Calculating Royalty: "Costs" Subsequent to Production

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CALCULATING ROYALTY: “COSTS” SUBSEQUENT TO PRODUCTION

Professor Owen L. Anderson
Royalty Valuation:
Should Royalty Obligations Be Determined Intrinsically, Theoretically, or Realistically?
Part 1
Why All the Fuss? What Does History Reveal?

Owen L. Anderson

THE ISSUES:

(1) WHY SO MUCH RECENT ROYALTY LITIGATION?

(2) WHAT DOES "ROYALTY" MEAN?

(3) MUST LESSEE PAY ROYALTY ON VALUE ADDED BY "POST-PRODUCTION" ACTIVITIES UNDER COMMON GAS ROYALTY CLAUSES?
My Conclusion

Absent an express royalty provision to the contrary, lessees should not have to pay royalty on value added by "post-production" activities.

Three general principles:

(1) royalty should be payable on "production;"

(2) production is not complete until a "first-marketable product" has been obtained;

(3) express royalty clause provisions govern over these first two principles, but because royalty clauses are both executory and anticipatory in nature, they should be construed as a whole, in light of current market realities (not narrowly construed by isolating certain words or phrases that ignore general intent).
So why all the fuss?

First, there is great disagreement over what constitutes “production.”

Compare: Texas, Oklahoma & Louisiana

Texas Courts

“Production,” under the habendum clause, requires actual extraction and use or marketing.

Likewise, under “market value”/“market price” gas royalty clauses, royalty is payable on current market value when gas is actually extracted from the ground and used or marketed, even though lessee may have received a different contract price and “take or pay” payments.

Nevertheless, under NationsBank, royalty gas is apparently valued immediately upon extraction at the wellhead (not after its actual use or marketing). [In other words, royalty is payable on the “intrinsic value” of gas at the wellhead and commonly calculated by deducting post-wellhead costs.]
Oklahoma Courts

Unlike Texas, “production,” under the habendum clause, occurs when a completed well is capable of producing oil or gas.

But, like Texas, “production,” under the royalty clause, requires actual production. Thus, like Texas, royalty is not payable on “take or pay” payments.

Nevertheless, unlike Texas, “market price” or “market value” royalties are generally payable on contract prices, not on current values when the gas is actually extracted.

Unlike Texas, royalty is valued upon marketing, not immediately upon extraction. [In other words, certain post-wellhead costs are not deductible.]

Louisiana

Like Texas and unlike Oklahoma, “production” under the habendum clause requires actual extraction and use or marketing of gas, but is valued immediately upon extraction.

However, like Oklahoma and unlike Texas, “market price” and “market value” royalties are generally paid on contract prices, not on current values when the gas is actually extracted.

But unlike both Texas and Oklahoma, royalty is generally owed on “take or pay” payments and settlements.
So why all the fuss now?

Because ***

*Nobody wants to take a lot of profit at their producing subsidiary* (anymore).

Jim Shaw, Associate Director
Royalty Management Program
Minerals Management Service


Why is that so?

1. The deregulation of natural gas marketing?

   Yes, partly.

2. The "reform" of the % oil & gas depletion allowance.

   Yes, the principal reason.
Example 1. using a 27.5% depletion allowance:
By pushing profits upstream or income downstream or both, a lessee (not making an arm’s length wellhead sale) claims $2.00/Mcf. gross income from the property.

Assuming a 15% royalty/overriding royalty burden, lessee’s royalty obligation is 30¢. Assuming a 5% production tax, lessee’s proportionate share of production taxes is 10¢. Thus, lessee’s net royalty/tax burden is 38.5¢.

Lessee’s depletion allowance is 46.75¢ [production @ $2.00/Mcf less 15% royalty burden times 27.5% depletion allowance].

Lessee gains 8.25¢ [the difference between 46.75¢ depletion and 38.5¢ royalty/production-tax burden].

Example 2. using a 27.5% depletion allowance.
Lessee claims gross income of only $1.00/Mcf.

Lessee’s total royalty burden is 15¢, and lessee’s proportionate share of production tax is 4.25¢. Thus, lessee’s total royalty/tax burden in 19.25¢.

