Fourth Court of Appeals
San Antonio, Texas

MEMORANDUM OPINION

No. 04-21-00337-CV

ENERVEST OPERATING, LLC,
Appellant

v.

Stanley B. **MAYFIELD** and Gerry Ingham,
Appellees

From the 112th Judicial District Court, Sutton County, Texas
Trial Court No. CV06284
Honorable Pedro (Pete) Gomez Jr., Judge Presiding

Opinion by: Luz Elena D. Chapa, Justice

Sitting: Patricia O. Alvarez, Justice
Luz Elena D. Chapa, Justice
Irene Rios, Justice

Delivered and Filed: September 28, 2022

REVERSED AND REMANDED

Appellant EnerVest Operating, LLC appeals the trial court's judgment declaring it owed appellees Stanley B. Mayfield and Gerry Ingham royalties on fuel gas and attorney's fees. On appeal, EnerVest contends the trial court misconstrued the gas royalty and free-use provisions in the subject oil and gas leases. We agree, and we reverse the trial court's judgment and remand the case to the trial court for further proceedings consistent with this opinion.

BACKGROUND

This case involves the construction of the gas royalty and free-use provisions in two identical oil and gas leases covering several sections of land in Sutton County. Siblings Mayfield and Ingham are lessors under the subject leases, and EnerVest is the current lessee. EnerVest operates gas wells on the leases and pays Mayfield and Ingham royalties for their share of the gas. These royalties are paid pursuant to the terms of the gas royalty provision in the leases, which provides:

> The royalties to be paid by lessee are . . . on gas, including casinghead gas and all gaseous substances, produced from said land and sold or used off the premises or in the manufacture of gasoline or other product therefrom, the market value at the mouth of the well of one-eighth of the gas so sold or used, provided that on gas sold at the wells the royalty shall be one-eighth of the amount realized from such sale[.]

EnerVest collects gas from two batteries—the IH Mayfield Battery, which is located on the leases, and the CenterPoint #17 Battery, which is located off the leases. EnerVest sends this gas downstream for processing and eventual sale. When EnerVest sends the gas downstream, it must use some of it to power compressors and dehydrators because the gas sold must be compressed and dehydrated to meet quality specifications for processing plants or pressure specifications for delivery to processing plants and/or downstream pipelines. The gas it uses to power the compressors and dehydrators is known as fuel gas. EnerVest does not pay Mayfield and Ingham royalty on the fuel gas.

Mayfield and Ingham filed a declaratory judgment action asserting EnerVest had been misconstruing the gas royalty provision in their leases, improperly deducting fuel gas as a post-production cost from their total royalties, and consequently, miscalculating their royalties. They sought reimbursement for all deductions EnerVest withheld and attorney's fees. In response, EnerVest filed a general denial and counterclaimed for attorney's fees. It then moved for summary judgment arguing the gas royalty provision in the leases expressly provided for gas royalty

payments calculated based on the "market value at the mouth of the well." According to EnerVest, this phrase required Mayfield and Ingham's royalties to bear their share of post-production costs as a matter of law, and therefore it was proper to deduct fuel gas from their royalties as a post-production cost.

Mayfield and Ingham filed a response, asserting the gas royalty provision did not expressly allow for expense deductions and their leases contained a free-use provision limiting what gas an operator could use free from cost. The free-use provision states:

> Lessee shall have free use of oil, gas, and water from said land, except water from lessor's wells and tanks, for all drilling operations hereunder, and the royalty shall be computed after deducting any so used.

Mayfield and Ingham argued this provision did not allow EnerVest the free use of fuel gas because it only allowed an operator the free use of gas for drilling operations on the premises. Mayfield and Ingham further argued EnerVest's predecessors-in-interest agreed with this interpretation and paid them royalty on fuel gas.

The trial court denied EnerVest's motion for summary judgment. EnerVest then moved for entry of a final judgment, asking the trial court to reconsider the lease interpretation question and to conclude Mayfield and Ingham are not entitled to royalty on fuel gas. The trial court ultimately entered a final judgment construing the free-use clause as limiting EnerVest's free use of gas to gas used in drilling operations on the premises. It ordered EnerVest to pay Mayfield and Ingham royalty on the fuel gas it had used, cease deducting fuel gas as a post-production cost, and pay attorney's fees. EnerVest now appeals.

