income or working-interest revenues and related expenses. I've focused primarily on casinghead gas (*i.e.*, the wet, low-pressure gas associated with crude oil production), crude oil, and gas-well gas, in that order.

Those three types of production tend to fall into a litigation pattern – for instance, the lease or other instrument governing my clients' rights typically provides for pricing on a "market value" or "amount realized" basis. If "market value," either a "comparable sales" methodology or a "net back" methodology provides the means by which the parties assess the market value for the oil or gas – and whether my clients have received payments based on market value. If "amount realized," the state providing law for the dispute will prescribe a "highest price possible" standard or, even better for my clients, a "marketable condition" standard for determining whether the lessee has paid fairly.

My practice has become increasingly shale-gas intensive over the past year and a half. Because I practice in Dallas, I tend to handle matters involving the Barnett Shale, although I have consulted on a few Haynesville Shale and Marcellus Shale matters.

Disputes over shale-gas royalties tend to vary from the "market value"-"amount realized" pattern that I've seen in disputes over crude oil, casinghead gas, and gas-well gas. Shale-gas leases frequently blend the two standards "market value" and "amount realized," or confuse them, or depart sharply from them to create a new royalty basis. The numerosity and varied nature of Barnett Shale leases partially accounts for the uniqueness of shale-gas disputes. The lessees' and lessors' active attempts to re-write traditional royalty-clause language – which often rides roughshod over traditional term-of-art phrases and concepts – also accounts for the uniqueness of shale-gas disputes.

With my presentation to the 31st Annual NARO Convention, I'll survey the pattern I've experienced in disputes over crude oil, casinghead gas, and gas-well gas. Then I'll show how that pattern breaks down when I work on Barnett Shale leases. I'll discuss also some specific shale-gas volume issues.

The slides below come from screen shots of my Powerpoint presentation. Below each of them are concise discussions of the legal principles underlying the points I'm making with the slides.

James Holmes
October 2011

James Holmes enjoys a diverse practice of oil and gas cases and business cases. He has substantial trial and appellate experience. James was born, raised and educated in Texas. Before practicing law in Dallas, he earned his Bachelor of Science from Trinity University in San Antonio and his Juris Doctorate from the University of Texas School of Law in Austin, where he served as an Editor on the Law Review and graduated Order of the Coif.

Currently, James represents a large collection of royalty owners, bank-operated royalty/mineral trusts, non-operating working interest owners, and surface-estate owners by way of various legal matters in the Barnett Shale and in the legacy oil fields of Texas and New Mexico. He brings lawsuits for and/or defends his clients in various oil and gas matters. Also, when feasible, James will assist in the marketing of his clients' share of production and in pursuing other transactional remedies and work-outs as alternatives to litigation. He has special experience in gas-processing arrangements; the interdependency of gas plants and mature oil reservoirs; cradle-to-grave marketing arrangements for gas-well gas, casinghead gas and crude oil; and enhanced oil recovery via CO_2 flooding and other reservoir-pressure management.

James has been ranked by his peers for many years as a "Texas Super Lawyer," as shown in the Texas Monthly annual survey. James is an active member of several professional associations, including AAJ, TTLA and DTLA. He is chair of the AAJ's Oil and Gas Litigation Section, which he formed.

1. Crude Oil
2. Gas-Well Gas
3. Casinghead Gas

1. Crude Oil

"The royalties to be paid by Lessee are: . . . On oil , one-eighth of that produced and saved from said land, the same to be delivered at the wells or to the credit of Lessor into the pipeline; Lessee may from time to time purchase any royalty oil in its possession, paying the market value therefor."

Oil royalties usually allow the lessor (royalty owner) to take production in kind or to receive royalty payment based on "market value." When the lessor takes in kind, he cannot fault the lessor (producer) for failing to pay royalties on the appropriate basis. When the lessor does not take in kind, then he effectively sales his oil share to the producer – typically by way of a division order, transfer order, or similar instrument.*

The "comparable sales" and "net back" methodologies discussed below for gas royalties can apply to crude-oil royalties. If the lease, division order, unit agreement, or other instrument under which payments are made is silent on the pricing standard, then an "amount realized" basis typically applies (with the attendant "duty to market"). There is a "duty to market" oil in Texas and in other states. *See, e.g.*, *Cook v. Tompkins*, 713 S.W.2d 417, 420-21 (Tex. App. – Eastland 1986, no writ). The duty protects the lessor when the instrument (under which oil is bought/sold) is silent on the pricing standard – so that the lessee doesn't concoct an artificially low "amount realized" and base royalty payments on that low price. *See, e.g.*, *Amoco Production Co. v. Alexander*, 622 S.W.2d 563, 567 (Tex. 1981).

*Division orders probably don't affect the leases' or other instruments' express pricing standards (such as "market value") or the duty to market arising under the "amount realized" basis. *See, e.g.* TEX. NAT. RES. CODE § 91.402(h); *Williams v. Baker Exploration Co.*, 767 S.W.2d 193, 196 (Tex. App. – Waco 1989, writ denied). But if division orders supplant lease language or other instrument language governing the basis on which royalties are paid, then lessors may use Uniform Commercial Code provisions for sales of goods – under which courts will imply standards of "good faith" and reasonableness into the division orders' "open price terms." *See, e.g.*, TEX. BUS. & COM. CODE § 2.305 & cmt. 3. Such UCC terms offer some pricing protection to the lessors.

