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Analysis of Royalty Clauses and Issues – Past, Present and in the Future

[An analysis of the evolution of royalty clauses, up to and including current issues concerning recent decisions and pending cases, post-production costs, the *Heritage* case, royalties on gas plant products, and definitions of marketing and gathering]

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I. INTRODUCTION

The scope of this paper is primarily limited to current royalty disputes under Texas law, as anything beyond this limited scope would quickly become a treatise.

Prof. Owen Anderson, who regularly writes on royalty issues and teaches oil and gas law at the University of Oklahoma School of Law, but currently is a Visiting Professor at the University of Texas School of Law, where next year he will assume a full-time position, in 2003 wrote the following:

I can briefly summarize my present thought about many modern royalty valuation cases: although I am seldom surprised, *I am often appalled*. Although my views on royalty valuation, like the diverse views of other commentators on royalty valuation, have been ignored or misinterpreted by the courts, *I (and I hope others) remain undeterred in an effort to bring some level of common sense to royalty-valuation law*. Oil and gas resources are too strategically important to the future prosperity and security of the United States to leave this policy discussion solely in the hands of jurists.¹ (emphasis added).²

In *Royalty Jurisprudence: A Tale of Two States*,³ David E. Pierce, a Professor of Law at Washburn University School of Law, Topeka, Kansas, another highly respected authority on oil and gas law, and royalty cases, prefaced his excellent analysis with the following quote:

*It was the best of times, it was the worst of time, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of Light, it was the season of Darkness, it was the spring of hope, it was the winter of despair, we had everything before us, we had nothing before us, we were all going direct to Heaven, we were all going direct the other way. . . .*⁴

Given these bursts of optimism from two such eminent authorities, it seems a daunting task to write on appellate decisions in royalty cases, and indeed it is, because I too “am often appalled,” but, like Prof. Anderson, I likewise “remain undeterred” in bringing at least some level of common sense to royalty valuation, and this paper is written in that spirit, with hope and optimism that such concepts prevail in future oil and gas royalty cases.

¹ Owen L. Anderson, *Rogers, Wellman & The New Implied Marketplace Covenant*, 1 ROCKY MTN. MIN. FOUND. 13A (2003).

² Owen L. Anderson, *Royalty Valuation: Should Royalty Obligations Be Determined Intrinsically, Theoretically, or Realistically? Part 1: Why all the Fuss? What Does History Reveal?* Natural Resources Journal 37.3 (1997).

³ David E. Pierce, *Royalty Jurisprudence: A Tale of Two States*, 49 Washburn Law Journal 347 (2010).

⁴ CHARLES DICKENS, *A TALE OF TWO CITIES* 1 (Oxford University Press 1987) (1859).

In 2004, I undertook a CLE paper titled “Royalty Litigation in 2004 – An Update and a Look Ahead,”⁵ and in that paper, I engage in an exhaustive and often critical analysis of several of the landmark royalty cases, which I believe are either wrongly decided, or frequently cited by other appellate courts for propositions never intended. For those interested in a much more detailed analysis of those cases, I refer them to that paper.

I wish to express my thanks to Robert L. Theriot and Joshua P. Downer with the Liskow & Lewis firm in Houston for generously allowing me to use portions of their paper “Royalty and Deductions – Old Issues in New Plays,”⁶ to John B. McFarland with the Graves Dougherty Hearon & Moody, P.C. firm in Austin, for permitting me to use excerpts from his excellent Oil & Gas Blog: oilandgaslawyerblog.com.

Finally, my thanks to my colleagues at WattBeckworth, Madeline Mathews and Stephanie deJesus, for their assistance in attempting to keep me both accurate and literate.

II. OIL AND GAS ROYALTIES IN GENERAL

This paper is written for those lawyers who regularly practice in oil and gas law, as well as those who don’t, and for both a brief refresher may be helpful. To start, I am attaching the earliest standard form oil and gas lease that I have ever seen, which my great-grandfather signed in 1897 covering his 50-acre cotton farm in Navarro County north of Kerens, Texas. From it, no Great-Grandchild’s Trust ever resulted! But I attach it to illustrate how simple royalty clauses were in the beginning, and how their simplicity has now expanded to a complexity never imagined in 1897.

For the landowner, the royalty clause is the most important part of the lease, and along with the bonus money, is the principal consideration for granting the lease. In its most general terms, a royalty is a share of the revenue from sale of a product, and in oil and gas, it is a share of the revenue from the sale of the oil and gas produced.

In Texas, leases generally provide that the royalty on oil is a share of the oil itself - an “in-kind” royalty, whereas the royalty on gas is a share of the proceeds or amount realized from the sale of the gas, or a share of its market value.

Most disputes about royalties concern how royalties are calculated on gas production. Most oil production is still sold to purchasers at or near the well, and there is an established price in the field for the oil; the producer and royalty owner are both paid based on that price. Also, crude oil requires very little or no treatment before being used by the ultimate consumer, usually a refinery.

Gas is more complicated.

⁵ John Beckworth, Donato D. Ramos, Dick Watt, *Royalty Litigation in 2004 – An Update and a Look Ahead*, Civil Litigation Conference, The University of Texas School of Law Continuing Legal Education, October 28-29, 2004 (Austin); John Beckworth, Donato D. Ramos, Dick Watt, *Royalty Litigation in 2004 – An Update and a Look Ahead*, 19-1, TEX. OIL AND GAS L. J. 1 (2005).

⁶ Joshua P. Downer, Robert L. Theriot, *Royalty and Deductions – Old Issues in New Plays*, 39-1 SEC. REP. OIL, GAS & ENERGY RESOURCE L. SEC. ST. B. TEX. 135 (Fall 2014).

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