Lessee’s share of the 27.5% percentage depletion allowance is 23.375¢.

Lessee gains 4.125¢ [half of the 8.25¢ net benefit realized if the gas is valued at $2.00/Mcf].
Compare @ 15% Depletion

Example 1.
At $2.00/Mcf, lessee’s share of percentage depletion is 25.5¢. Lessee’s royalty/tax burden would still be 38.5¢.

Lessee loses 13¢.

Example 2
At $1.00/Mcf, lessee’s share is 12.75¢. Lessee’s royalty burden would still be 19.25¢.

Lessee loses only 6.5¢.

Compare Cost Depletion
No incentive to re-direct profits or costs. All costs, whether upstream or down, are deductible or depreciable.

Royalty History

“[T]here is something in the nature of the property right itself—something in the nature of the “bundle of sticks” that is a royalty that answers the question: The lessor’s percentage is a percentage of what? Consistent with the sharing arrangement with the Crown that gave the “royalty” interest its name, the most obvious answer is that the lessor’s royalty entitles the lessor to a share of the produced mineral in its natural state, after the mineral has been brought to the surface by the lessee.”

My Findings

There is no evidence of a “property law” definition of royalty or that the established point of royalty valuation was at the mouth of the mine or well (the point where raw ore or oil or gas was converted from real to personal property).

Rather the royalty entitlement depended entirely upon the language of the governing ordinance, decree, or contract.

Contractual terms varied, but payment of royalty upon the value of a merchantable product was common.

Sources other than the U.S.

Ancient Greece, the silver mines of Laurium, circa 480 b.c.

Roman Empire, marble quarries.

Cornwall & Devon, England, tin, 1263 - 1830s.

Derbyshire, England, lead, 1288.

Spain, precious metals, circa 1387 a.d. and circa 1559.

New Spain, precious metals, 1700s.

England, metals, 1850s.
Early U. S. Law

1. The royalty obligation is a sharing arrangement.

2. Payment obligations are determined by reasonably construing the royalty clause in light of the parties’ reasonable expectations and the clause’s anticipatory nature.

3. Royalty valuation depends upon the language of the royalty clause, not upon a property law definition of royalty.

4. Royalty valuation is commonly tied to the marketability.

5. Royalty valuation excludes value added by transportation.

6. If production is first sold beyond the first market, early cases are both divided and counter-intuitive on whether downstream profits must be shared with the royalty owner.

Early U.S. Law

Wright v. Warrior Run Coal Co.
Audenreid v. Woodward
Wolfing v. Ralston
Maloney v. Love
Wemple v. Producer’s Oil Co.
Clark v. Slick Oil Co.
Busbey v. Russell
Scott v. Steinberger
Martin v. Amos
Barton v. Laclede Oil & Mining Co.
Armstrong v. Skelly Oil Co.
Rains v. Kentucky Oil Co.
Clear Creek Oil & Gas Co. v. Bushmaer
Warfield Natural Gas Co. v. Allen
Scholarly Commentary

Merrill, Covenants Implied in Oil and Gas Leases § 85 (2d ed. 1940).

“If it is the lessee’s obligation to market the product, it seems necessarily to follow that his is the task also to prepare it for market, if it is unmerchantable in its natural form. It is erroneous to read into the royalty clause stipulations concerning the cost of marketing and preparation which are not specifically expressed.”

Fundamental Contract Law.

If a party to a contract owes a particular duty of performance [such as the duty to market production] that party has an obligation to absorb the costs of performance in absence of an express agreement to the contrary.

This principle is so fundamental that contracts scholars only discuss it in the context of whether unforeseen costs may excuse performance under the doctrines of impossibility and impracticability. There is never a suggestion that the other party to the contract is charged with such costs. Farnsworth, Contracts § 9.6 (2d ed. 1990); Jaeger, Williston on Contracts § 1963 (3d ed. 1978); Corbin, Corbin on Contracts § 1333 (1962).
[T]here is a distinction between acts which constitute production and acts which constitute processing or refining. Unquestionably, under most leases, the lessee must bear all costs of production. There is, however, no reason to impose on the lessee the costs of refining or processing the product, unless an intention to do so is revealed by the lease. It is submitted that the acts which constitute production have not ceased until a marketable product has been obtained. After a marketable product has been obtained, then further costs should be shared by the lessor and the lessee.

