ROYALTY UPDATE
&
TEN THINGS ROYALTY PAYORS AND PAYEES SHOULD CONSIDER

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STINSON LEONARD STREET

SESSION ROADMAP

- Framing the Issues
- Recent Cases
- *Fawcett v. Oil Producers, Inc. of Kansas*
- What's Next
- Federal Royalties
- 10 Things Payors & Payees Should Consider

FRAMING THE ISSUE

Types of Royalty Clauses:

- Market Value leases
- Proceeds leases
- Mixed

FRAMING THE ISSUE

Three primary approaches:

- At-the-Well states
- Marketable Product (Condition) states
- Marketable Product (Condition & Location) states

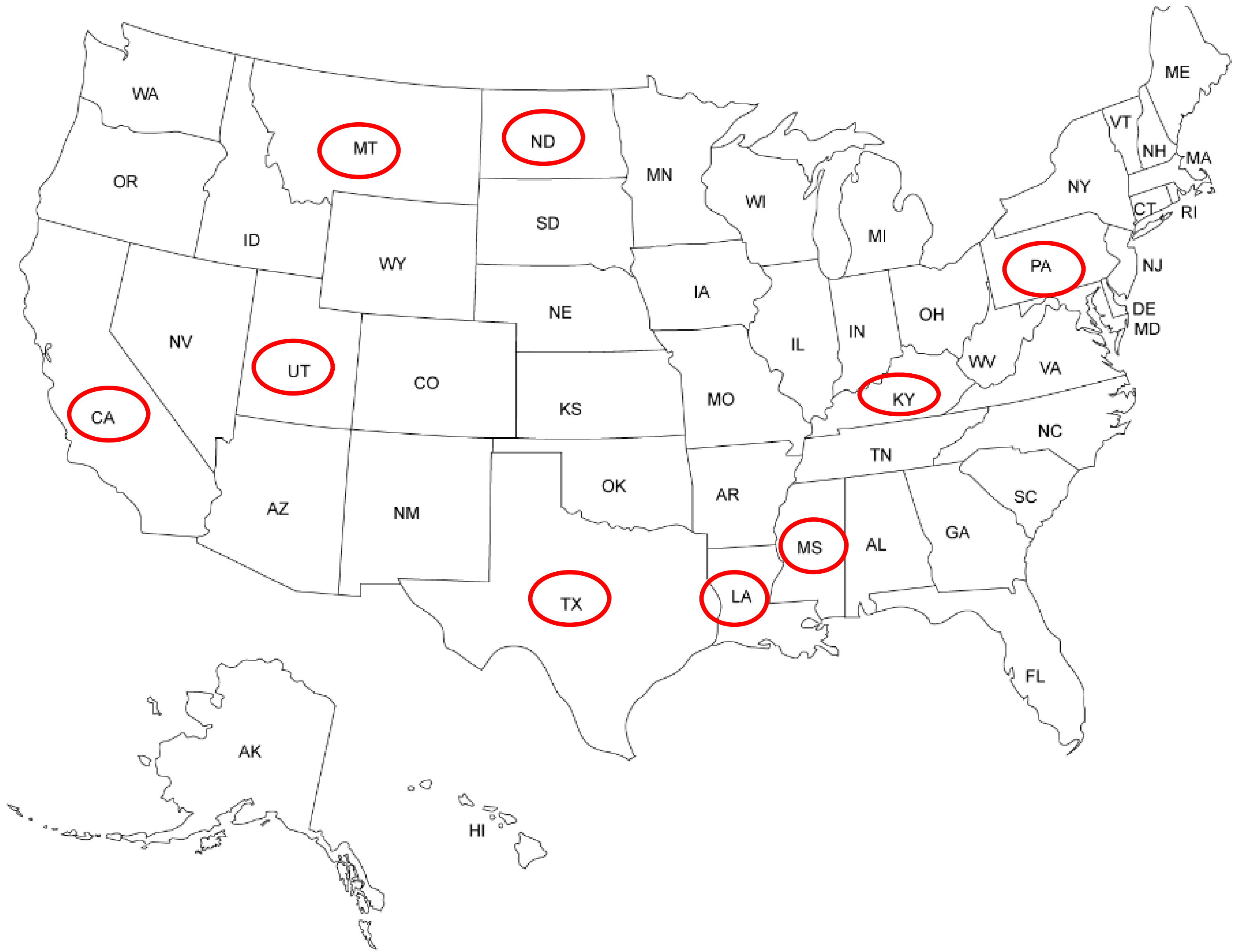
FRAMING THE ISSUE

At-the-Well states:

- Generally interpret "at the well" or "at the mouth of the well" language as establishing point at which WIO Lessee's obligation to bear all production costs ceases and RIO Lessor's obligation to bear a proportionate share commences

- Defines wellhead as the appropriate point to value production for royalty calculation

