Conducting the Royalty Owners’ Lease Audit

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Begin at the Beginning with the Lease
Fundamental Lease Analysis to Determine Obligations of the Lessee

- “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.” ---Professor David E. Pierce.

- Royalty Clause - Is the royalty to be paid on “market value” or “proceeds” or the “greater of market value and proceeds”?

- Where is the royalty to be paid? At the well head? At the point of sale, use or in the “field”?

- Is the royalty payable on all hydrocarbons actually produced, or payable only on what lessee actually sells?

- All these terms have different requirements and legal interpretations (see Vela, Yzaguirre and Heritage Resources).
Fundamental Lease Analysis to Determine Obligations of the Lessee

- Habendum Clause, Termination and Cessation
  - Is the payment of royalties a condition (termination of lease if breached) or a covenant (suit for damages if breached)?
- Lease Savings Clauses – continuous operations, shut-in royalty, etc.
- Fuel Use Clause – “free use of oil and gas”
- Allowable Deductions Clause – lessor’s pro rata share of severance taxes and other expenses allowed or prohibited.
- “Paying Quantities” Clause – is there a clause setting production thresholds for production in “paying quantities?”
- Minimum Royalties Clause – is there an obligation to pay a minimum dollar amount per net mineral acre covered by the lease?
- Express and Implied Covenants to Protect from Drainage – express offset requirement when well is within a stated distance of the lease line; avoid “reasonably prudent operator” standard
- Miscellaneous and Special Clauses – no common law right to audit the oil company’s books and records.
Reconciling Lease Language and Actual Operations: Applying the facts to the law

- Annotate the Lease clause by clause.
- Identify the strengths and weaknesses in the annotated Lease, review case law construing the various Lease provisions.
- Determine which clauses in the annotated Lease will require a field audit or the engagement of an engineer to ensure compliance.
- Think about your “Lease Audit Team”, and the engagement of an attorney, engineer, accountant with royalty audit experience, and data entry personnel.
Building the Royalty Owners’ Lease Audit Team

■ Lessor’s Role
  ➢ Determine objectives of the audit – damages, lease termination, lease amendments - is the audit worth the expense?
  ➢ Background information needs to be compiled.
  ➢ Documents, lease files, correspondence.
  ➢ Check stub data and other remittances.
  ➢ Surface access where applicable for field audit.
Building the Royalty Owners’ Lease Audit Team

- Lawyer’s Role
  - Legal interpretation of Lease and relevant documents.
  - Employment and direction of experts – an engineering expert will be a critical (and expensive) component of the audit process and any resulting litigation.
  - Negotiation with opposing counsel.
  - Drafting of settlement documents.
  - Request of information required under Chapter 91 of the Texas Natural Resources Code.
Building the Royalty Owners’ Lease Audit Team

- Engineer’s/Expert’s Role
  - Onsite inspection and evaluation of lessee’s operations.
  - Ideally, the engineer has experience working with producers and knows the “tricks of the trade”.
  - Volume and value analysis of lessee’s data.
  - Knowledge of “industry standards, customs and usage”.
  - Preparation of damage model that can be defended in court.
  - Lease development and drainage analysis.
  - Technical recommendations to improve lease and negotiate settlement.
Building the Royalty Owners’ Lease Audit Team

- **Budget**
  - First phase: Fees and expenses for investigation and preliminary reports (if preliminary reports indicate problems, proceed to Second Phase).
  - Second phase: Fees and expenses for comprehensive report preparation (detailed audit report).
  - Third phase: Fees and expenses for negotiation with lessee (if no settlement, then proceed to Fourth Phase).
  - Fourth phase: Fees and expenses for litigation, arbitration or mediation, along with possible appeals.
Documenting and Evaluating Current Lease Operations

- Documentation of Lease Operations from Well Head to Point of Sale or Delivery

*Preserve evidence early and often!*
Documenting and Evaluating Current Lease Operations

- The first step is for legal counsel to send a formal written information request to Lessee (Chapter 91.502 et seq. Texas Natural Resources Code) for 12 required informational items
  - *Shell Oil Co. v. Ross*
- Lessor (or his auditor) can conduct a preliminary check stub data analysis in comparison to what the Railroad Commission reports show:
  - Volume analysis
  - Value analysis
- It is useful to compile data in spreadsheet form on a well-by-well basis.
- An engineer should make a surprise visit to the leased premises to conduct a field audit, with camera and note pad in hand.
- The engineer should identify the company personnel with whom we spoke, and video record the operations.
Documentation of Lease Operations

