



Royalty deductions

A practical, defensible framework for small and mid-size oil & gas operators

Executive takeaways

- Deductions are not a one-size-fits-all accounting choice. They depend on lease language, applicable state law, and field-specific facts.
- The highest-friction line is typically the boundary between “production” (borne by the operator) and “post-production” steps that make production marketable and deliver it to a buyer.
- The most durable program is a lease-by-lease rules matrix that defines deductible cost types, allocation logic, disclosure language, and the documentation supporting the method.
- A repeatable process—supported by controls, complaint response, and audit-ready backup—reduces disputes and stabilizes cash flow in low-price environments.

Where deductions typically arise

Exploration Always operator	Production (at the wellhead) Always operator	Treating (post-production) Shared if lease/law allow	Marketing (post-production) Shared if lease/law allow
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1. What “royalty deductions” mean in practice

Royalty deductions (often called post-production deductions) are charges against royalty that allocate certain costs of moving hydrocarbons from the wellhead to a downstream point of sale. In many U.S. leases, the lessor’s royalty is free of the costs to explore, drill, complete, and produce at the well. The debate typically begins after production, when oil or gas is gathered, treated, compressed, dehydrated, transported, processed, or otherwise prepared and delivered for sale.

At The Bugle Group, we treat deductions as a compliance and documentation problem: if the lease, governing law, and the field facts support a particular cost category, the operator can apply it consistently—with clear allocation logic and plain-language disclosure on the royalty statement.

2. The controlling inputs: lease language, law, and field circumstances

Whether a cost is deductible is driven primarily by (1) what the lease says, (2) how courts in the applicable jurisdiction interpret similar language, and (3) the physical and commercial facts of the field (for example, where title transfers, what services are required to reach pipeline specs, and whether the operator sells at or away from the wellhead).

Common lease phrases that change the analysis include:

- “at the well,” “at the wellhead,” or “net proceeds” language
- “free of cost” clauses and the specific costs listed
- marketable-condition or “marketable product” concepts recognized in some states
- clauses that expressly allow or prohibit transportation, compression, treating, or processing deductions

3. Cost categories operators most often evaluate

The most common deduction candidates are downstream services that make production acceptable to a purchaser or move it to a sales point. Typical categories include:

- gathering and transportation (truck, pipeline, or gathering systems)
- compression, dehydration, treating, and processing fees
- marketing fees (when supported and properly defined)
- certain taxes or governmental charges where the lease and state practice support pass-through
- electricity or fuel in limited, fact-specific situations (for example, where the lease contemplates use of lease gas as fuel and an alternative is required)

Practical caution

Many disputes arise from category mislabeling (“marketing” vs. “transport”), inconsistent allocation across leases, or insufficient backup when a mineral owner requests support. A defensible program treats each lease as its own rule set and ties every deduction to that rule set.



4. A defensible implementation approach

The Bugle Group's method is built around repeatability and audit readiness. In practice, that means translating lease language and controlling law into a rules matrix that your accounting team can apply consistently.

A. Build a lease-by-lease rules matrix

- Extract and normalize royalty and valuation clauses for each lease and any amendments.
- Map each lease to the governing jurisdiction and relevant case law themes (e.g., “at the well,” marketable-condition).
- Define which cost categories are allowed, disallowed, or conditional—and what facts trigger each condition.

B. Define allocation and documentation standards

- Allocation: specify the basis (volumes, index differentials, contract terms, or other consistent basis).
- Documentation: invoices, contracts, measurement data, and the chain from service → allocation → statement line item.
- Disclosure: consistent statement descriptions and a ready explanation for owner inquiries.

C. Operate with controls

- Monthly review checkpoints for new contracts, new wells, or changed sales points.
- Exception handling for leases with unique language or heightened owner sensitivity.
- A complaint-response playbook: fast retrieval of backup + clear, consistent explanations.



5. What executives should ask before adopting deductions

Do we know, lease by lease, what's allowed?	A "blanket" approach is where most avoidable disputes start.
Can we explain each line item in plain language?	Clarity reduces complaints and accelerates resolution.
Are we consistent across owners in the same lease?	Inconsistency is easy to spot and hard to defend.
Can we produce backup quickly?	Speed and completeness matter when owners escalate.
Do we have a documented policy for edge cases?	Edge cases are where litigation risk concentrates.

Disclaimer

Deductibility and outcomes depend on lease terms, applicable law, contracts, and operating circumstances. This paper is educational and not legal advice.



References

- Heritage Resources, Inc. v. NationsBank, 939 S.W.2d 118 (Tex. 1996) (Texas Supreme Court royalty valuation context).
- Burlington Resources Oil & Gas Co. LP v. Texas Crude Energy, LLC, No. 17-0266 (Tex. 2019) (Texas Supreme Court opinion on post-production costs in a royalty assignment).
- U.S. Energy Information Administration (EIA), “Natural gas explained: Delivery and storage” (overview of gathering, processing, and transportation).
- National Association of Royalty Owners (NARO), educational materials and glossary (royalty-owner terminology and common questions).
- Holland & Hart LLP, “Deducting Post-Production Costs From Fee Royalty” (plain-language overview of common post-production cost categories and lease drivers).

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