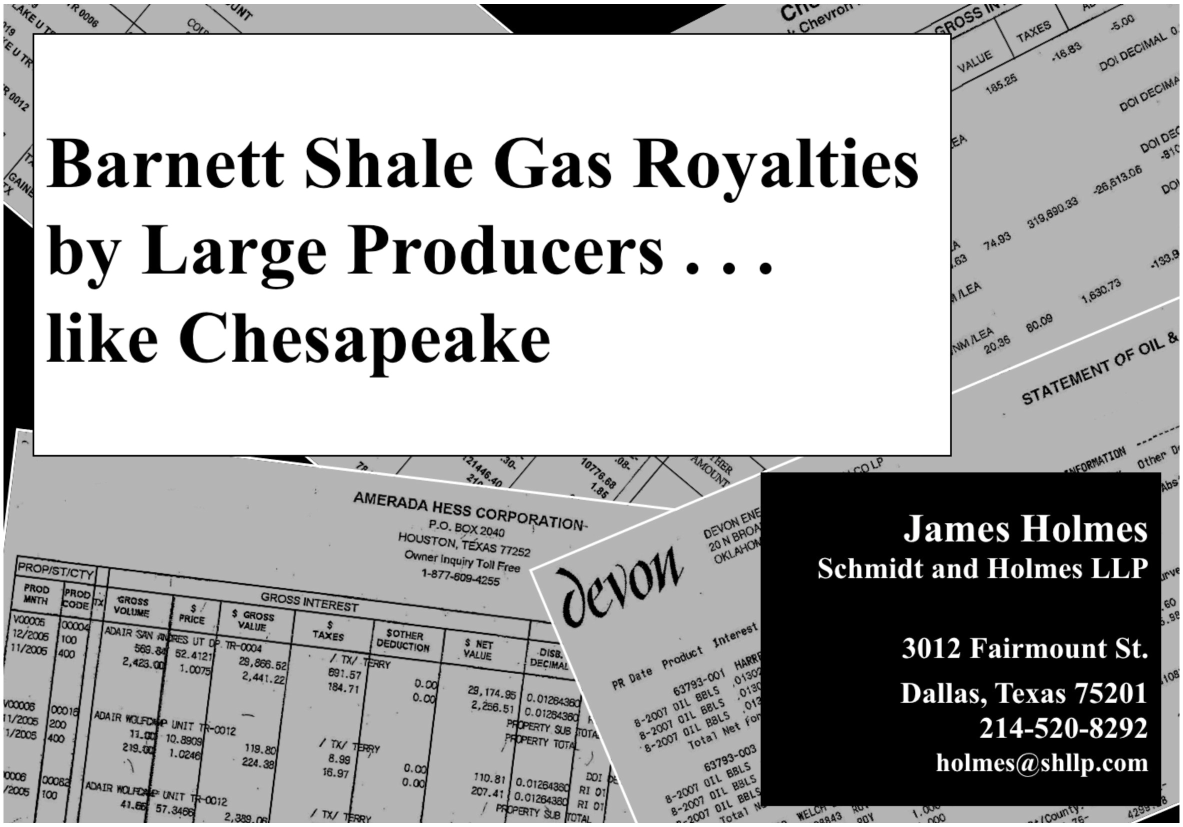

Barnett Shale Gas Royalties by Large Producers . . . like Chesapeake

James Holmes
Schmidt and Holmes LLP

3012 Fairmount St.
Dallas, Texas 75201
214-520-8292
holmes@shllp.com

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I've spent most of the past decade in lawsuits against large oil companies. The 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.

My practice has become increasingly shale-gas intensive over the past three years. Because I practice in Dallas, I tend to handle matters involving the Barnett Shale, although I have consulted on a few matters involving the Haynesville Shale (LA predominantly) and the Marcellus Shale (OH, PA, NY and WV).

I currently represent several royalty owner groups in shale-gas litigation pending in Texas federal courts. Much of this litigation concerns Chesapeake's low pricing for its shale-gas royalty payments. Chesapeake entities are defendants in my clients' lawsuits. Although I cannot share confidential information that I've learned via these lawsuits, I can discuss the general legal and factual concepts at play – such as the pleadings and public statements by the parties.