First looks can be deceiving
Documentation of Lease Operations

Look closer…
Documentation of Lease Operations

- And even closer!
Documentation of Lease Operations

- What you see driving by…
Documentation of Lease Operations

What you see driving by...
Gas Compression, “Fuel Use” and Shrinkage

- Fuel Use for Gas Compression, Means of Compression and Shrinkage
  - What size compressor is being used?
  - Is gas from different leases being compressed together?
  - Whose gas is being used to fuel the compressor?
  - Is the gas from your Lease being used to fuel a compressor to benefit gas from another lease? Is it a separate lease within the same production unit?
  - Shrinkage is the difference between the amounts of gas produced at the wellhead and the gas that enters a pipeline for sale. The losses include those from the separation process, field use, as well as fuel, flare gas and plant liquids extraction.
  - Where is the royalty measured? At the well head (no allowance for shrinkage), or upon entry into the pipeline (shrinkage will affect the amount of royalty paid)?
Look a little closer…untagged bypasses of fuel meter
Documentation of Lease Operations

And keep looking…interconnection of valves controlling gas flow to compressor
Unmetered fuel valve open
Documenting and Evaluating Current Lease Operations

- Allocation vs. Metering
  - What does the Lease require?
  - What does the Gas Contract require?
  - Is there commingling of different interests?
  - Is there a “check meter” to monitor the “main meter”?
  - Is there a meter to measure any gas that is flared?

- BTU Measurement, Actual and Approximate
  - Where is the BTU measurement made and how often?
  - What is the pressure base?
  - Is your royalty gas commingled with other gas of different BTU?
  - Does your lease have a BTU adjustment requirement?

- Condensate Measurement, Actual and Approximate
Evaluation of Metering Practices and Meter Error

Good Metering
Evaluation of Metering Practices and Meter Error

Poor Metering
Evaluation of Metering Practices and Meter Error

No static element = no gas measurement
Evaluation of Metering Practices and Meter Error

Fuel meter No static element – Meter not recording = no attempt to measure gas
Evaluation of Metering Practices and Meter Error

No static recorder – not measuring any fuel but compressor was operating at that time
Evaluation of Metering Practices and Meter Error

Bypass without locks or tags
Evaluation of Metering Practices and Meter Error

Uncontrolled bypass of meter
Evaluation of Metering Practices and Meter Error

Set up to comply with industry standards
Post-Production Deductions

- “Market value at the well head” by definition is burdened by post-production costs, regardless of specific lease terms to the contrary—Heritage Resources Inc. v. NationsBank, 939 S.W.2d 118 (Tex. 1996).
- “Market value at the point of sale or use” can be free of post-production costs if the specific lease terms so provide. Id.
- The “Producer’s 88” form will probably contain “market value at the well head” language.
- With “market value at the well head” language present, even if the Lease form also evidences an intent to prohibit post-production expenses, a Texas court will likely find such prohibition language to be “surplusage”.


Use of Public Documents to Verify Lessee’s Check Stub Data and Independent Statutory Obligations of Lessee

- Railroad Commission Volume and Value Data
- Railroad Commission Permits and Forms
- Texas Comptroller’s Volume and Value Data Reported by Lessees
- Information Disclosed by Publicly-Traded Companies Pursuant to SEC Regulations and FERC Regulations
- *Shell Oil Co. v. Ross* – the check stub data may not tell the whole story
Preparing and Conducting the Initial Lease Audit Meeting With Lessee

- Preparation of Confidentiality and Tolling Agreement – protects lessor from “statute of limitations” running during negotiations.
- Important issues to resolve in the negotiation and drafting of Confidentiality and Tolling Agreement – ensures a smoother and more productive discovery process and exchange of information between Lessor’s royalty audit team and Lessee’s staff.
- A lessee will want to ensure that any documents reviewed during any settlement discussions will be subject to later assertions of privilege should the parties end up litigating.
Preparing and Conducting the Initial Lease Audit Meeting With Lessee (continued)

- Checklist of documents needed for Lease Audit:
  - All documents related to the Lease, Amendments, Memorandum, Letter Agreements, etc.
  - All Gas Purchase Contracts affecting any part of the production for the Lease
  - Run tickets showing oil purchases in the field
  - RRC permits and filings
  - Allocation statements and calculations
  - Balancing agreements and reconciliation statements
  - Drilling reports
  - NGL Processing Agreements
  - JOAs and JIBs
  - Field wide gas flow schematic diagram
  - Comptroller data
  - SEC Filings if Lessee is a public company
  - Sales packages and any prospectus describing the lease and its reserves in anticipation of sale or financing
Resolution of Matters Discovered in Royalty Owner’s Lease Audit