ANALYSIS

Oil and Gas Lease Construction

An oil and gas lease is a contract, and how its provisions are interpretated is a question of law we review de novo. *BlueStone Nat. Res. II, LLC v. Randle*, 620 S.W.3d 380, 387 (Tex. 2021);

Endeavor Energy Res., L.P. v. Discovery Operating, Inc., 554 S.W.3d 586, 595 (Tex. 2018). When, as here, the parties agree an oil and gas lease is unambiguous, our primary task is "to ascertain the parties' true intentions as expressed in the writing." *BlueStone*, 620 S.W.3d at 387; *see Burlington Res. Oil & Gas Co. LP v. Tex. Crude Energy, LLC*, 573 S.W.3d 198, 203 (Tex. 2019); *Heritage Res., Inc. v. NationsBank*, 939 S.W.2d 118, 121 (Tex. 1996). We start with the contract's express language and "examine and consider the entire writing in an effort to harmonize and give effect to all the provisions of the contract so that none will be rendered meaningless." *Burlington*, 573 S.W.3d at 203 (quoting *Seagull Energy E & P, Inc. v. Eland Energy, Inc.*, 207 S.W.3d 342, 345 (Tex. 2006)) (internal quotation marks omitted). We "interpret the language" by "giv[ing] terms their plain, ordinary, and generally accepted meaning unless the instrument shows that the parties used them in a technical or different sense." *BlueStone*, 620 S.W.3d at 387; *Burlington*, 573 S.W.3d at 203 (quoting *Heritage*, 939 S.W.2d at 121) (internal quotation marks omitted).

Gas Royalty

The parties dispute whether royalty is owed on fuel gas. EnerVest contends it does not owe Mayfield and Ingham royalty on fuel gas under the plain terms of the leases. According to EnerVest, because the gas royalty provision in the leases contains the phrase "market value at the mouth of the well," Mayfield and Ingham must bear their share of post-production costs, and fuel gas is a post-production cost. Therefore, for Mayfield and Ingham to bear their share of post-production costs, it does not owe them royalty on fuel gas.

Mayfield and Ingham, however, argue EnerVest is improperly deducting fuel gas as a post-production cost from their royalty. They contend EnerVest owes them royalty on fuel gas because the gas royalty and free-use provisions in the leases do not allow EnerVest the free use of fuel gas. They further contend EnerVest's predecessors-in-interest paid them royalty on fuel gas.

1. Market Value at the Well

A royalty payment "represents a lessor's fractional share of production for a lease," and it "may be calculated at the wellhead or at any downstream point, depending on the lease terms." *BlueStone*, 620 S.W.3d at 387. Royalties on gas are typically free of production expenses, but they are "usually subject to post-production costs, including taxes, treatment costs to render it marketable, and transportation costs." *Heritage*, 939 S.W.2d at 122; *see Burlington*, 573 S.W.3d at 203 (explaining post-production costs applies to "processing, compression, transportation, and other costs expended to prepare raw oil or gas for sale at a downstream location."). This is because "[p]roducts on which post-production costs have been expended are generally more valuable than products straight out of the well." *Burlington*, 573 S.W.3d at 203. These general rules may be modified by the parties as they see fit. *BlueStone*, 620 S.W.3d at 387; *Burlington*, 573 S.W.3d at 203; *Heritage*, 939 S.W.2d at 122.

Royalty provisions specifying a "market value at the mouth of the well" calculation require the royalty holder to share in post-production costs. *Burlington*, 573 S.W.3d at 205; *Heritage*, 939 S.W.2d at 123. As explained by the Texas Supreme Court, the phrase "has a commonly accepted meaning in the oil and gas industry." *Heritage*, 939 S.W.2d at 122. "Market value is the price a willing seller obtains from a willing buyer." *Id.* When royalty is valued "at the well[,] but the sale takes place after the product has been processed and transported . . . the sales price must be adjusted to properly calculate the royalty payment." *Burlington*, 573 S.W.3d at 203 (citing *Heritage*, 939 S.W.2d at 122–23). This adjustment is made by "subtract[ing] the costs of bringing the product to market (the post-production costs) from the sale price obtained at the market." *Id.*; *see BlueStone*, 620 S.W.3d at 388–89 (stating when location for measuring market value is "at the well" or equivalent phrasing, market value is determined by subtracting post-production costs from proceeds of downstream sale).

Here, the gas royalty provision expressly provides for the calculation of royalties based on "the market value at the mouth of the well." The provision uses a phrase with a commonly accepted meaning in the oil and gas industry by identifying the location for measuring market value "at the well." *See BlueStone*, 620 S.W.3d at 387; *Heritage*, 939 S.W.2d at 122. Market value is therefore determined by subtracting post-production costs from downstream sale proceeds, and as a result, the royalty holder shares in post-production costs. *See BlueStone*, 620 S.W.3d at 388; *Burlington*, 573 S.W.3d at 205; *Heritage*, 939 S.W.2d at 123.