OTHER SCHOLARLY COMMENTARY FAVORABLE TO A FIRST MARKETABLE PRODUCT RULE


Thuss, Texas Oil and Gas Law § 126 (2d ed. 1935).

Compare:

Williams, Oil and Gas Law § 645.2 (1995);
Summers, The Law of Oil and Gas § 589 (1958);
Sullivan, Handbook of Oil and Gas Law §§ 92 and 70 (1955).
**Conclusions Respecting Part I**

1. The primary cause of current royalty litigation is depletion reform. Natural gas deregulation is secondary.

2. Throughout early history (both U.S. and foreign), royalty provisions have been construed in light of:
   - their express language;
   - the parties' reasonable expectations;
   - their anticipatory nature;
   - and their purpose.

3. Early U.S. case law supports a marketability approach.

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**Part 2**

Should Courts Contemplate the Forest or Dissect Each Tree?

(a look at modern royalty case law)
My basic conclusion:

Many modern gas royalty clauses should be viewed as a forest of clauses expressing similar anticipatory obligations to share with the lessor.

Royalty clauses are intentionally general in language so that they will function fairly and efficiently for what may be decades of production, regardless of the specific circumstances.

Unfortunately, many modern royalty cases ignore the fundamental principle that royalty means a "share."

* Not included are clauses drafted by lessors, state, federal or Indian leases, and clauses custom drafted for a specific use.

Construction of Royalty Clauses

"Too much dependence is placed upon the language of a printed form, in the preparation of which at least one party has had no part and to the selection of which the other frequently has given no consideration, if upon a variance of that language a difference is established in a duty not specifically referred to." Maurice Merrill, Covenants Implied in Oil and Gas Leases § 85 (2d ed. 1940).

"[Royalty rights] must be determined, not by isolating certain words from the connection in which they occur, and putting an interpretation upon them without regard to their relative situation, but by considering all the language of which the words form a part." Maloney v. Love, 52 P. 1029 (Colo. Ct. App. 1898).
“Resort to grammatical parsing is less instructive... than is a consideration of the purpose of the gas royalty clause, taken as a whole.” Piney Woods Country Life School v. Shell Oil Co., 726 F.2d 225, 230 (5th Cir. 1984).

Regrettably, however, the *Piney Woods* court failed to heed its own advice.

Often, modern royalty cases distinguish words that are really synonyms.

**Examples:**

*Vela* (distinguishing "market price" and "proceeds") and *Piney Woods* (distinguishing "market value" and "proceeds").

*But see, Tara Petroleum Corp., Hilliard, and Henry* (making no such distinction).

*Roye Realty* (in dicta, suggesting a distinction between "proceeds" and "amount realized").

*But see, Upham* ("Webster defines... 'proceeds' as the 'amount realized from the sale of property'.") and *Skaggs* (the court held that "amount received" means "proceeds").
Where did this “parsing” get started?

Perhaps inadvertently: *Shamrock Oil & Gas Corp. v. Coffee.*

The court makes an *evidentiary distinction* between “market price” (established by looking at actual arm’s length contracts and sales) and “market value” (established by expert testimony concerning market prices).

The court made no *substantive distinction* between these terms, but merely preferred the former as evidence where a single price was known.

*Vela* See also, *Foster* (an earlier federal case reaching a similar result).

Gas contract was made in 1934 for the life of the lease at 2.3¢ per Mcf. (Initially, there was no market because purchaser was unwilling to pay 3¢ for compression.)

At time of litigation, new gas was being sold for 16¢ per Mcf., less 3¢ for compression. Lessors essentially sued for the difference pursuant to a “market price” royalty clause.

Held: 5 to 4 for the lessors.
Royalty clauses contemplate market realities.

They refer to “market price,” “market value,” “proceeds,” or “amount realized”--terms well known to the marketplace.

