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Royalty

ROYALTY

- Share of production or value free of expenses of “production”
 - Heritage Res., Inc. v. NationsBank, 939 S.W.2d 118 (Tex. 1996)
- Hedge against uncertainty
 - Inefficient in hind sight, but works well in foresight
- Lessor’s principal compensation if hydrocarbons are produced
 - Bonus, delay rentals, shut-in payments, etc.
 - Appalachian Basin – Different perspective



(1) "Meaning" of royalty?

- Webster's Third New International Dictionary:
 - "a share of the product ... or a payment ... for permitting another to exploit, use, or market ..."
- Williams & Meyers Manual of Oil and Gas Terms:
 - "A share of production, free of expenses of production."



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(2) "Meaning" of royalty?

Parties are free to define "royalty":

- Fixed % (or fraction) of production
- Variable rate—increases with rate of production
- Flat rate royalty for natural gas – Early leases
- "Reserve in kind" - [Delivery obligation]
- "Pay in value" - [Payment obligation]
 - based on sales proceeds or
 - independent of proceeds
 - calculation methodology [express terms]
- Usually free of costs of "production"



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(3) "Meaning" of royalty?

Should be defined by the parties but oftentimes courts play a paramount role!!!

- Key terms for construction include:
 - "posted price,"
 - "market value" and "market price" (prevailing)
 - "gross proceeds"
 - "net proceeds"
 - "at the well"
 - "produced and saved" (production)



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Why "royalty"?

- Historically Used in Mineral Development
- Uncertainty
- Costs of Development
- Risk Allocation



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Kinds of Royalty Interests

Our focus: royalty clause of the oil and gas lease, but:

- A “royalty interest” or “nonparticipating royalty interest” or “freestanding royalty interest” may be carved directly from a mineral or fee simple interest
 - Duration may be perpetual, for a fixed term, or indefinite (“for so long as production”)
- An “overriding royalty interest” may be carved out of the “working-interest” side of a lease
 - Duration is ordinarily limited to duration of lease from which the ORRI was carved, but an ORRI can expressly apply to lease “extensions or renewals,” and equity may extend an ORRI to prevent fraud (“wash out”)
- Above terms are not consistently used

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Royalty Characteristics

- Non-possessory interest in real property – *Sheffied v. Hogg*, 77 S.W.2d 1021 (1934)
- Subject to ad valorem tax
- Statute of Frauds
- Once produced, royalty interest becomes personal property -

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Oil Royalty History

- Historically, oil royalty was reserved in kind
 - But lessee was often authorized to deliver oil royalty to pipeline or purchaser on lessor's behalf
 - Often, lessee was further authorized to sell (and /or purchase) oil royalty at "posted price"
- Today, oil royalty is often payable "in value,"
 - sometimes reserved "in kind,"
 - sometimes lessee has option to pay in value
 - sometimes lessor has option to take in kind

Bruce M. Kramer, Interpreting the Royalty Obligation by Looking at the Express Language: What a Novel Idea?, 35 Tex.Tech L.Rev. 223 (2004)

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In Kind Oil Royalty Clause

"To deliver to the credit of the lessor, free of cost in the pipeline to which lessee may connect its well, 1/8 part of the oil produced and saved...."



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[The Oil and Gas Lease from A to Z: Classification, Scope of Grant, and Duration; Royalty Clauses; Implied Covenants; and Other Clauses](#)

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