

NEGATIVE PRICES & ROYALTY CALCULATIONS

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CHAPTER 3



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- Member of five-person executive committee: *In re Johnson & Johnson Talcum Powder Products Marketing, Sales Practices and Products Liability Litigation*, Case No. 3:16-md-2738 (D.N.J.). Representing thousands of women alleging that talcum powder products cause ovarian and uterine cancer.
- Co-liaison counsel: *In re: Chesapeake Barnett Royalty Litigation #2*, MDL No. 48-000000-15 (48th District Court, Tarrant County, Texas). Representing royalty and mineral owners in mass action against operator for royalty underpayments.
- Co-lead counsel: *In re: Asbestos, Catalyst, and Silica Toxic Dust Exposure Litigation*, Master Docket No. SX-15-CV-096 (U.S.V.I. Sup. Ct.). Representing several hundred individual workers exposed to asbestos while working in a refinery on St. Croix, U.S.V.I.
- Co-lead counsel: *In re: Crude Oil Commodity Futures Litigation*, Case No. 1:11-cv-3600 (S.D.N.Y.). Represented thousands of investors who lost money after rogue trading companies manipulated the market for crude oil. Burns Charest settled the case in 2015 and are administering the settlement.

DANIEL CHAREST

Daniel Charest developed his trial-lawyer skills at a nationally-recognized litigation firm, Susman Godfrey, where he became a partner, tried cases, and ran his clients' cases. Over the years, he has developed an effective, efficient approach to lawyering that focuses on his client's needs and achieving their desired outcome. He established Burns Charest LLP in early 2015 to build a trial-ready firm that focuses on complex, commercial litigation with skills, smarts, and hard work.

While his interest and experience, including past trials and multiple, existing matters reflects a significant focus in oil and gas matters. For example, Mr. Charest has handled high-profile litigation on behalf of landowners in mineral rights cases against energy corporations in many of the nation's major oil & gas regions. But Mr. Charest's body of work reaches beyond any particular practice area. He has run cases involving antitrust, breach of contract, oil & gas, financial-service companies, business torts, such trade secret misappropriation and unfair competition, consumer protection, class actions, fraud, insurance bad faith, and wrongful death. His work has taken place across the United States, in both federal and state courts. Mr. Charest's docket has involved procedural and jurisdictional challenges such as removal and remand, class certification, transfers, temporary restraining orders, temporary injunctions, and appeals. In all, the body of work is, simply, high-stakes commercial litigation.

Mr. Charest clerked for Judge Edith Brown Clement on the Fifth Circuit Court of Appeals. And he is admitted to practice in the District of Columbia., Texas, Virginia, and the U.S. Virgin Islands, as well as numerous federal districts and appellate courts across the country.

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NEGATIVE PRICES AND ROYALTY CALCULATIONS

I. INTRODUCTION

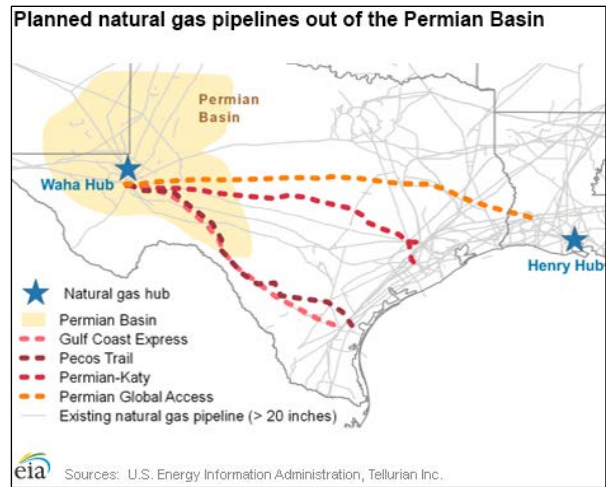
The shale boom has created, in circumstances, conditions of depressed gas prices that have yielded negative valuations for natural gas at the wellhead and, less frequently, at the hub. Neither the lessor nor the lessee want negative prices. But disagreements may arise about which party should pay to sell gas. The tension further increases if negative valuations result from imprudent marketing (or simply self-dealing) rather than a “cost of business” necessary to realize profitable oil production.

