Disputes over natural gas royalty payments becoming more common

Posted Saturday, Apr. 20, 2013

BY JIM FUQUAY
jfquay@star-telegram.com

Charles and Robert Warren didn't know quite what to think when the sales prices for natural gas listed on their Chesapeake Energy royalty statements were far less than prices listed by XTO Energy on statements for production on another property.

"At first, the difference was small," said Charles Warren, a Dallas attorney, referring to checks sent by the producers for natural gas wells drilled separately on hundreds of acres in Johnson County. But the disparity grew and grew until "it was not a small amount," with the difference in total payments amounting to a six-figure amount, he said.

In August 2011, Chesapeake had sent letters to royalty owners in the Barnett Shale explaining that the company would begin deducting "post-production costs" from the natural gas sales prices used to calculate royalty payments. At the time, the company said royalty owners whose leases prohibited those charges -- which represent the expense of gathering, compressing and treating gas so it can be sold -- would not see the costs deducted.

The Warrens' lease prohibits such charges, but Chesapeake began deducting the costs anyway, according to a lawsuit filed last year by the Warrens and another Johnson County couple. Post-production costs can amount to roughly 80 cents to $1 per 1,000 cubic feet (mcf) -- a big slice when gas prices dip below $2 an mcf, as they did last year.

By March 2012, the Warrens were receiving as little as 42.4 cents per 1,000 cubic feet (mcf) for the gas produced from the eight wells on the Chesapeake leases, court documents show.

Their lawsuit is one of a number of disputes being waged over the size of royalty payments, including another lawsuit filed in March by large southern Tarrant County landowners, including Fort Worth investor Ed Bass and the Trinity Valley School. Bloomberg News reported last year that Chesapeake faced at least eight lawsuits in five states alleging underpayment of royalties. And last year, Chesapeake settled litigation with Dallas/Fort Worth Airport, agreeing to pay the airport $5.3 million in additional royalties to settle claims that the airport was underpaid.

But the Warrens' suit is different in one significant measure: It seeks class action status, a rarity for a Texas oil and gas royalty dispute. The matter is now before U.S. District Judge Barbara Lynn in Dallas.

Julie Wilson, Chesapeake's top officer in the Barnett Shale, declined to address the Warrens' suit, citing the pending litigation.

But, she said, "Chesapeake representatives are working cooperatively and collaboratively with representatives of the Bass family and other plaintiffs ... to review and amicably resolve these issues."

Chesapeake is the second-largest producer in the Barnett Shale and easily the largest in Tarrant County.

Disagreements between producers and mineral rights owners are fairly common, experts say. But the sharp decline in natural gas prices seen since 2008, bottoming out at a 10-year low at about $1.90 per mcf in April 2012, sent producers scrambling to hang on to narrowing profit margins, leaving royalty owners to scrutinize their statements.

"When prices are high, the companies are less worried about costs," said John McFarland, an Austin oil and gas attorney who has represented landowners in royalty cases. For example, he said, Chesapeake's 2011 letter to royalty owners pointed out that the company hadn't previously been deducting costs that it was contractually allowed to take.

"That indicates they were becoming more cost-conscious," McFarland said.

Once a dispute arises, however, it generally takes a large landowner with enough revenue at stake to justify what can be expensive legal action. For example, the attorney representing Ed Bass and other landowners said when that lawsuit was filed that he expected to seek millions in underpayments.

**Seeking answers**

It doesn't necessarily take a lawsuit to get an energy company to respond to a problem on royalties. More often, it just takes making inquiries, consultants say.
"If you're looking to reconcile royalty errors on your own, first follow the company's owner relations system to a 'T,'" said Davis Powell, co-founder of ShaleTrak, a Louisiana royalties management service for landowners. That probably means starting with a letter stating your concerns, he said.

"If they don't respond, do it again," Powell said. "If you do it the right way, the professional way, they will pay attention."

Debbie Moore, president of a neighborhood association in southwest Arlington, got results when she questioned the prices reported by Chesapeake on royalty statements to her and other residents last year. It took several calls and letters, Moore said, but homeowners in the Willow Bend/Thousand Oaks area just south of Interstate 20 recently started receiving adjusted royalty checks that more than doubled their payments for production in 2012.

The neighborhood's lease included a particularly strong clause prohibiting cost deductions, the result of advice from another neighborhood group during the leasing process in 2008, Moore said.

Making inquiries can also lead to unwelcome news, as Paul Weide learned earlier this year. When the Fort Worth resident questioned the unusually low prices on royalty statements from Chesapeake, he learned that his lease on a home in the TCU area said nothing about whether the producer could deduct post-production costs.

In that case, silence was hardly golden.

"Texas law is that normally, the [parties] share the burden of getting the gas to a marketable condition," said Bob O'Boyle, a Dallas attorney with Strasburger & Price who is representing the Johnson County landowners. That's why knowledgeable landowners, including his clients, signed leases with specific language prohibiting the deductions, he said.

In Weide's case, the cost deductions consumed nearly all his sales price. In May 2012, Weide's royalty was based on prices as low as 29 cents per mcf, according to his royalty stub from Chesapeake.

He still doesn't think the costs are correct, even if they are allowed. As with the Warrens, his royalty stubs don't itemize the deductions.

Instead, the costs are included in what the company reports as its sales price for the gas.

Weide called it "another gross example" of the gap between what homeowners know and what a producer knows about mineral rights leases, sales prices and allowable costs.

"Most people have no idea" what's at stake, Weide said.

Last month, he wrote to Fort Worth Mayor Betsy Price suggesting the city double-check its royalties. A city spokesman told the Star-Telegram that the city is doing preliminary research into the issue.

Weide is also exploring whether the amount of production listed on his royalty stubs is correct, since Texas Railroad Commission data reports more production from one of the three wells in his group's lease than Chesapeake is reporting. Moore said that's also the case with her neighborhood's reported production, and she is seeking additional information.

Class action sought

O'Boyle said his firm's research shows that "the same language" in his clients' lease prohibiting post-production costs "shows up in hundreds of leases in Johnson and Tarrant counties."

"That was the market at the time, no costs" he said of 2006, when the Warrens' signed a lease with Four Sevens Oil Co., which later sold the lease to Chesapeake.

Class action lawsuits on royalty issues in Texas are rare. McFarland, the Austin lawyer, said he couldn't think of one that has reached the courts.

"The problem is that generally it's not the same language. Therefore, you can't bring a class action," he said.

In its response to the Warrens' lawsuit, Chesapeake asked Judge Lynn to dismiss the claim, saying the lease allows the cost deductions. The company's November filing cites a number of precedents for its position, including a 1996 Texas Supreme Court decision called Heritage Resources vs. NationsBank. That ruling found that some deductions are allowed even if one clause in the lease prohibits them, depending on what other lease terms say about how the value of the gas or oil will be set.

O'Boyle said it's up to Lynn to decide which interpretation applies.

"All you've got to do is look at two sentences in every lease and tell us what it means," O'Boyle said of Lynn's role. He expects that step to take another month or two.

Jim Fuquay, 817-390-7552

Twitter: @jimfuquay