- Pre-Litigation Mediation or Arbitration – are the parties close enough in settlement talks to alleviate need for expensive and lengthy litigation?
- An aggressive mediator may be worth the expense if he or she can get the parties closer to resolution.
- Once the matter is in the court system, the parties lose a certain amount of control.
Structuring the Settlement

- Cash, Increase in Royalty Percentage, Production Payments, or all of the above?
- The “sliding scale” approach to negotiating a settlement – more cash or more drilling/capital obligations
- Lease Amendments
  - Amended Royalty Clause to clarify value and deductions
  - Drilling Obligations
  - Surface Use Amendments
  - Release of Acreage or Depths
  - Metering requirements
Case Law Affecting the Royalty Owner’s Lease Audit

- **Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866 (Tex. 1968)**
- The oil and gas leases provided for a “market-value” royalty for off-premises sales, and a “proceeds-based” royalty for sales of gas at the well.
- Because the lessee sold the gas produced off the premises, the royalty owners claimed they were owed a market-value royalty, rather than a much lower royalty based on the proceeds the lessee actually received under a long-term sales contract.
- The parties can draft either a “market value” or a “proceeds” royalty provision, and their intent will be followed by the courts.
- The plain terms of the lease required the lessee to pay a market-value royalty even though the lessee received less than market value under its long-term sales contract.
- The lessor benefits from a rising market for gas, and avoids being locked in a long-term sales contract along with the lessee.
Recent Case Law Affecting the Royalty Owner’s Lease Audit

- **Yzaguirre v. KCS Resources, Inc., 53 S.W.3d 368 (Tex. 2001).**
- “Market value” lease like *Vela*, but the facts are reversed, the contract price or “proceeds” was greater than the “market value”.
- The lessee’s long-term sales contracts were lucrative and the market for natural gas was depressed, so the “proceeds” received by the lessee would cause a higher royalty to be paid than if the royalty was based on the “market value”.
- Again, the parties can draft either a “market value” or a “proceeds” royalty provision, and their intent will be followed by the courts.
- Supreme Court says “too bad.” If the rule in *Vela* applies when “market value” is greater than contract “proceeds”, then you still obtain “market value” when “proceeds” may be higher.
- The lesson is: draft the royalty clause to provide for the higher of “market value” or “proceeds”, but in no event less than an agreed percentage of an objective index, such as the Houston Ship Channel price for natural gas found in industry trade publications.
Recent Case Law Affecting the Royalty Owner’s Lease Audit

- Lessor was charged for a share of post-production costs greater than its proportionate royalty share.
- Supreme Court upheld and re-affirmed *HECI vs. Neel* by holding that Lessor’s recovery was barred by limitations because they could have discovered the overcharges 14 years earlier as they were not “inherently undiscoverable”.
- Plaintiffs argued that Wagner & Brown had falsely told them that the fees were only 12 cents per mcf, rather than 25 to 30 cents.
- How can a party be allowed to rely on the statute of limitations when he or she misrepresents material facts?
- If your lessee is not providing information you have requested, the law requires you to seek that information from other sources (RRC, working interest partners, gas purchasers, etc.).
Recent Case Law Affecting the Royalty Owner’s Lease Audit

- Kerr-McGee drilled a well located 660 feet from the plaintiffs' lease.
- Kerr-McGee did not drill an offsetting well on the plaintiffs’ lease, and the plaintiffs sued Kerr-McGee for failing to protect their lease against drainage from the neighboring well.
- The trial court awarded $860,000 in damages, and the Court of Appeals affirmed.
- The Supreme Court reversed, ruling that the plaintiffs should have no recovery, and refused the plaintiffs' request to remand the case for a new trial.
- The Court held that the plaintiffs' expert witness had not adequately explained how he had measured the amount of gas that would have been produced from a well on the plaintiffs’ lease if Kerr-McGee had drilled it; the Court said that there was "simply too great an analytical gap between the data [relied on by the expert] and the opinion proffered."
**Recent Case Law Affecting the Royalty Owner’s Lease Audit**

- *HECI Exploration Co. v. Neel*, 982 S.W.2d 881 (Tex. 1998)
  - HECI sued an adjacent operator for illegal production on an adjoining lease that damaged the common reservoir underlying both leases, and recovered a judgment for more than $3.7 million.
  - HECI did not inform its royalty owners of the suit and did not share any of the judgment proceeds with the royalty owners.
  - When HECI's royalty owners found out about the suit, they sued HECI to recover their share of the judgment.
  - The Supreme Court held that the royalty owners had waited too long to bring their suit, even though they did not find out about the suit until five years after the trial.
  - The Court held that the royalty owners should have known that the adjacent operator was damaging the common reservoir by its operations.
  - Your Lease form should require that the lessee notify you of any legal proceedings involving the leased premises, and that your royalty share should attach to any settlements or other benefits derived from your minerals.
Recent Case Law Affecting the Royalty Owner’s Lease Audit