AT-THE-WELL STATES



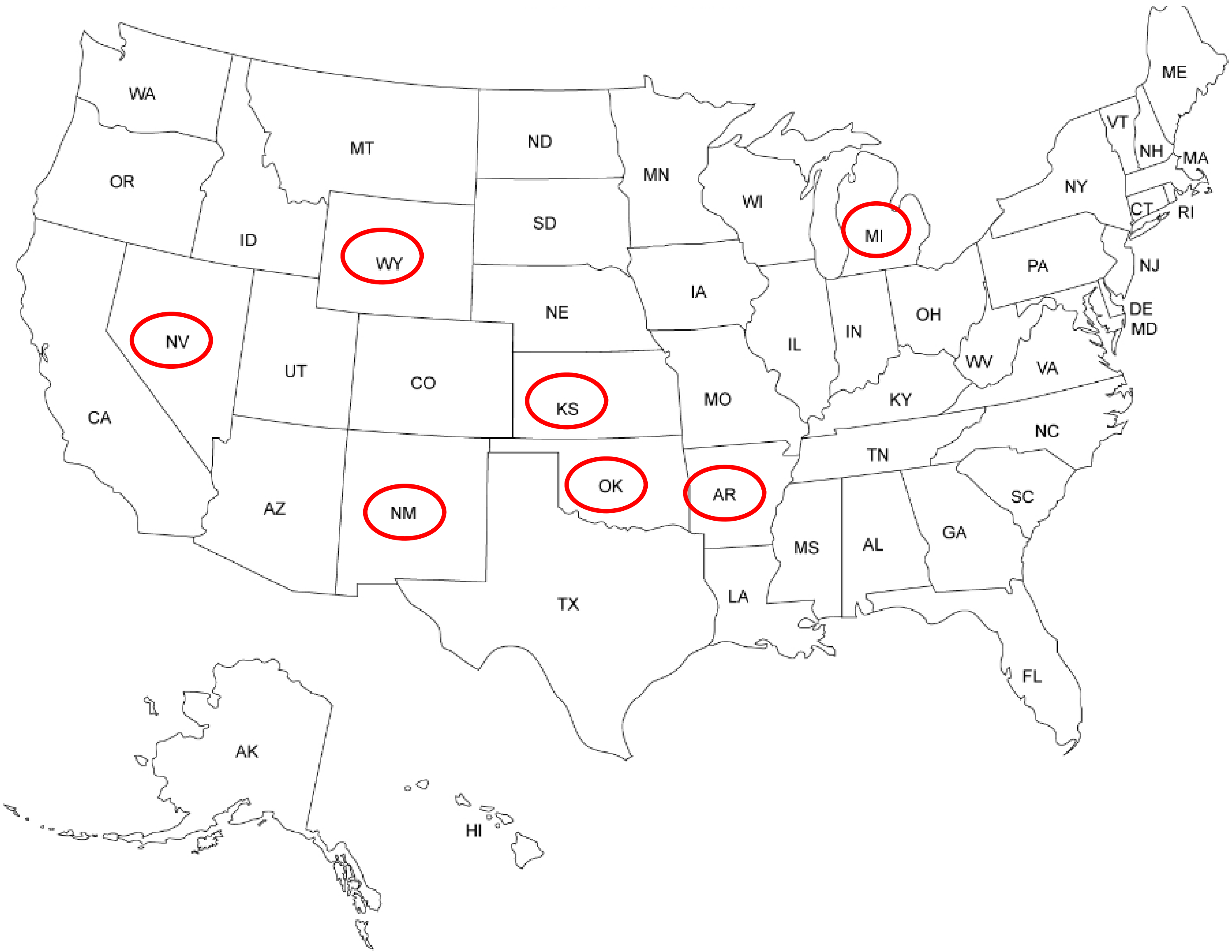
FRAMING THE ISSUE

Marketable Product states:

- Generally WIO Lessee is obligated to bear all costs to produce a "marketable product," after which RIO Lessor's obligation to bear a proportionate share commences

- Defines the point at which oil or gas first is in a marketable condition as the appropriate point to value production for royalty calculation