II. MARKET FORCES AND NEGATIVE PRICES

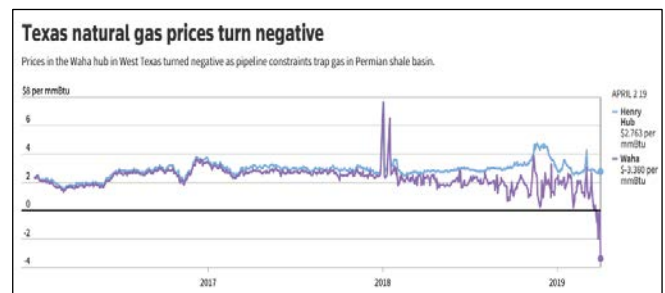
The shale boom has unlocked an abundance of resources and shifted the epicenter of oil and gas production. Indeed, the United States now stands as the world’s largest oil and gas producer of both oil and natural gas.¹ But the introduction of unprecedented (and growing) oil and gas production has not arrived without some casualties. While the price for oil has receded from past heights, natural gas prices have dramatically declined over the last decade.

In gas-centered plays like the Haynesville Shale, and, generally, Appalachia, the abundance of natural gas has driven down the commodity price significantly, to the point at which less-efficient marketers may find that the costs of bringing the gas to market begin to approach the price that can be obtained for it downstream.² In those plays, producers have an ability to slow production in response, providing at least some counterweight to a low-gas-price environment.

In contrast, production from the Permian Basin typically generates a combination of oil and natural gas in the same production stream. Unlike pure-gas plays, natural gas often flows in the Permian Basin as a byproduct to oil production because operators must produce the combined stream in order to capitalize on the primary value driver—oil. Because Permian oil production requires the production of gas, the increase in Permian Basin oil production has resulted in perverse conditions for the local natural gas market.



Gas produced from the Permian Basin is processed and sold at the Waha market hub. From Waha, pipelines take natural gas to further markets, like Cushing in Oklahoma or Henry Hub in Louisiana, and onward to the point of consumption. But, as the Permian Basin’s oil production has risen, the takeaway capacity from Waha for the natural gas produced as a result has failed to keep pace. The inability to connect markets has generated “a record-high spread between the Waha gas hub price and the U.S. benchmark Henry Hub in Louisiana.”³



The local gas pricing imbalance in the Permian Basin caused natural gas prices to fall below zero at the Waha hub in 2019.⁴ This negative local price environment effectively leaves operators with three options: (1) shut-in a profitable oil well; (2) flare unwanted gas; or (3) “sell” gas at negative prices. Operators find it difficult to justify shutting in profitable oil wells: “Surging volumes of natural gas have become a kind of a side product that drillers prefer to burn off instead of shutting

¹ U.S. ENERGY INFO. ADMIN., *The U.S. leads global petroleum and natural gas production with record growth in 2018* (Aug. 20, 2019), <https://www.eia.gov/todayinenergy/detail.php?id=40973>.

² See, e.g., Laura Legere, *Landowners Seek to Turn Off Wells When Royalty Checks Disappear*, PITT. POST-GAZETTE (Apr. 23, 2017), <https://www.post-gazette.com/business/powersource/2017/04/24/natural-gas-royalty-deduction-lease-expire-Pennsylvania-Chesapeake/stories/201704230084>.

³ Tsvetana Paraskova, *Texas Natural Gas Prices Plunge To All-Time Low*, OILPRICE.COM (Apr. 3, 2019), <https://oilprice.com/Energy/Gas-Prices/Texas-Natural-Gas-Prices-Plunge-To-All-Time-Low.html>.