- Lease termination based on numerous uncontested incidents of cessation of production.
- Supreme Court ignores the factual and legal questions of whether or not the lease terminated, ignores the temporary cessation of production doctrine.
- Holds that it does not matter whether lease terminated because the lessee now holds the lease by **adverse possession**.
- This is the first reported case in the country to hold that adverse possession statutes apply to recover title to an expired oil and gas lease.
- The Lease form should require that the lessee waive any claim for adverse possession.
Recent Case Law Affecting the Royalty Owner’s Lease Audit

- *Coastal Oil & Gas Corp. v. Garza Energy Trust*, 268 S.W.3d 1 (Tex. 2008)

- Royalty interest owners of natural gas lease brought action against gas well operator for subsurface trespass, breach of duty of good faith pooling, and breach of implied covenants to develop, market, and protect against drainage.

- Upon grant of review, the Supreme Court held that the rule of capture prevented royalty interest owners of natural gas lease from recovering damages against well operator on “frac” trespass claim.
Recent Case Law Affecting the Royalty Owner’s Lease Audit

- Shell had a “proceeds” lease with the plaintiff lessors.
- In paying royalties in a pooled unit, Shell did not use the price that it realized from selling the natural gas. Instead, Shell used a weighted average sales price ("WASP"), which it calculated by weighting its sale price and Forest Oil's sale price, according to their respective shares of gas, and then averaging these weighted prices.
- In 1995, Shell reimbursed some royalty owners because Shell had been calculating royalties based on the transfer price to Shell Gas Trading Company ("SGT") instead of the price Shell actually realized from its sale to a third party.
- In 2002, the General Land Office informed one of the plaintiffs that the GLO had received a settlement from Shell based on underpayment of royalties on natural gas produced from the plaintiff’s leased premises.
- In using the WASP, Shell, to its benefit, calculated the plaintiffs’ royalty payments in a manner that contradicts the express language of the Lease.
The evidence revealed that Shell underpaid royalties in at least two separate ways. There is evidence that Shell engaged in a practice of underpaying royalties by paying the arbitrary WASP, which was even different than an internal transfer price (the STG price) that Shell may have intended to base the price upon.

Shell argued that it had no "duty to state or disclose the exact price [it] received in an arms' length sale" in its royalty statements.

The unit price that Shell provided in its royalty statements did not reflect the price of the gas sold according to any method of calculation.

“Shell did have a duty to provide a unit price that was not arbitrary…”

The issue was whether the plaintiffs brought their claims in a timely manner, and even if they did not, did Shell fraudulently conceal the facts that would have given the plaintiffs a clue about the possible claims?

Dissenting opinion - As early as 1998, plaintiffs should have closely examined their check stubs and discovered that the "unit price" for the pooled wells was less than the "unit price" for the non-pooled wells, alerting them to the fact that the prices were being calculated differently for the wells.
Recent Case Law Affecting the Royalty Owner’s Lease Audit

- **Friddle v. Fisher, 378 S.W.3d 475 (Tex.App.—Texarkana 2012, pet. denied).**
- Friddle owned an “of royalty” NPRI in 84.7 acre tract.
- Lessee drilled a well crossing the subject tract and paid the lessors 100% of the royalty, without withholding the amount owed to Friddle.
- Friddle sued the lessors for wrongfully withholding monies owed to the NPRI owner.
- Lessors argued, inter alia, that Friddle’s claim was barred by limitations.
- Court ruled that discovery rule applied, distinguishing HECI and similar cases on the basis of the existence of a fiduciary duty between the executive and the NPRI owner:
  - “The NPRI holder in HECI and BP America had a duty to exercise reasonable diligence because he was not in a fiduciary relationship with the lessee, whereas the parties here are in such a relationship, thereby relieving Friddle of the duty to diligently inquire into the Fishers’ conduct.” *Id.*
Recent Case Law Affecting the Royalty Owner’s Lease Audit


Lessee formed unit and initiated a CO2 tertiary recovery operation to enhance production.