MARKETABLE PRODUCT STATES



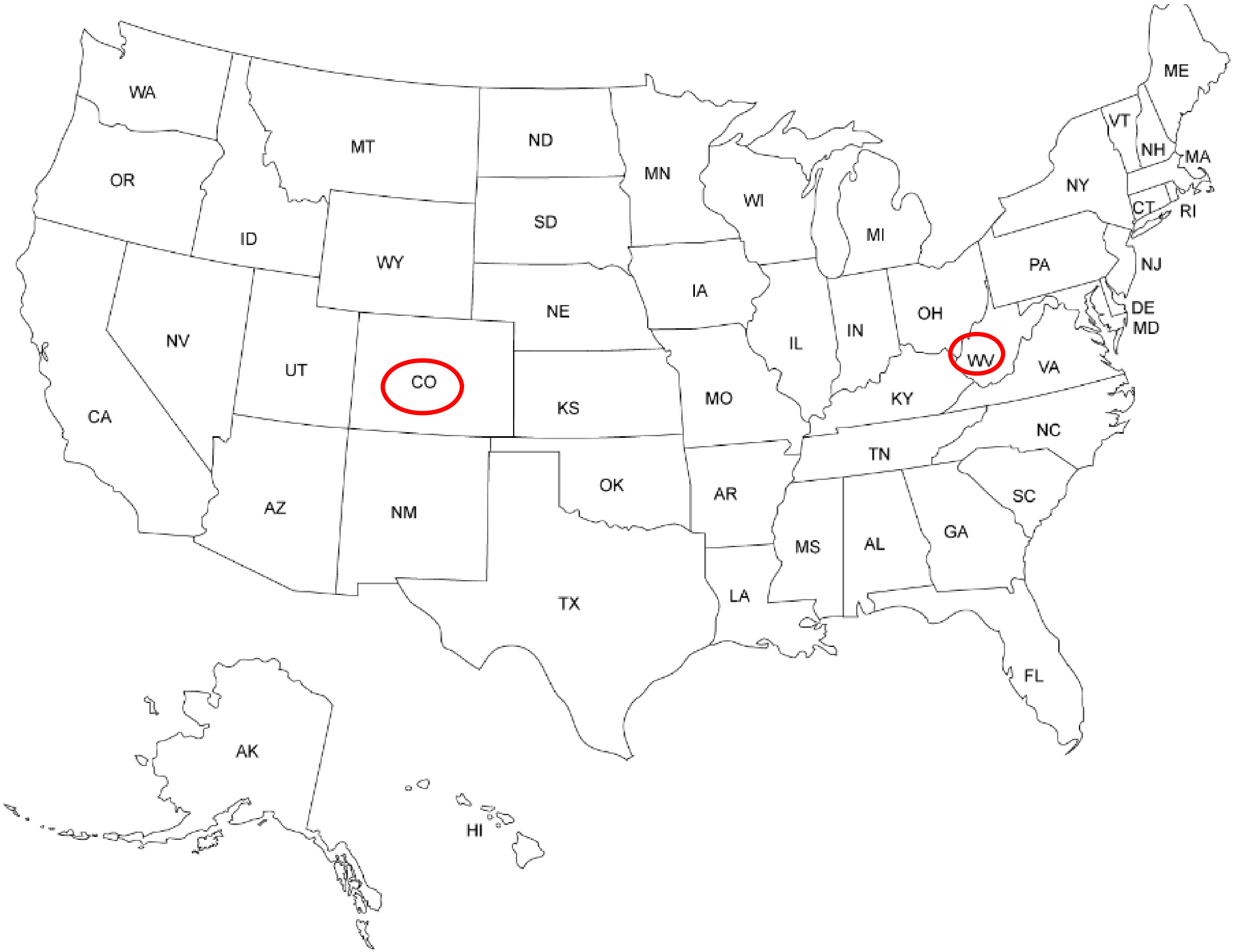
FRAMING THE ISSUE

Marketable Product (condition & location) states

- Generally WIO Lessee is obligated to bear all costs to produce a “marketable product” **and** transport that product to the market, after which RIO Lessor’s obligation to bear a proportionate share commences

- Defines the point at which oil or gas is both in a marketable condition and at the market location as the appropriate point to value production for royalty calculation

MARKETABLE PRODUCT (CONDITION AND LOCATION) STATES

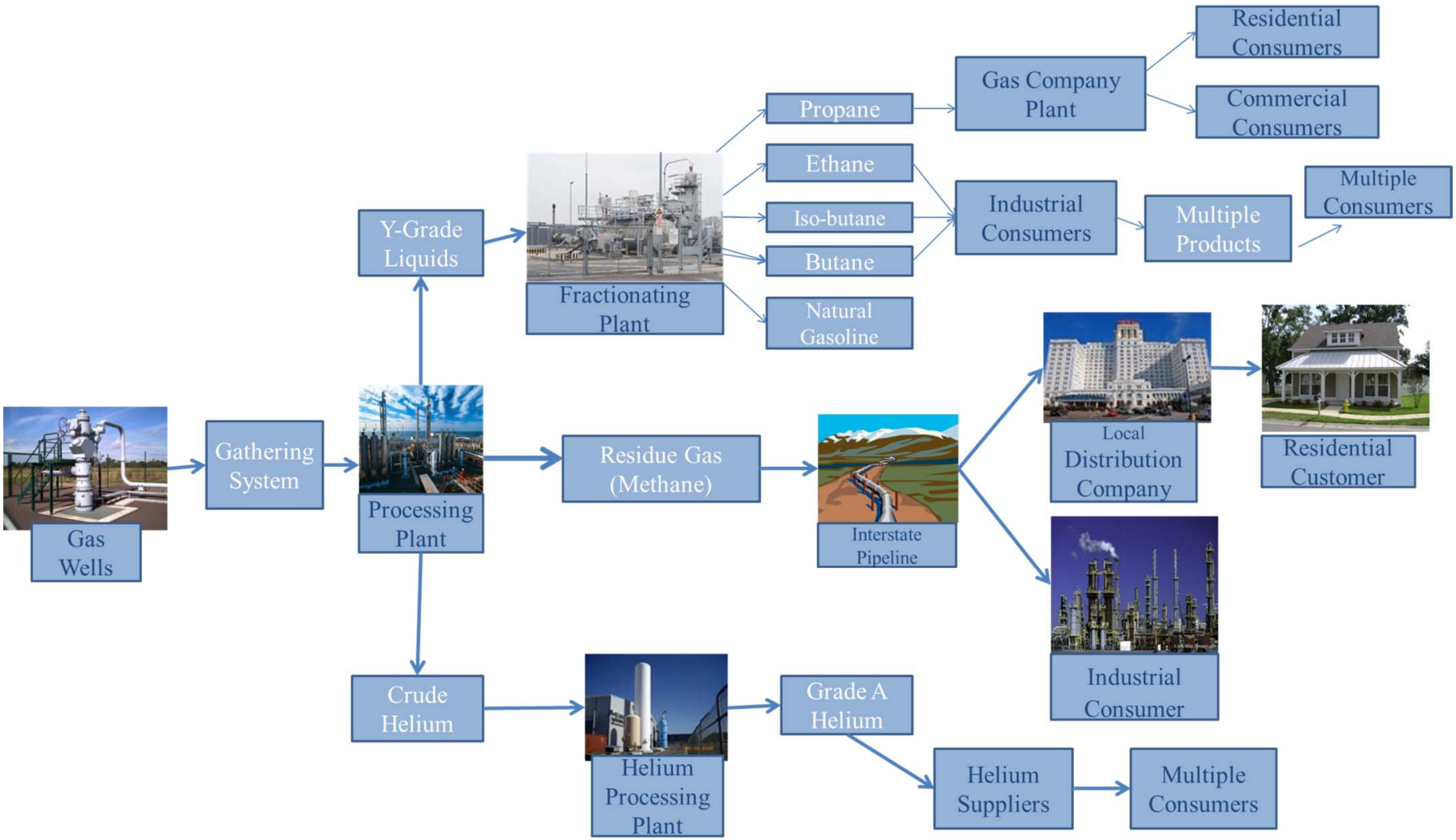


FRAMING THE ISSUE

- Value of production increases as it moves downstream

- Additional costs are required and generally enhance the value

$ → FRAMING THE ISSUE →$$$



FRAMING THE ISSUE

- Fundamental Question in Royalty Litigation:
  - Where along the value chain should the royalties be calculated?
- Instead of focusing on the "value," RIO Lessors typically focus on the costs or expenses:
  - What expenses can be deducted?
  - What expenses must the RIO Lessors pay?
- WIO Lessees often adopt this paradigm, try to answer these questions, and explain what expenses properly can be deducted

