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Post-Production Royalty Disputes

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I. SCOPE OF ARTICLE

The underlying purpose of the oil and gas lease is to grant one's minerals to another for the purpose of risking time and capital to explore for and produce hydrocarbons. Created without a predetermined lifespan, the oil and gas lease commences a relationship between lessor and lessee that may last for decades often surviving the succession of interests on both sides. The one monthly constant contact between the lessor and lessee is the payment of royalty on production. Of the various types of disputes that can arise between lessor and lessee, arguably the most common includes whether royalty payments have been properly paid. With the proliferation of custom royalty clauses applied to multi-phase and multi-product hydrocarbon production, transported and processed via complex multiple delivery systems and marketing arrangements, answering the question of proper payment can be challenging. Texas courts have recently provided litigants with new guidance in navigating custom royalty clauses and their application to royalty disputes. This paper will address the common issues arising out of post-production royalty disputes and how Texas courts have addressed them.

II. THE ROYALTY CLAUSE AND TEXAS DECISIONS

A. THE PRODUCERS 88 ROYALTY CLAUSE

The primary contractual obligation in an oil and gas lease is the duty to pay royalty once production is established. Lessees' calculation and payment of royalty over the years has generated many disputes leading to the creation of well-developed case law in Texas. Historically, royalty provisions under the leases were based on the "Producers 88" form royalty clause requirement to pay on the "posted price" for oil or either the "market value" at the well for gas sold off the lease or "proceeds" received by the lessee, if sold at the well. Although royalty provisions in modern custom leases have become much more complex, the question of how courts determine market value commonly arises in litigating older leases.

B. FAILURE TO PAY MARKET VALUE

In *Exxon Corp. v. Middleton*, 613 S.W.2d 240, 249 (Tex. 1981), the Texas supreme court examined whether Exxon had sold gas from the Middleton lease at market value. The *Middleton* lease covered acreage in Chambers County and contained the following typical producers 88 royalty clause:

> . . . on gas, including casinghead gas or other gaseous substances, produced from said land or sold or used off the premises or in the manufacture of gasoline or other product therefrom, shall be the ***market value*** at the well of one-eighth of the gas so sold or used, provided that on gas so sold at the wells the royalties shall be one-eighth of the amount realized from such sale.

Middleton treated all of Exxon's gas sales as occurring "off the premises" and the court agreed. *Id.* at 243. Thus, Exxon was charged with paying royalty based on the "market value" of the gas sold at the well. Middleton sued Exxon for failing to pay royalty on the market value of the gas and proffered expert testimony to establish Exxon's breach. The court noted that market value "may be calculated by using comparable sales" which are those sales "comparable in time, quality, quantity, and availability of marketing outlets." *Id.* at 246. Middleton's expert opined that Exxon had failed to pay royalty at market value and arrived at his conclusion by taking the average of the three highest prices paid for gas in the area. *Id.* In formulating his opinions, Middleton's expert reviewed nearly 30,000 Form 60-150 Gas Purchaser Reports ("GPR's") filed with the Texas Comptroller's office. The GPR's provided the following details:

a) the name of the purchaser and seller of gas;

b) the month and year of the transaction;

c) the lease and county from which the gas was produced;

d) the quality of the gas or whether it originated from an oil or gas well;

e) the volume purchased; and

f) the price.

Id. at 245.

In determining a relevant marketing area, the expert took sales from Texas Railroad Commission Districts 2, 3 and 4 which comprise a large part of the Texas Gulf Coast. The Court approved using sales from this area because:

1) sales comparable in time, quality, quantity and availability of marketing outlets occurred from these districts;

2) gas production, gathering, transmission and ultimate consumption occurred in these districts; and

3) one of the other Defendants' experts testified that many gas purchase contracts use TRRC Districts 2, 3 and 4 in their price redetermination clauses.

Id. at 247.

With regard to the quality of the gas sold, the court noted that:

1) the *Middleton* expert testified that most of the comparable sales were for sweet gas;

2) he adjusted the sales used according to the btu content of the gas;

3) the Defendants' experts testified that the quality of the gas was comparable;

4) the GPR's confirmed that most of the gas sold was for sweet gas;

5) the sales were all intrastate sales and thus sold in the same type of market, *e.g.* regulated market or unregulated market.

Id.

The court also found that the quantities of the sales, although different, were comparable because:

1) the *Middleton* expert testified that in these districts from the period between 1973 and 1975, quantity did not affect prices;

2) one of the Defendants' experts also testified that volume did not affect prices; and

3) the *Middleton* expert testified that by taking the btu value and making the necessary adjustments, differing volumes of sales could be made comparable.

Id.

In discussing comparability of marketing outlets, the court noted that the *Middleton* expert testified that TRRC Districts 2, 3 and 4 contained a substantial network of pipelines.
The court also found that the sales were comparable in time. The *Middleton* expert took the three highest prices from the first month of every quarter to establish market value. In validating this methodology, the court noted that the parties had stipulated that the market value of the gas would be determined quarterly.

In approving the use of the average of the three highest prices, the court noted that:

1) because prices were rising, the highest prices represented the most current transactions;

2) the *Middleton* expert testified that most gas contracts set initial and redetermined prices based on the highest prices in the area;

3) Exxon paid royalty on other gas based on the average of the three highest prices for sales over one million cubic feet per day and adjusted for btu content;

4) another Defendant had also agreed to using a similar formula in a separate arbitration proceeding and a negotiated gas contract.

C. HERITAGE AND THE NET BACK

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