- Lessee injected CO2 purchased from Kinder Morgan into the reservoir, comingling the CO2 with native gas.
- Produced gas taken to Kinder Morgan plant for removal of 90% of CO2 and 2/3 of the NGLs.
- Extracted CO2 is re-injected into reservoir.
- Remaining CO2 and NGLs extracted at downstream plant.
- Kinder Morgan charged Lessee a monetary fee and an “in-kind” fee consisting of 30% of the NGLs and 100% of the residue gas, on which Lessors received no royalty.
- Lessors sued claiming that the “in-kind” fee was an impermissible deduction for the expenses of production.
First lease at issue calculated royalty as “market value at the well”.

Because Lessor was claiming royalty underpayment, Lessor has burden to prove “market value at the well”, which may be done by either 1) comparable sales method; or (2) net-back method.

Comparable Sales Method
- Must compare royalty received to other sales that are “comparable in time, quantity, and availability of marketing outlets.”
- Court ruled that the record contained no evidence of comparable sales, as the gas at issue was high in CO2 content, and Lessors’ experts were unfamiliar with comparable sales of high CO2 content gas.

Net-back Method
- Involves subtracting reasonable post-production marketing costs from the market value at the point of sale.”
- Lessors argued that all activities that took place at Kinder Morgan’s processing facility were production expenses, and should not be deducted under the net-back approach.
Occidental Permian LTD. v. French

(continued)

- Court disagreed with Lessor and ruled that the Kinder Morgan plant provided both production and post-production services.
- Lessor had the burden to present sufficient evidence allocating the production and post-production expenses at the Kinder Morgan plant in order to calculate market value at the well under the net-back method, which Lessor failed to do.
- “Because neither method of proving market value at the well is properly supported by evidence, the evidence is not sufficient to show that appellant underpaid royalties under the Lease.” Id.
- Second lease provided royalty to be paid on “the net proceeds from the sale . . . After deducting the cost of manufacturing.”
  - Court again ruled that Lessor presented insufficient evidence allocating the various production and post-production activities taking place a the Kinder Morgan plant, and thus insufficient evidence of royalty underpayment.
  - Additionally, Lessor presented no evidence that Lessee breached its duty to market, as Lessor’s expert testimony was based on native gas without CO2, and did not take into account the impurities in the actual gas stream (even though such impurities were placed in the stream by Lessee).
Moving the Point of Sale to Reduce Post-Production Costs

- From Presentation by Stuart C. Hollimon
- Modern leases have strong “no deduction” clauses prohibiting lessee from charging lessor’s royalty with any deductions for the costs of marketing, transportation and processing.
- This can put a “disproportionate” burden upon the lessee.
- In response, some lessees have moved the point of sale closer to the lease to cut down on post production expenses.

EXAMPLE:
- Lessee is operator of property in South Texas that produces liquid rich gas.
- Production is gathered from the wells into a central delivery point (“CDP”) where condensate is separated from wet gas.
- Condensate transported to Houston Ship Channel and sold at $105 per barrel.
- Field price is $95 per barrel.
- Wet gas stream is processed and liquids sold at Mont Belvieu, and residue gas sold at Houston Ship Channel for $3.75 per MMBtu
Moving the Point of Sale to Reduce Post-Production Costs

- Lease prohibits deductions for post-production costs, so Lessee absorbs 100% of such costs.
- Lessee decides to move point of sale to avoid post-production expenses.
- Under new arrangement, Lessee sells condensate at the CDP at the lower price of $95, and sells the wet gas at the CDP for the lower price of $2.75.
- Economic impact of new point of sale:

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<th>Sale Price/BBL</th>
<th>Royalty</th>
<th>Gross to Lessee</th>
<th>Net to Lessee</th>
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<tr>
<td>Current:</td>
<td>$105 (HSC)</td>
<td>$26.25</td>
<td>$78.75</td>
<td>$68.75</td>
</tr>
<tr>
<td>New:</td>
<td>$95 (Field)</td>
<td>$23.75</td>
<td>$71.25</td>
<td>$71.25</td>
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<tr>
<td></td>
<td>(-$2.50)</td>
<td>(+$2.50)</td>
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</table>
Moving the Point of Sale to Reduce Post-Production Costs

- **WET GAS**

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<th>Sale Price/BBL</th>
<th>Royalty</th>
<th>Gross to Lessee</th>
<th>Net to Lessee</th>
<th>NGLS</th>
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<td>Current:</td>
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<td>New:</td>
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<td>$0.69</td>
<td>$2.06</td>
<td>$2.06</td>
<td>No</td>
</tr>
</tbody>
</table>

Conclusion:
Lessee may be able net greater profits by selling hydrocarbons on the lease at the royalty owner’s expense. However, close attention should be paid to the royalty provisions of the lease, as Lessee may be in danger of breaching the implied covenant to reasonably market the gas.