Source:
http://www.bloomberg.com/photo/a-natural-gas-wellhead-in-pennsylvania-/64167.html

Recently decided cases

AT-THE-WELL STATES

RECENT CASES: TEXAS

French v. Occidental Permian Ltd., 440 S.W.3d 1 (Tex. 2014)

- At issue was the cost of processing carbon dioxide for purposes of reinjection
- Case highlights the difference between at-the-well states and marketable product states
  - Texas Supreme Court explained royalties are generally "subject to postproduction costs, including . . . treatment costs to render production marketable"
  - Oxy argued removal of "CO_2 is necessary to make the casinghead gas marketable and is therefore a postproduction expense that must be shared by the royalty owners"
- By processing the gas, Oxy was creating greater economic benefit to the RIO Lessors, who would share in the value of the extracted NGLs

RECENT CASES: TEXAS

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

- Lease established "a perpetual, cost-free (except only its portion of production taxes) overriding royalty of five percent (5%) of gross production . . ."
- Although RIO Lessors might be subject to post-production costs upon taking payment in kind, this did "not suggest that they must be subject to those costs when the royalty is paid in cash."
  - “Cost-free” provision was intended to exclude post-production costs from the overriding royalty
- Lease disclaimed application of *Heritage Resources, Inc. v. NationsBank*
  - Court found the disclaimer could not “free a royalty of post-production costs when the text of the lease does not do so.”
- Chesapeake had improperly deducted post-production costs from overriding royalty interest (5-4 decision)

RECENT CASES: NORTH DAKOTA

Kittleson v. Grynberg Petroleum Co., 876 N.W.2d 443 (N.D. 2016)

Source: The Wall Street Journal,
http://www.wsj.com/articles/northdakotaoilproductiondropped-again-in-january-1457718358

- “Sour gas with little to no market value”
- Royalty clause required payment to RIO Lessor of “the market value at the well for all gas . . . produced from the leased premises and sold . . .; provided however, that there shall be no deductions from the value of Lessor’s royalty of any required processing, cost of dehydration, compression, transportation or other matter to market such gas”
- While the “at the well” language allows deductions of post-production costs from sales price, the more specific “no deductions language qualifies and prevails over” the at-the-well clause

RECENT CASES: MONTANA

S Bar B Ranch v. Ominex Canada, Ltd., 942 F. Supp. 2d 1058 (D. Mont. 2013), *aff'd* 601 F. App'x 569 (9th Cir. 2015)

Source: Jessica Sena at @MTPetroleum, via Forbes.com

- RIO Lessor putative class argued WIO Lessee "cheated" the class by not disclosing deductions and the discovery rule and fraudulent concealment should toll the statute of limitations
- District Court ruled that Montana was an at-the-well state, WIO Lessee had no duty to disclose deductions, and statute of limitations barred the claim
- Ninth Circuit affirmed, holding that Montana was an at-the-well state

RECENT CASES: KENTUCKY

***Baker v. Magnum Hunter Production, Inc.*, 473 S.W.3d 588 (Ky. 2015)**

- Considered whether Kentucky would be a marketable product state or an at-the-well state
- Royalty clause: "one-eighth of the market price at the well for gas sold or for the gas so used from each well off the premises"
- Held Kentucky jurisprudence is consistent with the at-the-well approach and declined to adopt the marketable product approach, which "distorts the seven-eighths/one-eighth split of the 'market price at the well' for which the parties contracted"

Source: http://oilandgas.ky.gov/Pages/Welcome.aspx.

RECENT CASES: COLORADO

Lindauer v. Williams Production RMT Co., No. 14CA2502, 2016 WL 908452 (Colo. Ct. App. March 10, 2016)

- At issue was the costs incurred to transport gas to downstream markets beyond the first commercial market
- Court of Appeals held the operator was permitted to deduct reasonable costs of transporting gas to downstream markets and the transportation costs (unlike processing costs) did not have to enhance the value of the gas to be deductible

Source: http://www.huffingtonpost.com/2013/07/14/water-researchers-converg_n_3591574.html

- RIO Lessor has appealed to the Colorado Supreme Court

RECENT CASES: KANSAS

Sources: The Kansas City Star,
http://www.kansascity.com/news/business/article11859914.html; The Wichita Eagle,
http://www.kansas.com/news/local/article1320933.html.

FAWCETT V. OIL PRODUCERS, INC. OF KANSAS

352 P.3d 1032 (Kan. 2015):

- ✓Plaintiffs: class of RIOs with 25 oil and gas leases entered into between 1944 and 1991
- ✓Defendant: OPIK, the lessee-operator, sold the "raw" gas at or near the wells to various midstream companies (the first purchasers)
  - ✓ Purchase price was not a fixed amount, but rather was based on a percentage-of-index or a percentage-of-proceeds
  - ✓ First purchasers processed the gas stream and resold it downstream to second purchasers