Mayfield and Ingham, however, contend there is nothing in the gas royalty provision requiring the deduction of post-production costs from their royalty. For support, they contrast the language used in the gas royalty provision from the language used in the oil royalty provision. They argue the oil royalty provision specifically states a lessor "shall bear its proportion of any expense for treating oil to make it marketable as crude," and the gas royalty provision's absence of this language means EnerVest should not deduct post-production costs to calculate their gas royalty. We decline to adopt this reasoning. It ignores the gas royalty provision's express language, the general rules governing gas royalty interpretation, and the commonly accepted meaning of certain oil and gas industry terminology. Texas courts have made clear gas royalties are not free from post-production costs, and "[w]hen the location for measuring market value is 'at the well,'" then market value is calculated by subtracting such costs from sale proceeds. *BlueStone*, 620 S.W.3d at 387. We therefore hold the gas royalty provision's "market value at the mouth of the well" language requires the deduction of post-production costs from Mayfield and Ingham's royalty calculation.

2. Fuel Gas as a Post-Production Cost

As explained above, post-production costs refer to the costs expended to make the product more valuable, and these costs include "processing, compression, transportation, and other costs

expended to prepare . . . gas for sale at a downstream location." *Burlington*, 573 S.W.3d at 203. The Fifth Circuit has recognized fuel gas is a processing cost because "it is all used to facilitate the production of the gas that is sold," and it "contributes to the material enhancement of the value of the gas sold." *Piney Woods Country Life Sch. v. Shell Oil Co*., 905 F.2d 840, 856–57 (5th Cir. 1990) (explaining none of the fuel survives to be marketed); *Atl. Richfield Co. v. Holbein*, 672 S.W.2d 507 (Tex. App.—Dallas 1984, writ. ref'd n.r.e.) (holding no royalty due for fuel gas volumes where industrywide practice was to deduct allocated volume for fuel gas before computing settlement owed in royalties). It further explained the costs of such fuel can simply be "deducted directly from the supply of gas to be sold," and thus, no royalty is owed on it. *Piney Woods*, 905 F.2d at 857. Accordingly, we further hold EnerVest does not owe Mayfield and Ingham royalties on fuel gas. *See id*.

3. The Effect of the Free-Use Provision

Mayfield and Ingham next argue the free-use provision in the leases limits the free use of gas to gas used only for drilling operations on the premises, and therefore, EnerVest owes them royalty on fuel gas taken off the premises. For support, they rely on *BlueStone Natural Resource II, LLC v. Randle*.

In general, a free-use provision "governs the right of a lessee to use products derived from the leased premises in the operation of said lease." *BlueStone*, 620 S.W.3d at 393. It essentially allows a lessee the free use of gas by excluding the gas from the lessor's royalty calculation. *Id*. Often, the right to freely use gas is limited to gas used on the premises, but the parties are free to contract otherwise. *Id.* at 393–94. "[W]hether a free-use clause is geographically unconstrained depends on whether the parties' lease expresses such an agreement." *Id*. at 394.

In *BlueStone*, the lessee operator claimed the free-use clause gave it the right to the free use of leasehold gas in off-lease operations, and therefore, it did not owe the royalty holder

royalties on such gas. *Id.* at 393. The Texas Supreme Court disagreed, reasoning the plain language of the free-use clause limited the operator's free use of gas to gas used on the leased premises, and the operator owed the royalty holder royalty for gas used in off-lease operations. *Id*. at 394–99. To reach this conclusion, the Court first recognized the royalty clause contained broad language requiring the operator to pay royalty for gas "sold or used off the premises or for the extraction of gasoline or other product therefrom." *Id*. at 394. The Court then analyzed the plain language of the free-use clause and determined the clause authorized the operator to the free use of gas, but its free use was limited to gas "produced from said land in all operations which lessee may conduct hereunder." *Id*. According to the Court, this language meant gas used on the leased premises and could not be reasonably construed to off-lease uses. *Id.* at 399.

In this case, the free-use clause provides EnerVest with the right to the free use of gas "for all drilling operations hereunder." Mayfield and Ingham argue this language limits EnerVest's free use of gas to gas used for drilling operations on the premises, and as a result, EnerVest owes them royalty on the fuel gas because it was not used for drilling operations and was used off the premises. However, this construction amounts to an isolated reading of the free-use clause and ignores the plain language in the gas royalty provision, which requires the determination of gas royalty by market value at the mouth of the well. *See Burlington*, 573 S.W.3d at 203.