⁴ Scott DiSavino, *U.S. Natural Gas Prices Turn Negative in Texas Permian Shale Again*, REUTERS (May 22, 2019), <https://www.reuters.com/article/us-usa-natgas-waha-negative/u-s-natural-gas-prices-turn-negative-in-texas-permian-shale-again-idUSKCN1SS1GC>.

in wells and missing out on monetizing the oil production gushing out in the Permian.”⁵ Flaring faces financial, political, and regulatory challenges but remains a common practice.⁶

Faced with these options, operators may elect to sell gas at the depressed, negative Waha prices, effectively paying a third-party to take the gas off their hands. For those producers selling gas at unprecedented rates, the calculation of royalties presents some unanswered questions. How are royalties calculated when gas sells at the market hub for a negative value? How are royalties calculated when post-production costs render the lessor’s royalty negative, even when the market price remains above zero? What implications do periodic imbalances have on an operator’s duty to operate in a reasonably prudent manner? This paper examines these questions and attempts to analyze the legal consequences of a “negative royalty” in Texas.

III. TEXAS ROYALTY PAYMENTS

In Texas, an oil and gas “[r]oyalty is commonly defined as the landowner’s share of production, free of expenses of production.” *Heritage Res., Inc. v. NationsBank*, 939 S.W.2d 118, 121–22 (Tex. 1996). Production costs normally encompass costs expended in the exploration and actual bringing of hydrocarbons to the surface. Conversely, unless otherwise stated in the oil and gas lease, a lessor bears reasonable costs incurred after the production of oil and gas. *Id.* at 122.⁷ Royalty payments typically derive from a “market value” or “proceeds” royalty clause. In either case, depressed—or negative—rates for natural gas can affect the overall royalty calculation.

If the oil and gas lease contains a “market value” royalty clause, the amount of royalties owed to the lessor is derived from the “fair market value” of the gas as of the date of production. *Texas Oil and Gas Corp. v. Vela*, 429 S.W.2d 866, 871 (Tex. 1968). Texas courts define market value as “the price a willing seller obtains from a willing buyer” and have endorsed two methods to determine the market value at the well. *Heritage Res.*, 939 S.W.2d at 122 (citing *Exxon Corp. v. Middleton*, 613 S.W. 2d 240, 246 (Tex. 1981)). First, and most desirable, fair market value is measured by reference to sales that are “comparable in time, quality, quantity, and availability of marketing outlets.” *Id.* The second method, utilized in court only when comparable sales information is unavailable, is known as the net-back method. *Id.* The net-back method “involves subtracting

reasonable post-production marketing costs from the market value at the point of sale” to determine the market value at the well. *Id.* In practice, operators determine market value almost exclusively through use of the net-back method due to the practical inconvenience of basing market-value royalties on comparable sales analyses.

On the other hand, for a “proceeds” royalty provision, the lessor’s royalty is “calculated on what the lessee actually receives for the oil and gas.” *Yzaguirre v. KCS Res., Inc.*, 47 S.W.3d 532, 539 (Tex. App.—Dallas), *aff’d*, 53 S.W.3d 368 (Tex. 2001). The most common form of proceeds lease requires the calculation of proceeds “at the well” and is performed by determining the total proceeds at the point of sale and subtracting from those proceeds, the costs (i.e., post-production costs) attributable to the sale.

“[T]o protect a lessor from the lessee’s self-dealing or negligence” in the context of a proceeds lease, the Texas Supreme Court has held that Texas law imposes an “implied covenant to reasonably market oil and gas.” *Yzaguirre*, 53 S.W.3d at 374. As a result of this implied covenant, “a lessee under a proceeds lease has ‘an obligation to obtain the best current price reasonably available.’” *Union Pac. Res. Grp., Inc. v. Hankins*, 111 S.W.3d 69, 72 (Tex. 2003) (quoting *Yzaguirre*, 53 S.W.3d at 374).

The duty to market reasonably includes the “twin” duties of “marketing production with due diligence and obtaining the best price reasonably possible.” *TransAmerican Nat. Gas Corp. v. Finkelstein*, 933 S.W.2d 591, 596 (Tex. App.—San Antonio 1996, writ denied). “The standard of care is that of a reasonably prudent operator under the same or similar circumstances.” *Id.* (citing *Amoco Prod. Co. v. Alexander*, 622 S.W.2d 563, 568 (Tex. 1981)). While the implied duty to market typically focuses retrospectively on the lessee’s actions, the Texas Supreme Court recognizes that market value information, nevertheless, may weigh on the reasonableness of the lessees’ performance as operator: “[I]n a proper factual setting, failure to sell at market value may be relevant evidence of a breach of the covenant to market in good faith.” *Amoco Prod. Co. v. First Baptist Church of Pyote*, 611 S.W.2d 610, 610 (Tex. 1980). Under these authorities, market value—whether high, low, or negative—can serve as a relevant consideration for both “market value” or “proceeds” royalty clauses.