FAWCETT V. OIL PRODUCERS, INC. OF KANSAS

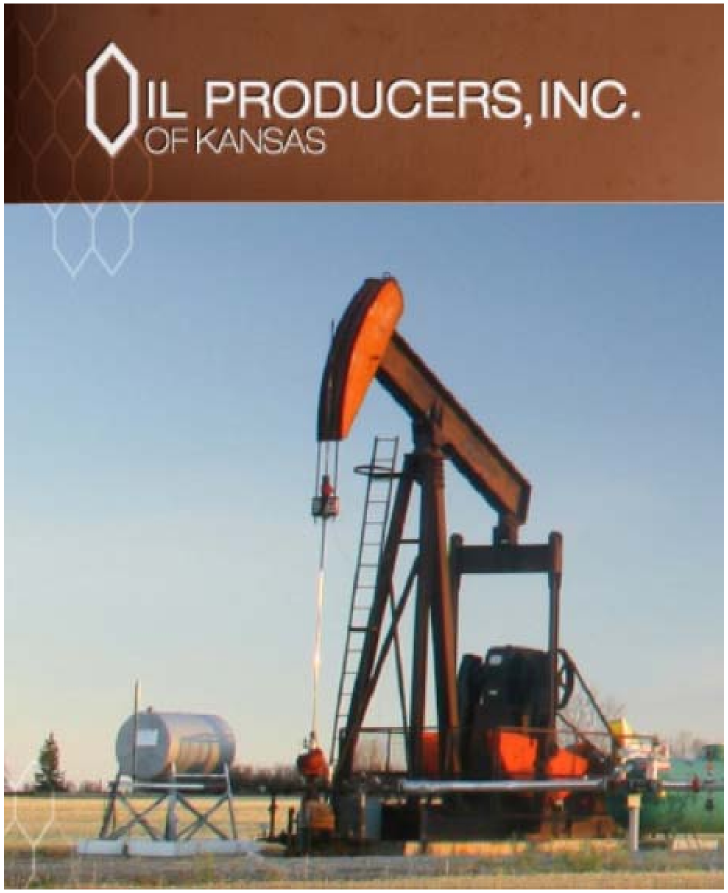
Plaintiffs argued:

- The sale, for royalty purposes, occurred when third-party first purchasers resold processed natural gas and NGLs downstream
- Gas not marketable (or "commercially fungible") until it was "pipeline quality"
- No expenses incurred before that point could be deducted

Trial court and Court of Appeals agreed

- "Gross sales price" for the gas OPIK sold was the downstream index or resale proceeds, ***not*** the lower upstream price the first purchasers paid to OPIK at the wellhead

FAWCETT V. OIL PRODUCERS, INC. OF KANSAS

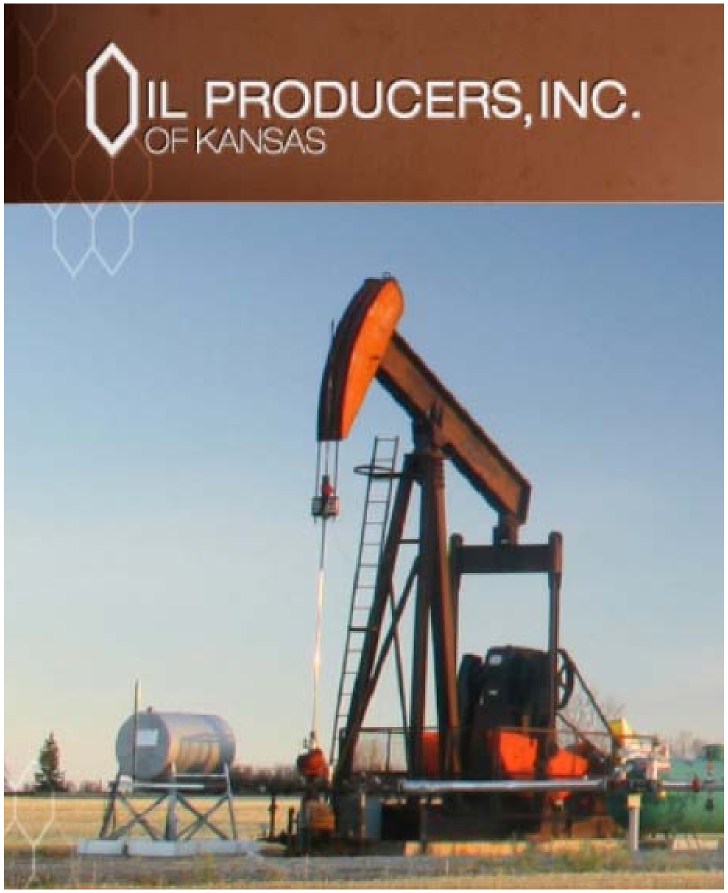


- Kansas Supreme Court first analyzed lease language and gas purchase contracts:

"An oil and gas lease which provides that the lessee shall pay lessor monthly as royalty on gas marketed from each well one eighth of the proceeds if sold at the well, or, if marketed off the leased premises, then one-eighth of the market value at the well, is clear and unambiguous as to gas sold at the wellhead by the lessee in a good faith sale, and the lessor is entitled to no more than his proportionate share of the amount actually received by the lessee for the sale of the gas." (quoting *Waechter v. Amoco Production Co.*, 537 P.2d 228 (1975))

- 22 of 25 leases were *Waechter* leases; other 3 also deemed *Waechter* leases

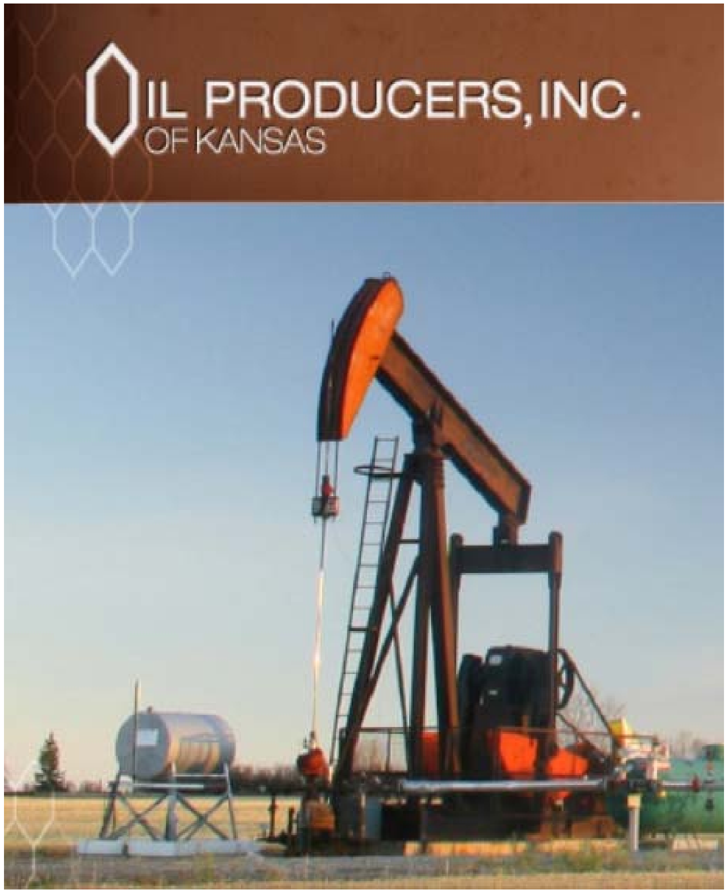
FAWCETT V. OIL PRODUCERS, INC. OF KANSAS



- Kansas Supreme Court rejected conclusion that the gross sales price was the downstream index or resale price: "the third-party purchase contract pricing formulas in this case more clearly represent negotiated sale price for the gas, i.e., the total sum paid in exchange for the gas delivered at the wellhead."