2. Gas-Well Gas
3. Casinghead Gas

"The royalties to be paid by Lessee are: . . . On gas or gaseous substances produced from said land and sold or used off the land or in the manufacture of gasoline, including casinghead gas, the market value at the well of 1/8th of the gas so sold or used, provided that if and when lessee shall sell gas at the wells lessor's royalty thereon shall be 1/8th of the amount realized from such sales."

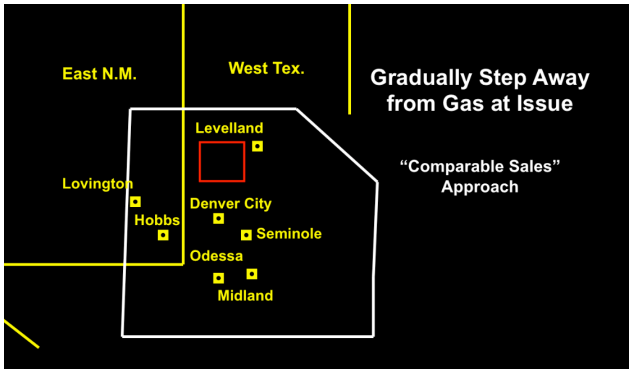
2. Gas-Well Gas
3. Casinghead Gas

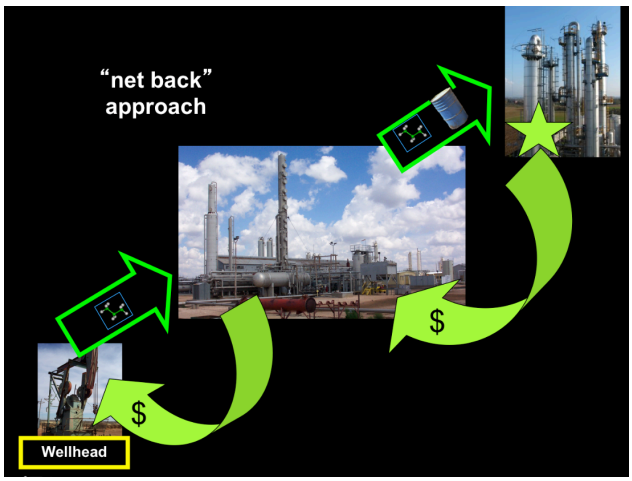
"market value"

"amount realized"

Often "on the [leased] premises" or "on the land" means a sales point or custody-transfer point somewhere on the lease's acreage description. Determining this point becomes quite complicated when the lease is unitized with other leases. Courts typically review the unit agreements to determine whether such agreements have amended the acreage descriptions in the underlying leases – thereby making *any* sales point or custody-transfer point "on the unit" to mean "on the [leased] premises" or "on the land." Royalty owners – who typically are not parties to the sales arrangements that designate sales points or custody-transfer points – can protest the "on premises" or "off premises" distinction, as necessary, in order to fall under either a "market value" royalty clause (which typically is "off premises") or "proceeds" royalty clause (which typically is "on premises"). *Middleton* and *Piney Woods* are two leading cases in Texas and nationally for settling disputes over the "on premises" or "off premises" distinction.

Exxon Corp. v. Middleton, 613 S.W.2d 240, 244 (Tex. 1981) (construing "off the premises" in the Producers 88 Lease form (and like forms): "We conclude 'off the premises' modifies both 'sold' and 'used.' The 'premises' is the land described in the lease agreement. Therefore, sold 'off the premises' means gas which is sold outside the leased premises."); *Piney Woods Country Life Sch. v. Shell Oil Co.*, 726 F.2d 225, 232-33 (5th Cir. 1984) (Widsom, J.) (holding that the mere transfer of title to gas (per the producer's third-party sales contract) does not determine true sales point for determination of which royalty clause applies, particularly when lessee can benefit (that is, can avoid a "market value at the well" obligation) by arbitrarily picking the transfer of title point).





"Market value" is an express contractual term. It has what courts call an "objective" meaning. Put differently, it has a pricing standard determined by a competitive marketplace, independent of what a lessee actually obtains under the sales arrangement at issue, and unimpeded by the particular buyer's or seller's marketing conduct at issue.

"Market value" is "an objective basis for calculating royalties that is independent of the price the lessee actually obtains." *Yzaguirre v. KCS Resources, Inc.*, 53 S.W.3d 368, 374 (Tex. 2001). "Market value at the well has a commonly accepted meaning in the oil and gas industry. Market value is the price a willing seller obtains from a willing buyer. There are two methods to determine market value at the well." *Heritage Resources, Inc. v. Nationsbank*, 939 S.W.2d 118, 122 (Tex. 1996) (citations omitted). "The most desirable method is to use comparable sales. A comparable sale is one that is comparable in time, quality, quantity, and availability of marketing outlets." *Id.* at 122 (citing *Exxon Corp. v. Middleton*, 613 S.W.2d 240, 246 (Tex. 1981); *Texas Oil & Gas Corp. v. Vela*, 429 S.W.2d 866, 872 (Tex. 1968)). "Courts use the second method when information about comparable sales is not readily available. This method involves subtracting reasonable post-production marketing costs from the market value at the point of sale." *Id.* at 122 (citations omitted).