⁵ Paraskova, *supra*, note 3.

⁶ Rebecca Elliott, *In America’s Hottest Drilling Spot, Gas Is Going Up in Smoke*, WALL ST. J. (Aug. 29, 2018), <https://www.wsj.com/articles/in-americas-hottest-drilling-spot-vast-volumes-of-gas-go-up-in-smoke-1535535001> (“‘There’s nothing for us to do,’ said Ryan Sitton, a member of the Texas Railroad Commission, which regulates oil and

gas operations. ‘If gas becomes a waste product, people will flare it.’”).

⁷ Post-production costs are those costs necessary to render the gas marketable, including taxes, compression costs, certain transportation costs, dehydration costs, and treatment costs to render the gas marketable. *See Heritage Res.*, 939 S.W.2d at 122.

IV. NEGATIVE ROYALTY: MARKET VALUE AND PROCEEDS-TYPE LEASES

As noted above, the standard for measuring whether a royalty payment is “correct” depends on the type of lease (i.e., market value or proceeds).

Market value royalty provisions raise the fundamental question of whether gas can have a negative value “at the well.” On the one hand, operators may correctly claim that a negative price is indeed the “price” of gas at the well that is then-prevailing in the market. On the other hand, the lessor no doubt will argue—with some merit—that a seller who is under no compulsion to sell would not do so for a negative price, and will wonder how it is that their gas could ever be worth less than “free.”

Proceeds leases, in contrast, require an analysis of the operators’ conduct in order to determine whether the negative royalty payment is proper. Although comparison to other prices in the market may be informative, the primary focus is whether the operator has met the reasonably prudent operator standard discussed above.

V. NEGATIVE ROYALTY: THE REASONABLY PRUDENT OPERATOR STANDARD

Whether generally with the advent of depressed prices or in recent, market-specific events in the Permian Basin, traditional royalty calculation methods, i.e., net-back method of calculation of net proceeds, can result in a negative value for gas royalties.

Selling gas at a negative hub price, such as has happened twice in 2019 at Waha, results in producers facing the unusual situation of paying the counterparty to take gas and quite obviously will lead to a negative royalty price on a standard lease. But even where the price of gas is positive at the downstream hub, traditional royalty calculations might, nevertheless, yield a negative royalty value at the wellhead if the

downstream prices are not sufficiently high enough to overcome the operator’s post-production costs. In that case, the “netting back” of post-production costs (whether in determining market value or calculating net proceeds at the well) will result in a negative value of gas “at the well.”

In either case, such a producer would likely have determined that it must rid itself of gas and it is more profitable to pay a purchaser to purchase the gas in order to continue producing oil.⁸

Even if the negative price represents “the best price reasonably possible” and, thereby satisfies one aspect of the duty to market, the duty also requires the lessee to “marketing production with due diligence.” *TransAmerican*, 933 S.W.2d at 596. If a reasonably prudent operator would flare (or reinject or otherwise store) the unvalued natural gas, the sale at a negative price would run afoul of the lessee’s duty to market with due diligence because the cost (and loss of value) would have been incurred in the face of other, viable options. If, on the other hand, the operator lacked choices, such that a reasonably prudent operator would pay someone to take the gas, the sale of natural gas at a loss might be considered a cost.⁹ And, if the negative price of gas could be considered a post-production cost associated with the production of oil, operators will seek to impose the lessor’s share of that cost onto the lessor’s royalty.

The calculus changes significantly when the lessee pays an affiliate more than the value of the gas to market the gas. In that case, the lessee may have been acting in its own interests (generating profit for its affiliates and/or its parent company) at the expense of the lessor.¹⁰ Lessors whose gas is produced and sold to the lessee’s affiliate at a negative price should thoroughly investigate the wellhead valuations and prices paid by other operators in the field.¹¹

⁸ As noted, this scenario occurs in the context of an oil well that produces gas in the same stream. If the well were primarily producing natural gas, negative prices may call into doubt whether the well was producing in paying quantities during the market imbalance. *See generally Clifton v. Koontz*, 325 S.W.2d 684 (Tex. 1959) (articulating the question as “[w]hether or not, under the relevant circumstances, a reasonable prudent operator would, for the purpose of making a profit and not merely for speculation, continue to operate a well in a manner in which the well in question was operated.”).

