By Stephen Gibson[1]

***Oil and Gas*: References to delivery "into the pipeline" in the assignment of an overriding royalty meant that "amount realized" allowed deduction of post-production expenses notwithstanding the customary understanding that "amount realized" disallowed deducting post-production expenses.**

Unless the parties specifically agree otherwise, an overriding royalty is unburdened by the cost of getting the minerals out of the ground; i.e., production costs. However, the overriding royalty interests are customarily subject to the post-production costs such as compression and pipeline transmission incurred to get the minerals to market.

The issue in *Burlington Resources Oil & Gas Co. v. Texas Crude Energy, LLC et al.* was whether the wording of an assignment made the overriding royalty interest subject to these kinds of post-production costs. The assignment contained two clauses describing the overriding royalty. The "granting clause" defined the overriding royalty interest as one "delivered to [the overriding royalty owner] *into the pipelines … with which the wells may be connected*, free and clear of all development, operating, production and other costs." (Emphasis added). This "in kind" overriding royalty payment is calculated according to the price "at the well" so that the price from delivery elsewhere is subject to reduction by post-production expenses involved in delivering the minerals from the well site to the purchasers.

The assignment's "valuation clause," however, blurred the seeming clarity of "at the well" in kind payment provision in the granting clause. This particular valuation clause specified that the overriding royalty could also be paid in cash. The royalty owner could elect the cash alternative that calculated payment according to "*amount realized* from such sale of such production and any products thereof." (Emphasis added). If the royalty owner elected the cash alternative, the "amount realized" formula applied regardless of *where* the sale occurred.

The lack of specificity about where the sale was to occur led to the parties' dispute whether "amount realized" referred to the *net* amount of sales price – in other words, after deducting post-production costs – or *gross* amount of the sales price with no post-production deduction. An opinion for a unanimous court by Justice Blacklock declared the "amount realized" language was unambiguous – neither party urged otherwise – and meant the *net* proceeds of the sale after reduction by proportionate post-production expenses.

The opinion acknowledged intermediate appellate decisions that "amount realized" meant *gross* sales amount, undiminished by production costs. The opinion rejected that those decisions meant that this phrase *invariably* meant free from post-production costs. The opinion chastised the court of appeals for so concluding because the Supreme Court of Texas had "never held that an 'amount realized' valuation method frees a royalty holder from its usual obligation to share post-production costs even when the parties have agreed to value the royalty interest at the well."

Here, the opinion concluded that defining the delivery point as "into the pipeline" in both the granting and valuation clauses meant that the parties objectively intended to permit deduction of post-production expenses from the

[1] The opinions expressed are solely those of the author. They do not necessarily represent the views of Munsch, Hardt Kopf & Harr, P.C. or its clients.

overriding royalty. Reading “amount realized” in light of this conclusion, the opinion held that phrase meant *net* proceeds in the context of this particular agreement.

Although it did not label it as such, the opinion bolstered this conclusion by resort to industry custom and practice as described in oil and gas treatises. However, because the agreement was unambiguous, the court refused to consider the parties’ own treatment of the agreement, including their history of deducting post-production costs. Instead, the opinion looked to the terms of other agreements related to the same transaction that referred to actual net proceeds as supporting its conclusion that “amount realized” meant *net proceeds*. Notwithstanding the conventional wisdom and industry custom that “amount realized” usually meant free of deduction for post-production expenses, as used in this assignment “amount realized” was most reasonably interpreted to allow these expenses to be deducted from this overriding royalty.

The opinion, therefore, has ramifications for more than just oil and gas contract disputes. It demonstrates how the court views the roles of “surrounding circumstances,” industry custom and practice, and course of dealing vis-à-vis a purely textual approach to contract interpretation. In addition, it does so even when the opinion does not overtly recognize these interpretive tools.