These terms require:

- a willing buyer,
- a willing seller,
- a marketable product,
- a market, and
- a sale.

And contrary to Vela-type cases, the same gas from the same field can have different market values.

*Phillips Petroleum Co. v. Bynum* illustrates this.
The most unfortunate *Vela*-type case: *Piney Woods*.

The key words of the bifurcated royalty clauses:

If sold/used off the premises: “market value at the well”

If sold at the well: “amount realized”

Judge Wisdom held that the gas was not sold at the well.

To hold otherwise “would place the lessors at the mercy of the lessee” and allow lessee to “avoid the payment of market value royalty.”

“[S]trange results ... may occur if the determination of whether gas is ‘sold at the well’ turns solely on the place where title passes.”
The *Piney Woods* Gamblers’ Bargain

“A landowner is offered leases by two producers. The first offers a 1/8 market value royalty; the second offers a 1/6 proceeds royalty. The landowner decides to lease to the first operator, because he thinks the market value of gas will rise enough to compensate for the lower fractional share. This is a business risk: if the price does not rise enough, the lessor loses money. If, however, the price rises as the lessor thought, the lessor has won his bet, just as the lessee has lost his gamble that the price would not rise....”

“At some point, the lessee may find the continued operation so unprofitable that it is more economical to cease production. At this point the lessor has a strong incentive to renegotiate the lease.”
Where are we? The gas was not sold at the well; thus, royalty is owed on current “market value at the well.”

Problem: the gas at the well is “extremely sour” and must be converted into “marketable sweet gas.”

At the Well “describes not only the location of the gas for royalty purposes, but its quality....”

Judge Wisdom’s Solution: although “least desirable,” “market value” royalty can be calculated by taking the “actual sales price of gas less costs” after all.

The End Result: A Real Gamblers’ Bargain

(1) If gas is truly sold “at the well,” royalty is owed on the sale proceeds (perhaps set by a long-term, fixed-price contract).
(2) If gas is not sold at the well, royalty is due on current market value at the well when extracted.
(3) The lessee controls where the gas is sold (limited by market realities and good faith), provided that a sale ostensibly made at the well must really be at the well, not “off the premises.”
(4) Provided however, that “market value at the well” for gas sold “off the premises” may be determined by subtracting post-wellhead costs (including a rate of return after taxes) from the contract price (not current market value), if the trial judge concludes that this “least desirable” valuation method is nevertheless appropriate under the circumstances.
"Wild Cards" for future Piney Woods:

The trial court's discretion concerning:

(1) Whether lessee's "at the well" sale violates the implied duty to market at the best available price and terms?

(2) Whether an "at-the-well" sale is really at the well?

(3) What constitutes the best evidence of "market value at the well" for gas sold "off the premises"? (comparable sales, expert testimony of value, or the actual downstream contract price less post-wellhead costs)

(4) Whether the lessee's actual calculation of post-wellhead "costs" is appropriate?

The Bottom Line

Neither a lessor nor a lessee would knowingly make this gamblers' bargain.

If lessors were really concerned about being locked into the pricing terms of a long-term contract that was not of their making, they would insist on a pure "market value" royalty clause like the one in Vela.
But a lessee would not knowingly accept such a bargain, let alone draft a lease royalty clause with this intent.

In a rising market, lessee would have to pay more and more royalty even though the lessee may have made a prudent decision to sell gas for a set term at a fixed price.

**Lessees’ Intent**

Regarding post-wellhead costs, lessees knew how to address them directly:

“Lessor’s interest shall bear its proportion of any compression, treating, and other expenses necessary to render the gas marketable.”


But, as George Siefken teaches in his 1954 article.

An alert lessor could too easily amend this clause:

**NOT**

“Lessor’s interest shall bear ....”
Three Fundamental Principles

1. A royalty clause should be construed in its entirety against the party who offered it, in light of the fact that it is the means by which the lessor receives the primary consideration for a productive lease.

2. In light of legal history and absent an express lease provision, a lessee who discovers oil or gas in paying quantities is obliged to “produce” a “marketable product.”