⁹ It is an open question as to whether that cost would be considered a post-production cost (and therefore chargeable against the royalty under most leases), or a production cost (which must be borne by the operator). If the sale of the gas from a production stream at a negative price was deemed to be necessary to allow continued production and sale of the more-valuable oil from that same stream, one might argue the cost resulting from the sale of gas at a negative price

constituted a cost of production to be borne by the lessee completely. *See French v. Occidental Permian Ltd.*, 440 S.W.3d 1, 9–10 (Tex. 2014) (drawing the distinction of production-related costs based on whether the activity “is necessary” to the production of oil).

¹⁰ Even if the decision made stems from a global perspective, the operative question is whether the lessee acted as a reasonably prudent operator of the one lease in question without regard to other relationships and/or other leases it might hold. *Amoco Prod. Co. v. Alexander*, 622 S.W.2d 563, 570 (Tex. 1981) (rejecting a field-wide rationale for operations because “Amoco owed the Alexanders the duty to do whatever a reasonably prudent operator would do if the Alexanders were its only lessor in the field.”).

¹¹ Lessors can perform a rough investigation by comparing the prices received from different operators (if the lessor has more than one tract under lease); reviewing severance tax records; hiring an independent consultant to audit their royalties, or by simply talking to their friends and neighbors in the area.

VI. RECOUPMENT, SETOFF, AND THE VOLUNTARY PAYMENT RULE

The common law doctrine of recoupment has been proffered as a basis for applying negative royalties to reduce a lessor's royalty payments. And the voluntary payment rule has been applied to prevent lessees from seeking to reclaim excessive past royalty payments. Evaluation of the applicability of these concepts to the royalty context requires an understanding of the similarities and differences among the doctrines.

A. Recoupment

Recoupment "is an equitable doctrine designed to 'determine a just liability on the plaintiff's claim.'" *Matter of Holford*, 896 F.2d 176, 179 (5th Cir. 1990) (quoting *In re Clowards, Inc.*, 42 B.R. 627, 628 (Bankr. D. Idaho 1984)). In Texas, courts limit the application of recoupment to a defensive matter:

[T]he supreme court has confined recoupment to the very narrow situation in which the claim for recoupment is "predicated on a factor which would vitiate a contract either in whole or in part as of the time the contract was made." Recoupment has thus been interpreted as a defensive doctrine, dependent upon the assertion of a contract cause of action by a plaintiff, and "available only to reduce or satisfy [a] plaintiffs' claim."

Bray v. Bray, No. 04-98-00633-CV, 1999 WL 391874, at *1 (Tex. App.—San Antonio June 16, 1999, pet. denied) (internal quotations and citations omitted). Recoupment requires that both "(1) some type of overpayment must have been made, and (2) both the creditor's claim and the amount owed to the debtor must arise from a single transaction." *Sommers v. Concepcion*, 20 S.W.3d 27, 34 (Tex. App.—Houston [14th Dist.] 2000, pet. denied) (emphasis added) (citing *In re Malinowski*, 156 F.3d 131, 133 (2d Cir. 1998)). "The typical recoupment situation involves a credit and debit arising out of a transaction for the same goods or services." *Id.*

B. Setoff

Texas law also allows for the similar but distinct equitable claim of setoff. Setoff "allows entities that owe each other money to apply their debts to each other." *Sommers*, 20 S.W.3d at 35. Setoff is only proper "where the demands are mutual, between the same parties, and in the same capacity or right." *Brook Mays Organ Co., Inc. v. Sondock*, 551 S.W.2d 160, 166 (Tex. App.—Beaumont 1977, writ ref'd n.r.e.). "Where setoff is allowed, there are mutual debts arising from different transactions, which contrasts with the single transaction required in recoupment." *Sommers*, 20 S.W.3d at 35 (emphasis added).