In *BlueStone*, when determining the impact of the free-use clause on royalty, the Texas Supreme Court first recognized the lease's broad royalty provision did not require the operator to deduct post-production costs when calculating the royalty holder's royalty. 620 S.W.3d at 391–93; *see Carl v. Hilcorp Energy Co.*, No. 4:21-CV-02133, 2021 WL 5588036, *4 (S.D. Tex. Nov. 30, 2021) (pointing out lease in *BlueStone* was not subject to "market value at the well" language). Here, unlike the royalty provision in *BlueStone*, the gas royalty provision in this case requires Mayfield and Ingham to bear their share of the post-production costs by using the common,

industry phrase "market value at the mouth of the well." We must harmonize the gas royalty and free-use provisions and give meaning to the "at the well" industry language, which makes the gas royalty provision a "critical clause" in calculating gas royalty; we thus conclude *BlueStone* is not instructive. *See Heritage*, 939 S.W.2d at 121 (identifying gas royalty provision as critical clause"); *see also Carl*, 2021 WL 5588036, at *4–*5 (concluding *BlueStone* does not address "market value at the well" lease that allows for deduction of post-production costs and therefore, is not instructive). Accordingly, we conclude the free-use clause in this case does not alter the gas royalty provision's requirement for Mayfield and Ingham to bear their share of post-production costs.

4. Past Actions of Predecessors-in-Interest

Finally, Mayfield and Ingham argue EnerVest's predecessors-in-interest agreed with their interpretation of the gas royalty and free-use provisions and paid them royalty on fuel gas. EnerVest contends, however, their predecessors' prior conduct is not binding and does not alter the plain language of the lease provisions.

We reject Mayfield and Ingham's assertion because it would require us to interpret their leases based on past conduct, which would alter the plain language of the leases. When a lease is unambiguous, our review of its meaning is confined to the lease, and we must enforce it as written. *Sun Oil Co. (Delaware) v. Madeley*, 626 S.W.2d 726, 728 (1981). "In the face of an unambiguous lease, past conduct or promises do not give rise to estoppel." *Yzaguirre v. KCS Res., Inc.*, 47 S.W.3d 532, 541 (Tex. App.—Dallas 2000), *aff'd*, 53 S.W.3d 368 (Tex. 2001) (holding conduct of prior lessee who paid lessor greater royalties than they were entitled to under the terms of lease did not give rise to estoppel). Accordingly, the past conduct of EnerVest's predecessors-in-interest does not change our interpretation of the plain language of the leases. *See id*.

5. Conclusion

Having determined the plain language of the gas royalty provision requires Mayfield and Ingham to bear their share of post-production costs and not be paid royalty on fuel gas, we conclude the trial court erred in construing the free-use clause as requiring royalty on fuel gas, ordering EnerVest to reimburse Mayfield and Ingham royalty for the fuel gas used to date, and ordering EnerVest to cease charging for fuel gas as a cost of post-production.

ATTORNEY'S FEES

Finally, EnerVest challenges the trial court's award of attorney's fees to Mayfield and Ingham. EnerVest argues should we determine the trial court misconstrued the leases and conclude royalties are not owed on fuel gas, EnerVest requests we remand the issue of attorney's fees to the trial court for further consideration.

Here, the trial court awarded attorney's fees to Mayfield and Ingham under the Declaratory Judgments Act ("the Act"). The Act provides the trial court with discretion to "award costs and reasonable and necessary attorney's fees as are equitable and just." TEX. CIV. PRAC. & REM. CODE § 37.009. The award of attorney's fees is not guaranteed to a prevailing party, and a trial court may award fees to a non-prevailing party so long as such fees are equitable and just. *Teal Trading & Dev., LP v. Champee Springs Ranches Prop. Owners Ass'n*, 534 S.W.3d 558, 596 (Tex. App.—San Antonio 2017), aff'd, 593 S.W.3d 324 (Tex. 2020). Both "the Texas Supreme Court and this court have held that in the event of a substantive reversal, remanding the issue of attorney's fees awarded pursuant to section 37.009 is appropriate." *Id*. Accordingly, we agree with EnerVest, and because we have concluded the trial court erred in its judgment, we remand the issue of attorney's fees to the trial court for reconsideration. *See id.*

CONCLUSION

Based on the foregoing, we reverse the trial court's judgment and remand the case to the trial court for proceedings consistent with this opinion.

Luz Elena D. Chapa, Justice