By reviewing my current shale-gas litigation, I hope with this paper and related speech to explore the key concepts that royalty owners must understand in order to dialogue with their producers over Barnett Shale gas royalties. Along the way, the paper and speech should equip them with knowledge, arguments and tools to strengthen their negotiation/litigation positions.

First, I'll start with a general survey of the disputes involving gas-well gas royalties, which Barnett Shale royalties tend to be, and royalty owners' rights in such disputes. Then, I'll provide some background law on "market value" leases, "proceeds" leases, "at the well" phrases, and (the lack of) class actions – because theses areas of law most directly govern Texas royalty owners' rights. Following these background sections, I'll move to Chesapeake's particular royalty-payment practices in the Barnett Shale.

James Holmes
November 2012

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 the Dallas Bar Association and the American Association for Justice. He is chair of the AAJ's Oil and Gas Litigation Section, which he formed.

In addition to his law practice, James operates Robur LLC, a crude oil first purchaser and marketer. He also manages Robur Capital, L.P., a value-investing style investment partnership, which is open to qualified investors.

No Peace
Under the Lease

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David Pierce, a prominent oil and gas law professor and former practitioner, has correctly observed that "there will never be peace – under the oil and gas lease" because "when compensation under a contract is based upon a set percentage of the value of something, there will be a tendency by each party to either minimize or maximize the value." David E. Pierce, *The Royalty Value Theorem and the Legal Calculus of Post-Extraction Costs* at 152, §6.01, PROCEEDINGS OF THE TWENTY-THIRD ANNUAL ENERGY & MINERAL LAW INSTITUTE (May 20-21, 2002). Tug-of-wars over royalty valuations are virtually inevitable under every oil and gas lease or sharing arrangement. Royalty disputes become especially prevalent when producers (*i.e.*, lessees) see an economic advantage for themselves in not sharing hydrocarbon value with royalty owners, as is often the case with gas marketing. *See generally* 5 HOWARD R. WILLIAMS & CHARLES J. MEYERS, OIL AND GAS LAW § 856.3, at 411-12 (rev. ed. 2008) ("Where the interests of the [lessee and lessor] diverge and the lessee lacks incentive to market gas, closer supervision of his business judgment will be necessary.")

Royalty disputes proliferate in the arena of gas royalties, which are operationally more complex than oil royalties and in which royalty owners are entirely dependent upon their producers to market royalty gas. Royalty owners frequently lack the ability to take royalty gas in kind and thereby circumvent their producers' poor marketing behavior – that is, their producers' practices of obtaining for themselves hydrocarbon value and not sharing such value with royalty owners. Even when royalty owners can take gas in kind, they typically do not have sufficient volumes to make the endeavor worthwhile. Also, most royalty clauses are too limited in content; therefore, they lack sufficient provisions to anticipate the varied factors that will play some role in determining gas royalties – consequently giving the producer wide discretion to handle many unknowns. *See* John McFarland, *Issues Concerning Royalty Valuations and Deductions*, presented at National Oil & Gas Royalty Conference, November 2002, and subsequently published in PETROLEUM ACCTG. & FIN. MGMT. J. (Univ. of N. Tex. Inst. of Petroleum Acctg., Fall/Winter 2002, Vol. 21, No. 3) (surveying seven key issues affecting gas-royalty payments and concluding "most royalty clauses" do not adequately address the issues).

Royalty owners must monitor and regulate their producers' marketing behavior. Among their tools for doing so are the following:

1. **Seek information.** For instance, use form letters like those attached as "Exhibit A" to this paper in order to ask insightful questions of your producers.

2. **Attempt negotiation and compromise outside of legal proceedings.** When the concepts discussed in this paper clearly show that according to your lease you've been underpaid on gas royalties, then many reputable producers will compromise, give you money for past underpayments, and re-work your future payments to comply with your lease rights.