3. When a marketable product is first obtained: is a question of fact; is the logical point where the exploration and production segment of the oil & gas industry ends; is when the primary objective of the lease is achieved; and is thus the logical point for the calculation of royalty.

The Troublesome California “at the well” Cases:

Alamitos Land Co. v. Shell Oil Co.
Vedder Petroleum Corp. v. Lambert Lands Co.
Atlantic Richfield Co. v. State.

Troublesome “at the well” cases from other states:

Heritage Resources, Inc. v. NationsBank., TX

Schroeder v. Terra Energy Ltd., MI
"market value of gas at the well"

The court concludes:

that “market value at the well” has a commonly accepted meaning in the oil and gas industry and

that “market value” means “the price a willing seller obtains from a willing buyer.”

But, then concludes

that “market value at the well” can be calculated by “subtracting reasonable post-production marketing costs....”

The lease in NationsBank also provided:

“there shall be no deductions from the value of Lessor’s royalty by reason of any required processing, cost of dehydration, compression, transportation, or other matter to market such gas.”

The court concludes that this language was “surplusage as a matter of law.”
What did the lessors intend?

Their intent was to share in all proceeds received by the lessee for the sale of oil and gas without deductions

--even beyond the point of first-marketability,

--but never less than market value at the well as a hedge against "sweetheart" sales.

Query whether a court should honor this intent, given the lessors’ retention of the phrase “at the well”?

The Troublesome “marketable product” cases:

Wood v. TXO, OK
TXO v. CLO, OK
Sternberger, KN (not so troublesome)
Garman, CO
various compression cases
The Troublesome “proceeds” cases.

*Miller v. Buck Creek Oil Co.*, “net returns,” WY

*Upham v. Ladd*, “proceeds,” TX

*West v. Alpar*, “proceeds,” ND

*Schroeder v. Terra Energy Ltd.*, “gross proceeds,” MI

*Martin v. Glass*, “net proceeds,” TX

*Gilmore v. Superior Oil Co.*, “net proceeds,” KS

The Economist Ponders the Forest

Ex Post: Royalty is inefficient, like an excise tax.

Ex Ante: Royalty is rational and reasonably efficient.

Royalty may be “cost free,” but it is not “risk free.”

Problems with royalty clauses result from bad drafting or unfortunate court decisions or both.

Basic marketplace realties (such as “marketability”) should be considered in properly interpreting royalty clauses.
Conclusions

Construe lease royalty clauses as a whole in light of the following factors:

>royalty clauses are anticipatory in nature;

>they call for a sharing;

>they govern royalty for the duration of production;

>because leases are freely assignable and often assigned, lessees have a variety of lease forms in their portfolios, the terms of which cannot be efficiently nor easily honored if every variation among the royalty clauses is subjected to grammatical parsing.

Unfortunately, many courts tend to over-interpret royalty clauses, often emphasizing a single word or phrase, e.g.:

“produced and sold or used,”
“off the premises,”
“at the well,”
“amount realized,”
“proceeds,” or
“market value.”

“free of cost in the pipeline”

This approach is illustrated by cases such as
Vela,
Middleton,
Piney Woods,
NationsBank.
The Typical Royalty Clause Contemplates:

- real and willing buyers

- real and willing sellers

- dealing with a real product in the real marketplace

- actual commercial sales of a “product”
  (requiring both “production” & “marketing”)

The Typical Royalty Clause Does Not Contemplate:

- that royalty be paid on value added by post-
  “production”
  (that is after a first-marketable product is in fact obtained)

The Effect of A Marketable-Product Approach

- simplifies royalty accounting by using known values

- separates the e & p segment of the industry at the logical place

- treats lessees the same regardless of size or situation
  [lessees do not share downstream profits or losses with lessors]

- through royalty accounting, lessors share transportation costs whether incurred before or after marketability is obtained [including compression not directly related to extraction]
Litigation

- overall, less likely (as valuation is simplified)
- class actions on a field-wide basis may be more likely
- class actions on a region- or state-wide basis less likely.

My Views Are Adopted In

Rogers et al. v. Westerman Farm Company et al.,