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"Update on Oil & Gas Royalties Litigation-Key Valuation Issues"

Executive Summary

Issue: *When oil and gas prices are lower than expected, royalties go down. This is often when litigation picks up. But the real issue has to do with a lack of clarity in the text of royalty and lease documents. And this issue boils down to the valuation point, the physical location where the commodity or products are measured.*

Challenge*: The Courts have produced a hodgepodge of rulings that tend to be specific to individual cases. Cash is king, so if you can get to the actual, observable movements of cash through the value chain, then the value can be allocated properly. It would be even better if lease and royalty documents were drafted more carefully!*

Solution: *Map and model the actual cash flows penny by penny the same way that supply chain professionals map and model each step. Oil and gas production is a supply chain that ends up in a place where the commodity is changed into something that is useful, like fuel, rubber, or natural gas that is dry and safe to burn in a power plant. And let us keep our eyes on a critical case before the Texas Supreme Court-* ***BlueStone v. Randle.***

Royalties disputes and litigation are as old as royalties themselves, but they do ebb and flow with commodity prices. Higher prices tend to mean that royalty owners are happy, and often do not scrub their royalty statements carefully. Lower prices lead to a closer look, and that's when the arguments begin.

What continues to be contentious here in Texas involves the text of how royalties are calculated and paid.[1]

- What are the gross profits?
- What is the market "at the well" valuation?
- What are the production costs?
- What does it mean to make oil or natural gas "marketable"?

It is true that oil and gas production involves complexities that other businesses do not have, and the gathering, processing, transportation, and marketing processes and costs can be opaque. However, as a former treasury professional with two Fortune 100 energy companies, I can articulate that cash does not lie. If the royalty and lease agreements are written better, to be very clear about how each and every movement of cash is calculated and accounted for, then there will be fewer disputes.

There are many royalty dispute cases in Texas every year, and this state's Supreme Court has produced a body of rulings that are usually very linked to the exact language of specific royalty and lease documents. Rather than go through this body of work, dating back to ***Heritage Res., Inc. v. NationsBank, 939 S.W.2d 118, 120-21 (Tex. 1996),*** I'd like to probe a case that is quite fresh: ***BlueStone Natural Resources II, LLC v. Walker Murray Randle, No. 19-0459.***

1 https://www.rrc.state.tx.us/about-us/resource-center/faqs/royalties-faq/

BlueStone Natural Resources II, LLC v. Walker Murray Randle, No. 19-0459[2]

The Texas Supreme Court agreed to hear this case on September 17th, 2020. It is a very important case because it touches two critical issues. First, there is language in the leases, that was added in an addendum, that attempts to change the term on the original document from "market value at the well" to "gross value received." The second issue, which will be more and more critical as electric frac continues to grow, has to do with whether or not production from a well that is used as a fuel can be deemed "operations which Lessee may conduct hereunder." Electric frac means that the big engines used to force fluids into the ground (hydraulic fracturing), are gas-fired engines, and not the more common diesel engines. Electric frac is growing because it is both more efficient, thereby cheaper, and better for the environment.

It will not just be Texans watching this case; various states around the nation that have oil and gas production in meaningful levels will also be watching. This includes Ohio, Pennsylvania, Oklahoma, New Mexico, Louisiana, Colorado, and others. It might be time to answer some key questions!

1. Are "gross value received" and "gross proceeds" the same exact thing?
2. If not, why not?
3. Do either or both determine the actual valuation point for a sale?
4. Is this the same as valuation point at a well?
5. If not, why not?
6. Are they observable, economically viable valuation methods?
7. What is the difference between a valuation point at a well and a valuation point at the moment of a sale?
8. How does title transfer of a raw commodity, an intermediate product, and/or a finished product; play into this debate?
9. How can we draft these documents more clearly so as to avoid disputes, particularly when commodity prices are low? (I know, the Supreme Court is not going to give us the answer to this question!)

This case is very significant case. The oral arguments made last September really pointed out how so many previous decisions on these topics conflict and/or leave open significant issues. We await with bated breath for a decision from the Court, and we shall see if the decision makes things clearer or continues to kick the can down the road.

Essential Valuation Factors

ValueScope assists clients by providing independent, third party valuations that are generally triggered by an event, such as a sale, a buy, estate planning, tax work, GAAP application, bankruptcy, and litigation. A short cheat sheet of the key valuation items we use to assess oil and gas royalties are summarized right here:

