

ROYALTY ISSUES IN 2015 AND BEYOND

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- For a more expanded discussion of many of these issues, *see* Dick Watt, Donato D. Ramos, John Beckworth, *Royalty Litigation in 2004: An Update and a Look Ahead*, The University of Texas School of Law Civil Litigation Conference, October 28-29, 2004, condensed in Dick Watt, Donato Ramos & John Beckworth, *Royalty Litigation - Key Issues*, 19 Tex. Oil & Gas L. J. 1 (2005). *See also* Pearson, "Gas Royalty Calculation 2005 — An Update," OIL, GAS & ENERGY RES. L. SECTION REPORT No. 3 at 4 (St. Bar of Texas 2006).
- Problem: snippets from prior cases continue to be rotely applied over and over by judges who do not understand their original context, and then exacerbate and compound confusion by applying misunderstood maxims to ever-changing fact situations.
- Goal: a unified theory of gas royalty – chaos vs. clarity and predictability

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ROYALTIES ON GAS – MARKET VALUE AND PROCEEDS

- Early gas marketing practices
- “Proceeds” or “amount realized”
- The original rationale for using “market value” in gas royalty clauses—deductibility of post production costs when gas sold at a point that is off the lease
- The bi-furcated gas royalty clause
 - Combines “market value” and “proceeds”
 - which is used depends upon the point of sale

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ORIGINS OF MARKET VALUE ROYALTY CLAUSE

“When I was a young lawyer in the late 1950's, . . . I believed I understood gas royalty clauses based on ‘proceeds’ or ‘net proceeds’ or ‘gross proceeds’. **But I was baffled by the words “market value at the well” found in most lease forms.**

My mentors, who were older and wiser, explained that it is sometimes necessary for the lessee to transport gas from the well to the purchaser’s pipeline, perhaps off the lease and some distance away. **The words ‘market value at the well’ were designed to enable the lessee, for royalty purposes, to construct an artificial (but fair) wellhead value by deducting transportation costs from the price he received at the purchaser’s pipeline.** Thus, if it costs the lessee 2¢ per Mcf to transport the gas to the purchaser’s pipeline, where he sells it for 10¢ Mcf, the presumed wellhead value for royalty purposes would be 8¢ per Mcf.”

Thomas W. Lynch, *The Deductibility of “Post Production” Costs in Calculating Gas Royalties*, Review of Texas Oil and Gas Law X, Energy Law Section, Dallas Bar Association, August 24, 1995 (Dallas). (Emphasis added). Thomas W. Lynch is a former vice president and general counsel of Sun Oil Company and Oryx Energy, and former chairman of the Oil, Gas and Mineral Law Section of the State Bar of Texas.

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AT THE OUTSET, WHAT CAUSES SO MANY PROBLEMS HERE?

- Both methods – market value and proceeds - presume a practice that almost never occurs: natural gas sold “at the well”
- While some modern leases address this, most leases (even new ones) still use “market value” and “proceeds” as royalty standards
- By 1948, lawyers were already frustrated enough to state:

“... the ordinary royalty clause pertaining to gas is one of the most ambiguous and incomplete provisions of an oil and gas lease ever to be brought before the courts.”
Joseph T. Sneed, *Value of Lessor's Share Production Where Gas Only is Produced*, 25 Tex. L. Rev. 641, 656-57 (1948).
- But at least at that time, “market value” was “calculated” by subtracting post-production costs from “proceeds” – royalty based on proceeds and market value are identical, except for cost
- And after 1948, it gets worse -- gas is regulated and gas marketing practices change

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THE MAJOR ROYALTY CASES

- *Texas Oil & Gas Corp. v. Vela*, 429 S.W.2d 866 (Tex. 1968).
- *Exxon Corp. v. Middleton*, 613 S.W.2d 240 (Tex. 1981).
- *Amoco Prod. Co. v. First Baptist Church of Pyote*, 579 S.W.2d 280 (Tex. Civ. App.–El Paso, 1979), writ ref'd per curiam n.r.e., 611 S.W.2d 610 (Tex. 1980).
- *Cabot v. Brown*, 754 S.W.2d 104 (Tex. 1987).
- *Heritage Resources, Inc. v. NationsBank*, 939 S.W.2d 118 (Tex. 1996).
- *Yzaguirre v. KCS Res., Inc.*, 53 S.W.3d 368, 373 (Tex. 2001).
- *Union Pac. Res. Grp., Inc. v. Hankins*, 111 S.W.3d 69 (Tex. 2003).

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