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

2021 Fundamentals of Oil, Gas, and Mineral Law

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Overview

- What is the lease royalty?
- Measurement, Calculation, and Payment
- "At the Well" or "in the field" :Post-Production Costs
- Market Value or Market Price

The Lease Royalty

“ The landowner's share of production, free of expenses of production.”

- Heritage Resources, Inc. v. NationsBank, 939 S.W.2d 118 (Tex. 1996)

“A royalty interest, as one of the five attributes of a mineral estate, is an interest in real property, and thereby has the same attributes as real property. As such, a royalty interest may be severed from the mineral estate and held separately, pooled, conveyed, or reserved in connection with a conveyance of the mineral estate.”

- Aery v. Hoskins, Inc., 493 S.W.3d 684 (Tex. Ct. App – San Antonio)

Royalty Interests

- Lessor’s Royalty - Paid to the lessor as main consideration for issuance of the lease

- Non-Participating Royalty – Royalty held by a non-executive interest holder
  - *KCM Financial LLC v. Bradshaw, 457 S.W.3d 70 (Tex. 2015)*

- Overriding Royalty - an interest which is carved from, and constitutes part of, the working interest created by an oil and gas lease
  - *EOG Resources, Inc. v. Hanson Production Co., 94 S.W.3d 697 (Tex. Ct. App – San Antonio, 2002)*

- Shut in Royalty is *not* Royalty: Royalty is a share of production. Shut in wells do not produce.

Royalty Provisions

Flat rate royalty:
$300.00 per year for each commercially-producing gas well drilled on the property

Fixed fraction/percentage of production:
Lessor shall receive 1/4 of 7/8 of the oil, gas or other minerals, free of all cost of operations and production or at its option [lessor] may elect to receive, free of cost, the value of 1/4 of 7/8 of all oil, gas or other minerals produced and saved from said premises.

Variable royalty
Lessee shall pay as royalty, the sum of not less than 16 2/3 percent of the gross proceeds from sales after deducting the oil used by Lessee for development and operation purposes on the lease: Provided, That when the quantity of oil taken from all the producing wells on any quarter-section or fraction thereof, according to the public survey, during any calendar month is sufficient to average one hundred or more barrels per active producing well per day the royalty on such oil shall be not less than 20 percent.

Defining Production

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

"Consequently, it has become well established under Texas law that the term **"production" as used in oil and gas leases means the actual physical extraction of the mineral from the soil**…. royalties are not owed unless and until actual production, the severance of minerals from the formation, occurs" - *Killam Oil Co. v. Bruni, 806 S.W.2d 264 (Tex. App.— San Antonio 1991, writ denied)*

Advanced payments, Take-or-Pay Settlements are not "production" and thus not part of the royalty obligation unless the lease specifies otherwise.

Is Flared Gas production? Look to lease and drafting of the royalty. Is royalty paid on "gas produced" or "gas produced and saved"

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

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