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Is "Into the Pipeline" the Equivalent of a Wellhead Valuation? Not So Fast, Says Texas Supreme Court

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Last week, the Supreme Court of Texas provided key guidance on lease royalty provisions that call for royalty valuation at the pipeline. In *Nettye Engler Energy LP v. BlueStone Natural Resources II LLC*, No. 20-0639, the court carefully scrutinized lease language to hold that oil and gas operator BlueStone properly deducted post-production costs incurred downstream of a wellsite gas gathering system. Significantly, the court rejected the court of appeals' rigid application of its *Burlington Resources* holding, explaining that courts must consider and harmonize the entire writing, rather than relying on a key word or phrase. In sum, valuation at the "pipeline" does not necessarily mean "at the well."

The nonparticipating royalty interest clause at issue stated that the grantor should receive his fractional royalty "free of cost in the pipe line, if any, otherwise free of cost at the mouth of the well or mine." The parties agreed that the royalty should be calculated at a pipeline, but disagreed about which pipeline should set the valuation. BlueStone valued the gas royalty at the mouth of the wellsite gathering system, while the grantor urged valuation at the transmission pipeline or further downstream because a "gathering system" differed from a "pipeline." The grantor also argued that a pipeline valuation implies the royalty should be calculated when the gas transfers to a third party. The Fort Worth Court of Appeals rejected the grantor's arguments and held in BlueStone's favor. The appeals court largely relied on the supreme court's decision in *Burlington Resources Oil & Gas Co. v. Texas Crude Energy LLC.*, in which the court construed an "into the pipeline" provision as functionally the equivalent of a wellhead valuation.

While the supreme court affirmed the court of appeals' ruling, it rejected the lower court's application of *Burlington Resources*—that case, it explained, did not establish an "immutable construct" for interpreting pipeline-based royalty provisions. Pipeline-based royalty language is thus not always the equivalent of a wellhead valuation. Instead, courts must consider and harmonize the entire writing based on its plain meaning.

The court reviewed the lease, common industry usage, regulations, statutes, and case law to hold that a gathering system could serve as the valuation pipeline. Because the *Nettye* lease did "not specify any particular pipeline or any particular *type* of pipeline, as it could have," and a gathering system is a species of pipeline, valuation at the wellsite gathering system was appropriate. Parties may, of course, contract to value royalty at certain pipelines or types of pipelines by saying so.

Although both *Burlington Resources* and *Nettye* interpreted valuation "in the pipeline" as the practical equivalent of wellhead valuations, neither decision creates an absolute rule. Rather, all parties must analyze their peculiar lease provisions to ensure that royalties are calculated correctly. Parties should also use care to ensure that drafted provisions reflect the parties' true intent.

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