2 http://www.search.txcourts.gov/Case.aspx?cn=02-18-00271-CV&coa=coa02

- The Valuation Date or Dates
    - Get this clearly established at the outset.
- The Purpose of the Valuation
    - What exactly is it for? Who will be reading it? This will determine the Standard of Value; there are more than one.
- The Standard of Value
    - "Fair market value," is mostly used for tax purposes, but it is really the primary and most customary Standard in the USA. "Fair Value" is the US GAAP application standard. Private capital firms use "Investment Value," and a large part of this will usually involve exit assumptions. "Intrinsic Value" is what equity research analysts use when they look at public stocks and bonds. "Liquidation Value" is used for distressed situations and can be forced or orderly. "Strategic value" is what you will see when big companies merge together, like when Shell acquired British Gas. The large premium paid is based on a very long range, and quite permanent, model of the combined companies. Using the proper standard of value is crucial to obtain an accurate determination of value and is necessary to avoid miscommunication in scoping the work up front.
- The Levels (Premise) of Value
    - Controlling interest basis means the value of the enterprise as a whole. It incorporates two components, the financial control level, and the strategic control level.
    - Marketable minority interest basis refers to the value of a minority interest, without control. It does, however, have liquidity as if it were freely tradable in an active market. The marketable minority level of value is also valued on an enterprise level of value, meaning that it is modeled on 100% of the expected cash flows of the enterprise.
    - Non-marketable minority interest basis means the value of a minority interest, that has neither control nor market liquidity.
    - Here is the point for this article-royalty interest owners do not own an interest in a business, so we view their interest to be either a marketable or non-marketable minority ownership interest in a business. This is often contentious, because lots of royalty owners do not understand why their valuation must be subjected to discounting. They do not control the drilling activity of the operator, and they have no voice in strategic direction or management decisions. Plus, royalty interests are not marketable the way that shares in a publicly traded company can be bought and sold easily. If you want a valuation that has no minority discounting, then buy the entire company!
- Important Industry Factors
    - There are no standardized rules for the valuation of oil and gas assets. The value of mineral and royalty interests is based on expected future cash flows generated by leasing and/or production, and this is driven by oil and gas market prices. It is a price-taker business.
- ValueScope considers and models a wide range of issues when we deliver this type of work:
    - Commodity Price Volatility
    - Technology
    - Basins/Access to Markets
    - Regulation
        - Treasury Regulations Section 1.611 - ***"the fair market value of an oil and gas property is the amount which would induce a willing seller to sell and a willing buyer to purchase."*** Additionally, Section 1.611-2(g) outlines some considerations that a valuation of mineral properties must include for tax-

oriented appraisals.

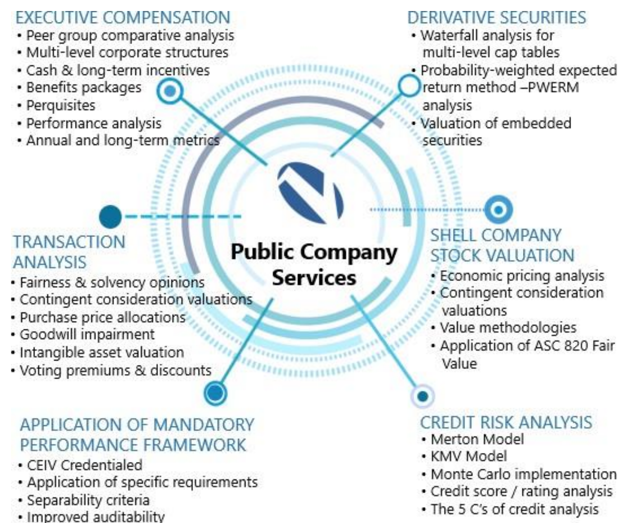
- Well Economics
- Financial & Strategic Condition of Operator
- Working Capital
- Leverage
- Capital Budgeting and Drilling Plans
- Break-even Analysis
- Post-production deductions
- The Asset-Based Approach
  - This approach is not useful for determining the value of a royalty interest, and we do not use it. Usually, a royalty owner purchased land which included the mineral rights and an allocation of surface versus mineral rights was never done. In other words, it can be hard to tell the cost basis of the assets, compounded by the fact that royalty interests are often family assets that are handed down for generations. Captain King and his partner Gideon "Legs" Lewis bought a 15,500-acre Mexican land grant called the *Rincon de Santa Gertrudis*, and this started the King Ranch of Texas. They paid $300; we cannot use that factoid in any meaningful way today for valuation purposes!
- The Market Approach
  - The market approach uses comps, both trading and transaction. ValueScope uses direct comparable transactions of royalty interests if they are available. However, they usually are not available, so the market-based approach is often not useful.
- The Income Approach
  - ValueScope generally uses this method, by building a discounted cash flow analysis. We are experts with PHD*Win* software, and this allows us to customize the economics of the facts of the actual wells and the deal, making it a bespoke valuation. We project production levels over the well portfolio's useful life. Revenue is based on both production and price; as such, we prefer to use simulation models to value over a range of oil, gas, and NGL prices. Cash flows net of severance, ad valorem taxes and other deductions is then discounted back to present value using a discount rate that is meaningful. In other words, the traditional "PV10" number using 10% is not useful; it is too low.

Conclusion

BlueStone v. Randle is a big deal, and we shall see what it produces. In the meantime, it is always best to find professionals who understand all the issues embedded on oil and gas royalties, including recent case history. This is the only way to get this kind of valuation done properly.

ValueScope: Measuring, Defending and Creating Value for Our Clients

ValueScope is a leader in the application of fair value measurement applying the Mandatory Performance Framework for better compliance with the Public Company Accounting Oversight Board.



For more information or to contact us for any need you may have, please feel free to write or call. We look forward to speaking with you.

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