C. Voluntary Payment Rule

"[M]oney voluntarily paid on a claim of right, with full knowledge of all the facts, in the absence of fraud, deception, duress, or compulsion, cannot be recovered back merely because the party at the time of payment was ignorant of or mistook the law as to his liability." *Samson Expl., LLC v. T.S. Reed Props., Inc.*, 521 S.W.3d 766, 779 (Tex. 2017) (quoting *BMG Direct Mktg., Inc. v. Peake*, 178 S.W.3d 763, 768 (Tex. 2005)). The voluntary payment rule can bar a lessee from seeking to recover royalties it later asserts were overpaid. *Id.* A lessee can avoid the impact of the voluntary payment rule with a showing that the royalty payment was made as a result of fraud, duress, or other compulsion.

VII. NEGATIVE ROYALTY: RECOUPMENT AND SETOFF

Because of the voluntary payment rule, payors who issue royalty checks in the ordinary course and do not reduce total (that is, gas + oil) royalty payments for the negative royalty associated with produced gas may not be able to recover the negative royalties in the future if it would otherwise be allowable to do so. Accordingly, most operators that later charge or account for negative royalties would prefer to share the loss up front rather than seek reimbursement later. And, as they control the revenue process, very little exists to stop those operators' exercise of self-help. Indeed, "payors routinely recoup royalty overpayments through unilateral 'adjustments,' 'off-sets,' 'revenue rebooking,' or otherwise withholding or debiting a payee's future royalties until the overpaid amounts are collected." Douglas R. Hafer and Daniel B. Mathis, *Mineral Royalty Mispayments: The Payor's Rights, Obligations, and Risks in Royalty Mispayment Scenarios, Including the Pitfalls and Prerogative of Self-Help Recoupment*, 18 TEX. WESLEYAN L. REV. 85, 98 (2011) [hereinafter *Mineral Royalty Mispayments*]. But the ability and willingness to dock a royalty payment does not mean a legal basis exists for these actions. Assuming the right to charge for a negative royalty, this section evaluates the legal method to do so.

As discussed above, "setoff" is a demand, arising out of a transaction extrinsic to the cause of action, which the debtor has against the creditor seeking to enforce a debt. And, by contrast, "recoupment" is a reduction or rebate by the debtor of part of the creditor's claim because of the debtor's right arising out of the same transaction. The distinction matters.

For single-lease transactions, recoupment appears to be the only viable doctrine for a lessee to claim any portion of the negative royalty against other, more profitable aspects of production. *See generally id.* at 106 ("Even if modern Texas courts interpret the doctrine of recoupment narrowly, it would seem that if a payor asserted overpayment of royalties as a defense to a claim

for underpaid royalties, such defense would fit even a narrow rule.”). A strict application of recoupment’s “single transaction” and/or “same goods or services” construct limits the ability to recoup to a single-month’s royalty payment. To do so, the costs associated with a negative royalty on gas would have to be subtracted from the royalties from oil from the same month of production. As applied to the royalty context, recoupment would provide a narrow window for the lessee.

On the other hand, setoff may be an appropriate vehicle for a lessee desiring to deduct a negative royalty on one lease against the royalty owed on a separate and distinct lease from which the negative royalty occurred. *See Graham*, 882 S.W.2d at 899 (citing BLACK’S LAW DICTIONARY at 1147); *see also Mineral Royalty Mispayments*, 18 TEX. WESLEYAN L. REV. at 107 (“[s]etoff would be available and useful in royalty recoupment cases if the payor has recouped overpaid royalties from wells subject to different leases.”) (emphasis added). Even with the broader range, setoff’s mutuality requirement remains a limiting factor. *See Brook*, 551 S.W.2d at 166. Accordingly, setoff appears applicable amongst two separate oil and gas leases that are between identical parties which act in the same capacity under both leases. *See id.* It could also be argued that setoff might justify single-lease adjustments for different production months, i.e., the opposite in timing from recoupment.