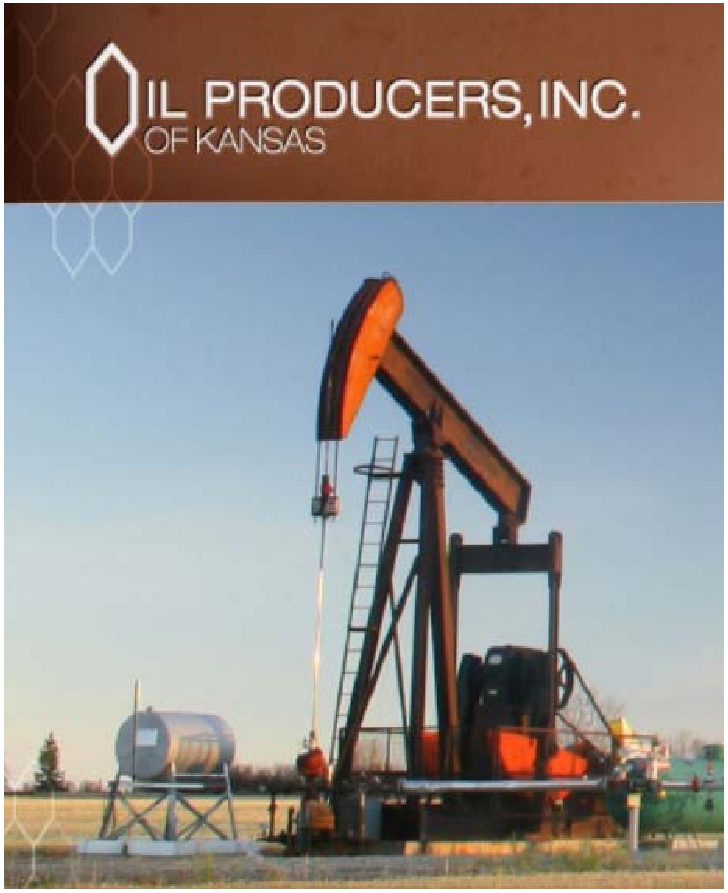
- Contract sales price was the price paid by the first purchasers to OPIK at the wellhead, ***not*** the higher downstream value of the gas

FAWCETT V. OIL PRODUCERS, INC. OF KANSAS



- Still, the RIO Lessors claimed "raw natural gas sold at the wellhead is not marketable as a matter of law or fact until it is processed and enters an interstate pipeline."
- Kansas Supreme Court, however, refused to equate marketable condition with pipeline quality
- After reviewing prior Kansas cases, the Supreme Court noted that the "precise quality or condition at which gas becomes 'marketable' . . . remains an open question."
- So the Court continues and provides an answer that question

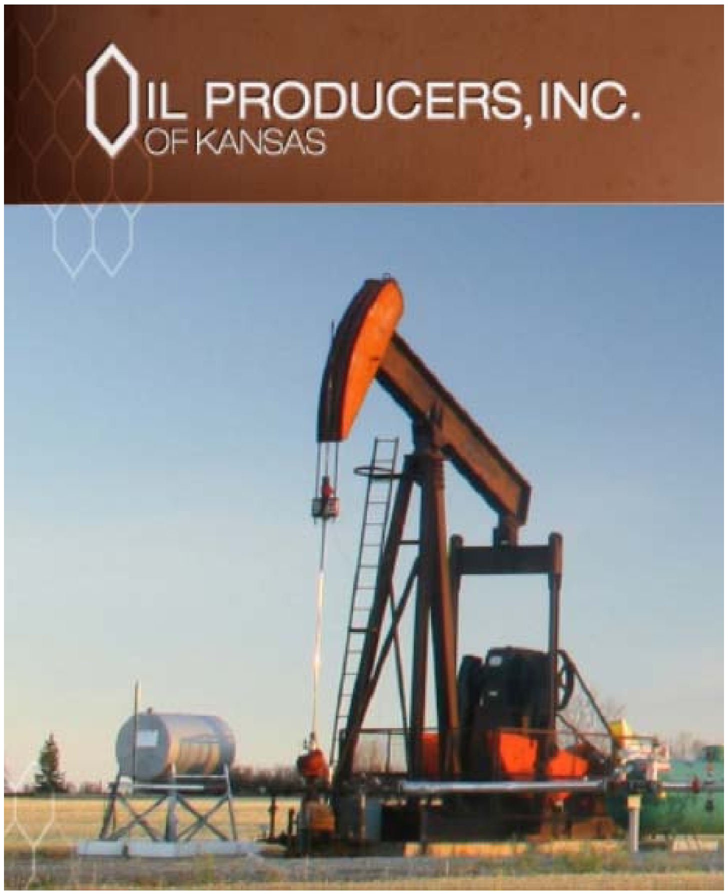
FAWCETT V. OIL PRODUCERS, INC. OF KANSAS



- Kansas Supreme Court draws a distinction between production expenses (e.g., equipping a well) and post-production expenses (e.g., fractionating gas):

"[W]hen gas is sold at the well it has been marketed; and when the operator is required to pay royalty on its proceeds from such sales, the operator may not deduct any pre-sale expenses required to make the gas acceptable to the third-party purchaser. But post-sale, post-production expenses to fractionate raw natural gas into its various valuable components or transform it into interstate pipeline quality gas are different than expenses of drilling and equipping the well or delivering the gas to the purchaser."

