PRESENTED AT

2019 Fundamentals of Oil, Gas and Mineral Law

March 28-29, 2018
Houston, Texas

The Oil and Gas Lease, Part II: The Royalty Clause in an Oil and Gas Lease

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THE OIL AND GAS LEASE, PART II: THE ROYALTY CLAUSE IN AN OIL AND GAS LEASE

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Summary: The royalty clause is one of the most important clauses in the oil and gas lease, but drafting and construction of royalty provisions can be challenging. In Texas, the calculation of the royalty obligation created under an oil and gas lease is determined by looking at the specific language contained in the royalty clause. Royalty terms in the lease such as "market value at the well" or "amount realized" establish how the royalty payor must measure and calculate royalty, and what post production costs can be allocated to the lessor interest. This paper considers some of the principal phrases used to describe such obligations and how the Texas courts have interpreted them and examines how that same language has been interpreted differently in other jurisdictions. The paper finally considers the impact of division and transfer orders and royalty payment statutes on royalty obligations contained in the lease.

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I. INTRODUCTION

At its simplest, a royalty is this: a cost-free share of production.[1] Yet drafting and interpreting royalty provisions is anything but simple. The task has resulted in numerous texts and treatises regarding royalty payments, each purporting to carry with them the weight of historic custom and equity.[2] These materials will not try to replicate those bodies of work, but will rather catalog the specific language used in many royalty provisions, Texas' approach to interpreting royalty conveyances, and the impacts of division order and royalty payment statutes on the simple "sharing arrangement" of the lease.[3]

By a narrow construction, the term "royalty" refers to a share of the production or the proceeds therefrom, "reserved to the owner for permitting another to use the property."[4] A royalty interest—or, the right to receive royalties— is one of the five essential attributes of the mineral estate.[5] States have created various ways to classify the mineral interest that may affect the nature of the royalty interest. Whether the royalty interest will be considered real or possessory property depends in part on whether the jurisdiction adheres to a "non-ownership" or "ownership-in-place" theory of mineral ownership.[6] States including Alabama, California, Illinois, Ohio, and Wyoming have adhered to the first of these theories in some cases, which surmises that no one can claim ownership of oil and gas until it is produced, vesting in the producer ownership over the minerals as personal property only following severance.[7] In these states, the mineral interest is incorporeal and non-possessory, often described as a *profit à prendre* or a license.[8]

Texas has adopted the "ownership-in-place" theory of mineral ownership, which vests the surface owner with ownership of the oil and gas beneath the property subject to limitations of the rule of capture.[9] Texas courts have construed the mineral lessee's interest as a fee simple

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[1] Heritage Res., Inc. v. NationsBank, 939 S.W.2d 118 (Tex. 1996)

[2] *See, e.g.,* Owen L. Anderson, *Royalty Valuation: Should Royalty Obligations be Determined Intrinsically, Theoretically, or Realistically?*, *Part 1*, 37 NAT. RES. J. 547 (1997); Bruce Kramer, *Interpreting the Royalty Obligation by Looking at the Express Language: What a Novel Idea?*, 35 TEX. TECH L. REV. 223, 224 (2004); PATRICK H. MARTIN & BRUCE M. KRAMER, WILLIAMS & MEYERS OIL AND GAS LAW [hereinafter Williams & Meyers] § 641 (LexisNexis 2018).

[3] Anderson, *supra* note 2, at 584 (citing Wright v. Warrior Run Coal Co, 38 A. 491 (Pa. 1897)).

[4] Carroll v. Bowen, 180 Okla. 215, 68 P.2d 773, 775 (Okla. 1937).

[5] Altman v. Blake, 712 S.W.2d 117, 118 (Tex. 1986) (these rights include: "(1) the right to develop (the right of ingress and egress), (2) the right to lease (the executive right), (3) the right to receive bonus payments, (4) the right to receive delay rentals, (5) the right to receive royalty payments"); *Lyle v. Jane Guinn Revocable Trust,* 365 S.W.3d 341, 351 (Tex. Civ. App. 2010), *cert. denied*; Hamilton v. Morris Res., Ltd., 225 S.W.3d 336, 344 (Tex. Civ. App. 2007) *cert. denied*.

