

Bracewell Secures Victory for Hilcorp in Royalty Dispute

News Release

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HOUSTON – The US Court of Appeals for the Fifth Circuit affirmed the complete dismissal of a lawsuit against **Bracewell LLP** client Hilcorp Energy Company after receiving answers last month from the Supreme Court of Texas to its certified questions. At issue was the proper treatment, when calculating royalty payments under a “market value at the well” lease, of produced gas that is used off the lease premises in post-production activities necessary to make other produced gas marketable for sale.

The case arises because produced minerals that have been processed, treated, and transported to a market for sale are more valuable than the same minerals when they are extracted from the ground. This difference in value can result in disputes between mineral producers and royalty holders. Many leases provide the royalty holder an interest in the value of the minerals “at the well” or use equivalent language indicating that the royalty interest is in the minerals as they come out of the ground, not after processing, transportation, or other “post-production” activities have increased the minerals’ value. Longstanding Texas law is that, for such leases, to calculate a royalty based on the value of the minerals “at the well,” the producer must deduct from the downstream sales proceeds the post-production costs that were required to get the minerals to the downstream market.

In this case, the royalty holders were not satisfied with their royalty payments based on the producer’s accounting for post-production costs. The royalty holders sued on behalf of a class, arguing that the producer could not deduct the value of produced gas used off the lease premises in post-production activities because the lease required payment of a royalty on all gas produced from the well. They relied on a recent case, *BlueStone Natural Resources II, LLC v. Randle*, 620 S.W.3d 380 (Tex. 2021), where the Supreme Court of Texas held that for a lease that was based on the “gross proceeds” from the minerals without deducting post-production costs —

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rather than a “market value at the well” lease — the lessee owed royalties on gas used off the lease because a “free use” clause there was limited to on-lease uses.

The district court dismissed the case and the royalty holders appealed to the Fifth Circuit, which certified two questions to the Supreme Court of Texas:

1. After *Randle*, can a market-value-at-the well lease containing an off-lease-use-of-gas clause and free-on-lease use clause be interpreted to allow for the deduction of gas used off lease in the post-production process?
2. If such gas can be deducted, does the deduction influence the value per unit of gas, the units of gas on which royalties must be paid, or both?

The Supreme Court answered in Hilcorp’s favor, ruling that “Hilcorp was entitled to account for reasonable post-production costs, which include the value of the gas used off the premises to prepare other royalty-bearing gas for sale.” The Supreme Court made clear that neither *Randle* nor the free-use clause impacts the outcome and that the plaintiffs, “as the holder of an ‘at-the-well’ royalty, must share in post-production costs – whether or not those costs include using some of the gas produced from the well.” Finally, the Supreme Court approved Hilcorp’s method of accounting for the post-production costs, recognized that the other accounting method described in the second certified question “would yield the same royalty payment,” and stated that “nothing in its opinion should be understood to state a preference for any particular method of royalty accounting, so long as the accounting results in the royalty holder being paid what he is lawfully owed.”

On June 4, the Fifth Circuit affirmed the dismissal of the lawsuit against Hilcorp consistent with the Supreme Court of Texas’s answers to the certified questions.

Bracewell lawyers involved in the matter included:

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