3. **Pursue a lawsuit.** Class actions are not feasible in Texas for royalty-owner cases. *But see Warren v. Chesapeake Exploration, LLC*, No. 3:12-CV-03581-M, United States Dist. Court, N.D. Tex. (filed Sept. 1, 2012) (attempting to certify a Barnett Shale royalty-owner class for over 300 "materially identical" form leases, the Four Sevens Oil Co. form lease now operated by Chesapeake). Efforts to establish venue for Texas royalty-owner classes in states other than Texas appear to have encountered troubles in the courts of those other states. Individual cases are feasible – but require trial and appellate courts that will apply Texas law in a balanced manner, as the law is written, and in favor of royalty-owner rights. Many royalty-owner attorneys, accordingly, are seeking Texas federal courts over state courts because of the poor perception of the Texas appellate system's treatment of royalty owners over the past 20 years.

4. **Ride the coattails of government action.** During the 27th Annual NARO Convention in Las Vegas, James Holmes recommended that royalty owners hope for and encourage government action against large producers, which could have an "invisible hand" effect of raising oil and gas royalties. For instance, if a state agency or the Minerals Management Service causes a large producer to pay better royalties or production-related taxes in a large lease/unit containing private royalty owners, those private royalty owners may see increased royalties because of the government action, as the producer is forced to apply higher prices on lease/unit production. In Texas it is unlikely that state or county taxing authorities will challenge the gas prices of large Barnett Shale producers. However, if they did so – and thereby obtained

higher prices for purposes of severance taxes and ad valorem taxes – their action could result in higher prices on which royalties are paid, benefitting some Barnett Shale royalty owners.

The tug-of-wars over royalty valuations between royalty owners and large producers are fights well worth fighting. Texas royalty owners have much to gain financially from enforcing their contractual and case-law rights for higher gas royalties. It is long past time for Texas royalty owners to become both politically minded and legally active in favor of their rights, which have seen far too much curtailment in Texas over the past 20 years. May this paper equip them with some of the knowledge, arguments and tools that they will need in order to strengthen their negotiation/litigation positions, as least as to Barnett Shale gas royalties.

Market Value

Market Price
Market Rate

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Many leases provide for "market value" gas royalties. "Market value" is an express contractual term – meaning, it appears as the words "market value," "market price," "market rate," "field price," or like expression in a royalty clause. Courts do not imply the term into the lease. Market value has what courts call an "objective" meaning. *See, e.g.*, *Exxon Corp. v. Middleton*, 613 S.W.2d 240, 245, 246 (Tex. 1981) ("Market value is defined as the price property would bring when it is offered for sale by one who desires, but is *not obligated to sell*, and is bought by one who is under no necessity of buying it." (citation omitted)). Put more specifically, market value is a pricing standard determined by a competitive marketplace, independent of what a producer actually obtains under the sales arrangement at issue, and unimpeded by the particular buyer's or seller's marketing conduct at issue or by a distorted marketplace. *See, e.g.*, 3 EUGENE KUNTZ, LAW OF OIL AND GAS § 40.4, at 332 (rev. ed. 1989) ("If, however, the lessee [producer owing royalty payments] is a corporate affiliate of the purchaser and that sale is not at an arm's length, the sale price will not be accepted as representing the market price or market value. Nor will sales on a market which is dominated by a few producers and purchasers establish an acceptable market price of gas."). Courts and litigants must get evidence of the objective marketplace and then prove that such evidence is the "market value" of the gas at issue.

For instance, the producer may have sold the gas for only $2/MMBTU, but if the relevant competitive marketplace showed that buyers and sellers were valuing similar gas in the area at $4/MMBTU, then the producer should have paid royalties on the $4/MMBTU price under a market-value lease.

Texas and especially Oklahoma provide helpful case law for understanding how courts will treat market-value leases. First, Texas provides that 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).

Oklahoma provides clearer and more stable law for understanding market value, although it contains a glitch that can trouble royalty owners' rights. Oil and gas lawyers often call this glitch the *Tara Petroleum* problem. Fortunately, the problem doesn't often affect shale gas or gas-well gas and, therefore, doesn't often enable producers to underpay royalties on such gas. (The *Tara Petroleum* problem can badly affect casinghead-gas royalties when the producer sells such gas under a life-of-lease style gas contract to a plant supplying various field services to an oil reservoir. But that's a topic for another speech and paper.)

Here's a brief summary of Oklahoma law on market value: Oklahoma provides three basic methods of establishing the market value of gas at the wellhead.