[6] E. KUNTZ, A TREATISE ON THE LAW OF OIL AND GAS § 2.4, *Theories of Ownership of Oil and Gas* (1987).

[7] Williams & Meyers, *supra* note 2, at § 203.1.

[8] *Id.*

[9] Other states that appear to have adopted the ownership-in-place theory include Colorado (*see* Simson v. Langholf, 133 Colo. 208, 293 P.2d 302 (Colo. 1956)); Kansas (*see* Richards v. Shearer, 64 P.2d

determinable estate in the oil and gas in place, giving the lease the effect of a "sale of an interest in land."[10] This conveyance confers a possessory or corporeal interest to the lessee, also divesting the mineral owner and royalty interest owner of the right to enter, explore, or develop the estate.[11] Thus, as one "stick" in the bundle of rights comprising the mineral estate, the royalty interest is considered a real property interest under Texas law, but is incorporeal.[12]

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With regard to minerals severed from the ground by production, Texas joins the majority of states in treating oil and gas as personal property, rather than realty, following the severance of the minerals by production.[13]

Along with the right to develop, the right to lease, the right to receive bonus payments, and the right to receive delay rentals, the mineral owner may convey or reserve the right to receive royalty payments.[14] Frequently, the mineral owner or lessor convey to the lessee all oil and gas in place, reserving for the lessor only the right to receive royalty as consideration for entering into the lease. After leasing the land for the purpose of production, the mineral and royalty interest owner is free to convey the royalty interest to another for the life of the lease or another period of time, or retain a reversionary interest in the entirety of the mineral estate when the lease terminates.[15]

Royalty interests may be long-term, coinciding with the lifetime of the producing well. Despite prohibitions against alienations of property that would violate the Rule Against Perpetuities, the royalty interest may indeed be perpetual.[16] In Texas, where oil and gas in place is corporeal and where the lease is deemed to provide a determinable fee interest,[17] the royalty share

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56 (Kan. 1937)), Maryland (*see* Kiser v. Eberly, 88 A.2d 570 (Md. 1952)), Michigan (*see* Atty. Gen. v. Pere Marquette Ry. Co., 248 N.W. 860 (Mich. 1933)), Mississippi (*see* Phillips Petroleum Co. v. Millette, 221 Miss. 1, 72 So. 2d 176 (Miss. 1954)), Montana (see Homestake Expl. Corp. v. Schoregge, 81 Mont. 604, 264 P. 388 (Mont. 1928)), New Mexico (*see* Jones-Noland Drilling Co. v. Bixby, 34 N.M. 413, 282 P. 382 (N.M. 1929)), North Dakota (*see* Bilby v. Wire, 77 N.W.2d 882 (N.D. 1956)), Pennsylvania (*see* Hamilton v. Foster, 272 Pa. 95, 116 A. 50 (1922)), Tennessee (*see* Murray v. Allard, 43 S.W. 355 (Tenn. 1897)), Washington (*see* McCoy v. Lowrie, 253 P.2d 415 (Wash. 1953)), and West Virginia (*see* Boggess v. Milam, 34 S.E. 2d 267 (W.Va. 1945)). However, these states differ as to whether both the mineral interests and the lessee's interests are corporeal or incorporeal. Williams & Meyers, *supra* note 2, at § 203.1.

[10] Cherokee Water Co. v. Forderhouse, 641 S.W. 522, 525 (Tex. 1982).

[11] *Id.*

[12] Ridge Nat. Res., LLC v. Double Eagle Royalty, LP, 564 S.W.3d 105, 113 (Tex. Civ. App. 2018).

[13] Phillips Petroleum Co. v. Adams, 513 F.2d 355 (5th Cir. 1975) ("Texas law provides that oil and gas are realty when in place and personalty when severed from the land by production.").

[14] *Id.*

[15] Williams & Meyers, *supra* note 2, at § 202.3.

[16] David L. Cruthirds*, Power to Execute Mineral Leases over A Severed Mineral Interest Is A Real Property Interest*, 32 S. TEX. L. REV. 337, 353 (1991).

[17] Kramer & Martin, *supra* note 15, at § 209 ("in Texas severed mineral interests and the interest of an oil and gas lessee are viewed as corporeal estates. The owners of royalty interests lack the right to

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