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COMMENTARY

Supreme Court of Texas Issues Three Important Oil and Gas Decisions

This month, the Texas Supreme Court decided three cases implicating oil and gas contract interpretation issues with important consequences to the industry. The Court held in all three cases that the plain meaning of a contract will prevail over an interpretation based on the industry's common views of the intended effect of a provision. This result can be troublesome for attorneys, landmen, and commercial dealmakers in the industry, as each has felt comfortable in the past relying on a common industry view of how certain key provisions in oil and gas contracts work. Consequently, these cases reinforce the need for a more careful review of key contract terms to ensure that the plain meaning of the text correctly expresses the intended commercial arrangement without the need to rely on what may have been the industry's customary interpretation.

Kachina Pipeline Co. Inc. v. Lillis

In *Kachina Pipeline Co. Inc. v. Lillis*, case number 13-0596, Supreme Court of the State of Texas, the central issue was whether the transporter, a natural gas transportation company, improperly charged a natural gas producer for compression costs associated with compressors located downstream from the transporter's receipt of the producer's gas into its gathering system and upstream from a third-party processing facility.

The gathering agreement between the transporter and the producer provided that the transporter could charge the producer for compression costs "to effect delivery" of the producer's gas. The producer argued that the natural pressure from his well was sufficient to deliver his gas to the transporter's pipeline system, and the downstream compressors only served the purpose of transporting the gas through the transporter's pipeline system and into the third-party processing facility. On the other hand, the Texas Pipeline Association and Gas Processors Association expressed their concern in *amicus curiae* letters to the Court, arguing that the language "to effect delivery of [producer's gas]" is common in the natural gas industry, and that these kinds of provisions are negotiated with the understanding that a pipeline will install compressors to serve multiple producers in a gathering system, who will share those centralized compression costs proportionally based on their share of total production.

Despite these protests, the Court held that the transporter could not pass these compression costs to the producer. The Court said that although the industry *amici* made it clear that producers often contract to share in the costs of downstream centralization of compression, "the Agreement does not express an objective intent that the producer would do so, and industry custom cannot impose obligations beyond those within the written Agreement." The Court interpreted the compression cost provision to be contingent upon the producer failing to overcome the transporter's working pressure. Based on this, the transporter could deduct only "the costs of compression installed during the term of the Agreement if required to overcome the working pressure in [the transporter's] system."

The Court's decision here demonstrates the consequences of relying on industry custom instead of the plain meaning of the words. The transporter could have easily clarified its intent by expressly providing that "delivery" includes final delivery to a third party.

Chesapeake Exploration LLC and Chesapeake Operating Inc. v. Hyder et al.

In *Chesapeake Exploration LLC and Chesapeake Operating Inc. v. Hyder et al.*, case number 14-0302, Supreme Court of the State of Texas, the Court was presented with the issue of whether an oil and gas lease allowed a producer to deduct postproduction costs from overriding royalty owners, as is typical of an overriding royalty, or whether the lease expressed a different agreement. Of three royalty provisions in the parties' lease, only one was in dispute. The disputed clause calls for "a perpetual, cost-free (except only its portion of production taxes) overriding royalty of five percent (5.0%) of gross production obtained" from directional wells drilled on the lease but bottomed on neighboring land.

The royalty owners argued that the "cost-free" requirement on the royalty could refer only to postproduction costs, because a royalty, by definition, is free of production costs. The producer, on the other hand, argued that "cost-free overriding royalty" is synonymous with overriding royalty, and that "cost-free" is simply emphasizing that the overriding royalty is free of production costs. The Court noted that leases discussed in previous cases support the producer's view. However, the Court found that "cost-free" in the overriding royalty provision includes postproduction costs—reasoning that if the royalty owners were to take their gas in kind, as they are entitled to do, they "might or might not incur postproduction costs equal to those charged by [the producer's marketing company]…" and "[t]he fact that the [royalty owners] might or might not be subject to postproduction costs by taking the gas in kind does not suggest that they must be subject to those costs when the royalty is paid in cash."

This was the first Texas Supreme Court case to discuss the 1996 *Heritage Resources Inc. v. NationsBank* ruling, which held that a royalty could be made free of postproduction costs. The Court made it clear that whether a royalty is free of postproduction costs depended on the text of the lease itself. As in the *Kachina* holding, this case demonstrates the importance of clear, careful drafting in oil and gas agreements. The fact that the Court agreed that "cost-free" typically means free of production costs in common industry practice, but still held that "cost-free" was not simply superfluous language, should further sensitize practitioners to the need to take better care in choosing language in reliance on past practice.

Plains Exploration & Production Co. v. Torch Energy Advisors Inc.

In *Plains Exploration & Production Co. v. Torch Energy Advisors Inc.*, case number 13-0597, Supreme Court of the State of Texas, the Court was asked to determine whether the excluded-assets provision of a purchase and sale agreement for certain oil and gas leases excluded a particular claim relating to reimbursement of bonus payments made by the seller to secure the leases. The seller under the purchase and sale agreement at issue argued that a particular claim for restitution of lease-bonus payments was excluded from the sale and that it was entitled to a portion of the related $83 million judgment that the new owner of the interests was awarded. The Court noted that this case was a "conventional contract-interpretation dispute" as to whether the seller was entitled to a portion of that judgment.

The seller sold its interest in certain oil and gas leases to the buyer pursuant to a 1996 purchase and sale agreement that excluded certain assets from the sale in an excluded-assets provision. The excluded assets expressly excluded claims and causes of action arising before the sale contract's effective date. A federal court subsequently determined that the leases at issue had been repudiated by federal law, and the buyer was awarded restitution of the lease-bonus payments the seller had originally paid to secure the leases.

The Court found that "the relevant excluded-assets provisions in the 1996 purchase and sale agreement are unambiguous and, as a matter of law, [the seller] did not retain ownership of the claimed asset." The excluded assets provision at issue provided that the seller would retain "claims and causes of action 'arising' or 'attributable to periods of time' before the contract's stated effective date of October 1, 1995, and all revenue 'attributable' to the conveyed property for any period before the contract effective date." The parties did not dispute that the claim did not accrue until after the effective date of the PSA, but rather they disputed "whether the excluded-assets provision applies to unripe claims." The Court determined that because the terms "arising from," "arising under or with respect to," and "attributable to" were used in reference to claims, a "pre-effective date causal nexus" was required for the seller to retain such claims. Because this claim arose after the effective date, the seller was not entitled to any of the judgment as a matter of law.

As with the previous two cases, the Court's decision demonstrates that unambiguous, explicit drafting is required in order for the intent of the parties to be respected, and that drafters must be meticulous in including exceptions, explanations, and standards for complicated subjects in order for the parties' agreed commercial expectations be respected by the courts.

Conclusion

These recent decisions by the Texas Supreme Court should put practitioners and industry members on notice that attention to specific language in a contract is crucial, and that even if certain language has a common understanding in the industry, the court will defer to the plain meaning of that language over industry custom and practice in the event of a dispute as to interpretation.

Lawyer Contacts

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