Actual Sale of Gas at Issue (The* Tara Petroleum *Problem, Potentially): "The first and most preferred [method] is an actual sale reached through arm's-length negotiations." *Howell v. Texaco, Inc.*, 112 P.3d 1154, 1159 (Okla. 2004) (*citing Tara Petroleum Corp. v. Hughey*, 630 P.2d 1269 (Okla. 1981)). This "first and most preferred" method uses the producer's (or producer's predecessor's) own gas-sales contract, which may have been entered many years before the gas on which royalties are due is produced and sold continuously. An old gas-sales contract can value such gas at very low prices – because gas prices tend to increase over long periods of time. The initial gas-sales contract must have resulted from good-faith negotiations and must be free from fraud, collusion or similar bad behavior between the initial gas seller and gas buyer. *See generally Tara Petroleum Corp. v. Hughey*, 630 P.2d at 1269 (holding that "market value" is determined based on the prices available when the producer entered into the long-term contract and not at the time of gas production and sale). *But see Piney Woods Country Life Sch. v. Shell Oil Co.*, 726 F.2d 225, 232-33 (5^{th} Cir. 1984) (Widsom, J.) (criticizing *Tara Petroleum* and holding that producers cannot alter or lower their "market value" lease obligations by way of contracts with third parties – when royalty owners are not parties to such contracts and have no control over them); 3 HOWARD R. WILLIAMS & CHARLES J. MEYERS, OIL AND GAS LAW § 650.2, at 646-47 (rev. ed. 2008) ("[E]vidence of prices paid under long term gas purchase contracts [such as a producer's own long term gas contract] is not admissible to prove 'value' or 'market price' of gas for purposes of a royalty clause.").

Comparable Sales: "If the market value at the wellhead is not established by an actual arm's-length sale at the best price available [that is, if the first method doesn't determine market value], then the market value may be constructed by evidence of the prevailing market price. Arm's-length wellhead sales or offers of purchase from the same well and close in time to the sale at issue are proof of the prevailing market price. Proof of arms'-length sales from other wells in the vicinity can also be used to establish the prevailing market price." *Howell*, 112 P.3d at 1159 (citations omitted).

Work-Back: Finally, "the market value may be established by the work-back method. Under the work-back method, the market value at the wellhead is calculated by subtracting allowable costs and expenses from the first downstream, arm's-length sale. When the gas is marketable at the wellhead, the reasonable post-production costs may be charged against the royalty payments." *Id.* at 1159 (citations omitted). When gas is not marketable at the wellhead, Oklahoma – being a "marketable condition rule" state (unlike Texas, Pennsylvania or California) – requires the producer to bear solely all post-production costs (*e.g.*, gathering, transportation, treating) necessary in order to create marketable gas and the producer cannot impose any such costs on royalty. *See generally Mittelstaedt v. Santa Fe Minerals, Inc.*, 954 P.2d 1203, 1205, 1208 (Okla. 1998). (Texas – like other states that do not subscribe to the marketable-condition rule – generally allows a producer to deduct post-production costs against royalty. *See, e.g.*, *Heritage Resources, Inc. v. NationsBank*, 939 S.W.2d 118, 121-22 (Tex. 1996) ("Although it is not subject to the costs of production, royalty is usually subject to post-production costs, including taxes, treatment costs to render it marketable, and transportation costs." (citations omitted)).

Most other states will follow or rely heavily upon the Texas and Oklahoma case law – or the oil and gas treatises that utilize such law – when their courts determine market value. And, the two states' laws in this area contain much overlap. As a royalty owner, you should know that your market-value lease entitles you to gas royalties at market prices – most specifically market prices for gas in the field (*i.e.*, at or near the place of production). Such market prices, as mentioned above, are determined independently of the prices at which your producer is actually selling the gas. Such prices, moreover, usually use a formula as follows:

SOME GAS INDEX PRICE	(*e.g.*, Henry Hub, Houston Ship Channel, Waha)
Less **REASONABLE ACTUAL POST-PRODUCTION COSTS**	(*e.g.*, gathering, transportation, treating, or a "differential" from a reporting service to approximate such costs)
Equals **MARKET VALUE PRICE IN THE FIELD**	(the price on which royalties should be paid)