In *Bright & Co. v. Holbein Family Mineral Trust*, the lessee withheld a lessor’s royalties after discovering erroneous overpayments. 995 S.W.2d 742, 744 (Tex. App.—San Antonio 1999, pet. denied). The lessor noticed he was no longer receiving royalties, demanded payment, and filed suit. *Id.* The lessee pled setoff as a counterclaim and as an affirmative defense. *Id.* at 746-47. However, the court determined that setoff could not serve as an affirmative defense because the earlier overpayments failed to negate the lessor’s later claim for nonpayment of royalties. *Id.* If anything, the assertions of prior overpayments amounted to a counterclaim rather than an affirmative defense. *Id.* But the court found the statute of limitations barred the lessee’s counterclaim, affirming the judgment in favor of the lessor for unpaid royalties plus interest. *Bright*, 995 S.W.2d. at 747.

Accordingly, in litigation, lessees should analyze the viability of its claim of recoupment or setoff, including the ability to timely and adequately assert the doctrines as counterclaims and/or affirmative defenses before withholding payments for past negative royalties. For their part, Lessors should strongly consider whether

the voluntary payment rule applies in opposition to either claim.

VIII. NEGATIVE ROYALTY: OPERATOR “SELF-HELP”

The operator’s typical, and likely preferred, course of action is to withhold the value of negative royalties in real time (or as real time as revenue checks can be). This constitutes self-help and, as such, can give rise to a new set of issues. A lessee may have a right to assert recoupment and/or offset in defense of a claim by the lessor. But a potential assertion of recoupment or setoff fails to provide an absolute right to withhold future payments. Indeed, “it is unclear whether or not self-help is permissible in Texas.” Paul Benavides and M.C. Cottingham “Cottie” Miles, *Royalty Overpayments and Underpayments - Who Pays the Price?*, STATE BAR OF TEXAS 35TH ANNUAL ADVANCED OIL, GAS & ENERGY RES., at 13.

Beyond the might-makes-right approach, operators who want guidance from the law in the area of self-help should be sure to hold only those funds related to the same lessor.¹² If an operator exercises self-help such that the lessor files suit to recover the withheld funds that were due but for the offset amount, the operator would have the ability to counterclaim for the overpayments—even beyond the limitations period. That reality emboldens the use of self-help in a practical sense.

Relations between lessees and lessors should also be taken into consideration when determining whether recouping and/or offsetting negative gas against positive royalties is a viable option. Therefore, maintaining honest and professional practices when recouping or offsetting negative royalties acts in the best interest of both the lessor and lessee.

IX. NEGATIVE ROYALTY: A LESSOR’S OPTIONS

Many lessors’ first indication that they are in a “negative royalty” environment comes when they receive a royalty “check” from the operator showing a negative amount for that month’s gas “payment.” Not surprisingly, many lessors will wonder how it is that they find themselves effectively paying someone else to take their gas from them. In evaluating a potential claim, lessors (or their counsel) should first consider and answer the following questions:

- (1) Is the well in question producing primarily oil or gas?
- (2) What is the reported wellhead value or royalty price received for gas produced from

¹² Anecdotally, at least one operator has drawn from funds associated with different wells and even different entities beneficially owned by the same individuals as self-help!

neighboring wells? How does it compare to the price given on the lessor's royalty statement?

- (3) To whom does the lessee/operator sell the gas once it is produced? As noted above, if the buyer is an affiliate of the lessee, a deeper investigation could be warranted.
- (4) What is known about the lessee's marketing arrangements? Is the lessee receiving a negative price for gas even in the face of prudent, efficient marketing costs? Or, alternatively, are the negative prices themselves really just the result of imprudent, inefficient marketing decisions amplified by a low, but positive, price environment.
- (5) What are the mechanics of the negative royalty? Is the operator passing through the negative price in "real-time"? Or, alternatively, is the operator exercising self-help through adjustments or "rebookings" months after the fact?

X. CONCLUSION

The shale boom created conditions of depressed gas prices that can yield negative valuations for natural gas sometimes at the wellhead and, less frequently, at the hub. Although neither the lessor nor the lessee are pleased with negative prices, tension can arise between the two when and if the negative valuations are suspected to be the result of imprudent marketing (or simply self-dealing), as opposed to a necessary "cost of business" that must be accepted in order to realize higher and more profitable oil production.