FAWCETT V. OIL PRODUCERS, INC. OF KANSAS



- Kansas Supreme Court draws a distinction between Kansas and Colorado
- In Kansas, “the duty to make gas marketable is satisfied when the operator delivers the gas to the purchaser in a condition acceptable to the purchaser in a good faith transaction.”
- Rather than focusing on the quality or condition at which gas becomes “marketable,” the Court adopts a pragmatic approach—gas is marketable when it can be marketed—i.e., is in a condition acceptable to a purchaser

FAWCETT V. OIL PRODUCERS, INC. OF KANSAS

Fawcett may be death knell for several common RIO Lessor claims:

- Gas is *per se* not marketable at the wellhead
- Gas is not marketable until it is "commercially fungible"
- Gas is not marketable until it is "pipeline quality"
- Wellhead gas sales agreements are not true purchase and sale agreements, but rather are akin to service agreements
- Royalties are due separately on each post-processed component of the gas stream

WHAT'S NEXT – IMPACT OF *FAWCETT*

RIO Lessors still have claims:

- Non-compliance with express lease terms
- Challenge the "good faith" nature of the WIO Lessor production sale agreement
  - Implied covenant of good faith and fair dealing
  - Implied duty to market & reasonably prudent operator
  - Affiliate, arm's-length & captive sale issues
- Reasonableness of the "deductible" expenses

WHAT'S NEXT – LEASE LANGUAGE

- Express language in the royalty clause should govern over implied terms
- Examining the express language is the obvious starting point & can be critical
  - Example: *Waechter v. Amoco Production Co.* (Kan. 1975)—"Lessee shall pay lessor monthly as royalty on gas marketed from each well one-eighth (1/8) of the proceeds if sold at the well, or, if marketed by lessee off the leased premises, then one-eighth (1/8) of the market value thereof at the well."

WHAT'S NEXT – TEMPORAL CONTEXT

- Consider the prevailing custom and practice and case law when the lease was executed
  - Helps provide basis for parties' reasonable expectations or understandings
  - Some states require this considerations
- In Kansas, royalty clauses "must be construed from the context of the leases and the custom and practice in the field at the time they were executed." *Matzen v. Hugoton Production Company* (Kan. 1958)
  - ("When [the lessors'] leases were executed it was the established custom and practice in the field to measure, determine the price, and pay royalty at the wellhead for the gas produced. . . .")

WHAT'S NEXT – HISTORICAL CONTEXT

Consider the history of marketing production

- Natural Gas Act (1938)
  - Eventually Included a regulated price for marketing or sale of gas at the wellhead
- How much of the production from your state has been sold at the well?
  - "Historically, about 85% of all gas purchasers paid the cost and built the lines necessary to gather and transport the gas to market" in Kansas. *Sternberger v. Marathon Oil Co.* (Kan. 1995)

WHAT'S NEXT – CASE SPECIFIC CONTEXT

Consider the context of each case

- In Kansas two cases held that compression cost were not deductible
  - *Gilmore v. Superior Oil Co.* (Kan. 1964) *and*
  - *Schupbach v. Continental Oil Co.* (Kan. 1964)
- But, the Kansas Supreme Court found the compression costs were necessary to produce a marketable product because the gas at issue was casinghead gas that did not have enough natural pressure to enter the first purchaser's gathering pipeline

WHAT'S NEXT – JURISPRUDENTIAL CONTEXT

- Consider broad context of the jurisprudence of your state

CASE	YEAR	PRODUCTION	WHERE MARKETABLE? (or point at which parties share expenses)
Scott v. Steinberger	1923	Gas	*Before* it was sold to the First Purchaser At the Well/On the Lease At the Inlet to Lessee's Own Gathering Pipeline System
Voshell v. Indian Territory Illuminating Oil Co.	1933	Oil	*Before* it was sold to the First Purchaser At the Well/On the Lease At the Inlet to the Oil Pipeline
Molter v. Lewis	1943	Oil	*Before* it was sold to the First Purchaser At the Well/On the Lease Before it was loaded on the Trucks
Matzen v. Hugoton Production Co.	1958	Gas	*Before* it was sold to the First Purchaser At the Well/On the Lease At the Inlet to Lessee's Own Gathering Pipeline System
Gilmore v. Superior Oil Co. & Schupbach v. Continental Oil Co.	1964	Casinghead Gas	*Where* it was sold to the First Purchaser In the Field, On the Lease, But After Initial Compression At the Inlet to First Purchaser's Gathering Pipeline System

CASE	YEAR	PRODUCTION	WHERE MARKETABLE? (or point at which parties share expenses)
Waechter v. Amoco Production Co.	1975	Gas	*Where* it was sold to the First Purchaser At the Well/On the Lease At the Inlet to First Purchaser's Gathering Pipeline System
Lightcap v. Mobil Oil Corp.	1977	Gas	*Where* it was sold to the First Purchaser At the Well/On the Lease At the Inlet to First Purchaser's Gathering Pipeline System
Matzen v. Cities Service Oil Co.	1983	Gas	*Where* or *Before* it was sold to the First Purchaser At the Well/On the Lease At the Inlet to either First Purchaser's or Lessee's Own Gathering Pipeline System
Sternberger v. Marathon Oil Co.	1995	Gas	*Before* it was sold to the First Purchaser At the Well/On the Lease At the Inlet to Lessee's Own Gathering Pipeline System
Fawcett v. Oil Producers, Inc. of Kansas	2015	Gas	*Where* it was sold to the First Purchaser At the Well/On the Lease At the Inlet to First Purchaser's Gathering Pipeline System

WHAT'S NEXT – CHECK STUB CLAIMS

- Many states have reporting statutes outlining information that must be conveyed to RIO Lessors
- RIO classes use the check stubs in two ways:
  - Defensive use: omissions and arguably false information render discovery of underpayment unlikely, thereby tolling statute of limitations
  - Offensive use: check stubs contain false or misleading statements or material omissions, thereby providing an independent cause of action (and possible punitive damages)

WHAT'S NEXT – LEASE REFORMATION CLAIMS

- RIO Lessors are asking the courts to re-write the leases, claiming:
  - Unconscionable based on unequal bargaining power
  - Unconscionable based on advances in technology , rendering the terms no longer equitable or consistent with the parties' intent

Royalties on Federal and Indian Oil and Gas Leases

FEDERAL REGULATIONS

ROYALTIES ON FEDERAL AND INDIAN OIL AND GAS LEASES

Current Regulations and Unbundling of Costs

- Office of Natural Resources Revenue (“ONRR”) performs compliance reviews of federal WIO Lesees to determine compliance with royalty calculation and payment requirements
- Federal WIO Lessees must put production into marketable condition at no cost to RIO Lessor
  - "marketable condition" means “lease products which are sufficiently free from impurities and otherwise in a condition that they will be accepted by a purchaser under a sales contract typical for the field or area” 30 CFR §1206.151

ROYALTIES ON FEDERAL AND INDIAN OIL AND GAS LEASES

Current Regulations and Unbundling of Costs

- Federal WIO Lessees may deduct transportation and processing costs **not** necessary to make the gas marketable
- Federal WIO Lessees must “unbundle” transportation and processing costs into allowed and disallowed costs
- Unbundling can be laborious and subject to conflicting authority

ROYALTIES ON FEDERAL AND INDIAN OIL AND GAS LEASES

Consolidated Federal Oil and Gas and Federal Indian Coal Valuation Reform Rule

- BLM unveiled new final rule on June 30, 2016, on how royalties for minerals on federal and Indian lands are calculated
- Effective January 1, 2017
- Applies to oil and gas produced from Federal onshore and offshore leases and coal produced from Federal and Indian Leases

ROYALTIES ON FEDERAL AND INDIAN OIL AND GAS LEASES

Consolidated Federal Oil and Gas and Federal Indian Coal Valuation Reform Rule

- Oil valuation regulations – 30 CFR Part 1206, Subpart C
  - Largely do not change the method by which oil sales are valued under prior regulation
  - New default valuation provision - §§ 1206.104 - 105
    - The ONRR may determine the value of the production if it determines the WIO lessee did not properly value the oil production

ROYALTIES ON FEDERAL AND INDIAN OIL AND GAS LEASES

Consolidated Federal Oil and Gas and Federal Indian Coal Valuation Reform Rule

- Gas valuation regulations – 30 CRF Part 1206, Subpart D
  - Rule does not significantly change valuation of arm's-length gas sales
  - Eliminates valuation benchmarks for non-arm's-length sales between affiliated companies → replaced with gross proceeds valuation method based on first arm's-length sale
    - OR, lessee may elect to pay royalties based on a value using the monthly high index price, less a standard deduction for transportation
  - New default provision, §§ 1206.143 – 144, if ONRR determines gas was not valued properly, it can determine the value

ROYALTIES ON FEDERAL AND INDIAN OIL AND GAS LEASES

Waste Prevention, Production Subject to Royalties, and Resource Conservation

- DOI released proposed rule on January 22, 2016; Extended comment period ended April 22, 2016 (81 Fed. Reg. 25, 6166)
- Primarily would impact:
  - royalties due on natural gas losses, such as where gas is vented, flared, or leaked during production activities, from onshore federal and Indian mineral leases, and
  - the royalty percentage allowable under federal leases

ROYALTIES ON FEDERAL AND INDIAN OIL AND GAS LEASES

Waste Prevention, Production Subject to Royalties, and Resource Conservation

- Proposed rule attempts to clarify when flared or vented natural gas is subject to royalties
  - Loss of gas is "unavoidable" (royalty free) when:
    - operator complies with all applicable requirements and takes prudent and reasonable steps to avoid waste and gas is lost from certain specified operations or sources
    - gas is flared from a well that is not connected to gas capture infrastructure
  - Gas loss not specifically found "unavoidable" is considered "avoidable" and subject to royalties

ROYALTIES ON FEDERAL AND INDIAN OIL AND GAS LEASES

Waste Prevention, Production Subject to Royalties, and Resource Conservation

- Current law:
  - BLM must set royalty rates for non-competitive leases at 12.5% (1/8)
  - MLA allows BLM to set a royalty rate of 12.5% or greater for competitive leases
  - BLM's existing regulation sets a flat rate of 12.5% for all new competitive leases

ROYALTIES ON FEDERAL AND INDIAN OIL AND GAS LEASES

Waste Prevention, Production Subject to Royalties, and Resource Conservation

- Proposed rule purports to:
  - Clarify that the royalty rate on all existing leases would remain the same;
  - Specify 12.5% fixed statutory rate for all non-competitive leases issued after the rule's effective date; and
  - For competitive leases issued after rule's effective date, allow the BLM to set royalty rates at or above 12.5%

10

THINGS ROYALTY PAYORS & PAYEES SHOULD CONSIDER

10 THINGS ROYALTY PAYORS & PAYEES SHOULD CONSIDER

1. Frame the issue based on the facts – value vs. costs
2. Focus on the royalty clause language
3. Custom and practice in the field (and the law in the state) when the lease was executed
4. Historical context in general
5. Timeline of cases from the particular state

10 THINGS ROYALTY PAYORS & PAYEES SHOULD CONSIDER

6. Developments from other jurisdictions
7. Good faith, arm’s-length and affiliate sales issues
8. Reasonably prudent operator claims
9. Reporting statutes and check stub fraud claims
10. Lease reformation claims

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