FUNDAMENTALS OF ROYALTY CALCULATION: HOW A FEW SMALL WORDS CAN MAKE A BIG DIFFERENCE

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Summary: This paper discusses the various types of royalty clauses and their most common components, as well as the proper methodologies for calculating royalties under each of those clauses.

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I. INTRODUCTION

An oil and gas lease is a contract between a lessor and a lessee.[1] Under a typical oil and gas lease, the lessor, as the owner of mineral rights in a tract of property, gives the lessee the right to explore for and produce oil, gas or other minerals from the property; and in turn, the lessee agrees to pay royalties to the lessor on any oil, gas or other minerals that the lessee successfully produces from the property.[2] A "royalty" is simply the compensation or consideration that the lessor is entitled to receive for allowing the lessee to exploit the lessor's mineral rights.[3] The "royalty clause" is the term or provision in an oil and gas lease that specifies how a lessee must calculate the lessor's royalties.[4]

As with any other kind of contract, an oil and gas lease is subject to the usual canons of contract construction.[5] The first and foremost canon of contract construction is that if a contract is unambiguous, a court must enforce it as it is written.[6] And at least in Texas, words matter. A royalty clause which entitles the lessor to "1/8 of any oil or gas production" is different from a royalty clause which entitles the lessor to "1/8 of the market value of any oil or gas production at the wellhead."[7] A royalty clause which entitles the lessor to "1/8 of the market value of any oil or gas production at

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[1]Exxon Corp. v. Emerald Oil & Gas Co., 348 S.W.3d 194, 201 (Tex. 2011). This paper will refer principally to oil and gas leases in describing the most common types of royalty clauses. Royalty clauses, however, are not unique to oil and gas leases. Mineral deeds, for instance, may contain provisions in which the seller reserves a royalty interest.

[2]*See* David E. Pierce, *Incorporating a Century of Oil and Gas Jurisprudence Into the "Modern" Oil and Gas Lease*, 33 WASHBURN L.J. 786, 788-89 (1994).

[3]*See* Griffith v. Taylor, 156 Tex. 1, 291 S.W.2d 673, 676 (1956); Lyle v. Jane Guinn Revocable Trust, 365 S.W.3d 341, 351 (Tex. App.—Houston [1st Dist.] 2010, pet. denied). Although this paper will refer primarily to royalty interests that derive from oil and gas leases, another common form of royalty interest is an overriding royalty interest. An overriding royalty interest typically is "carved out of the working interest" — *e.g.*, the lessee assigns it out of the lessee's working interest to a party other than the lessor. Southwestern Energy Prod. Co. v. Helfand, 491 S.W.3d 699, 714 n.9 (Tex. 2016). In Texas, the same principles that govern the calculation of royalties under an oil and gas lease also apply to an overriding royalty interest. *See, e.g.*, Chesapeake Expl., L.L.C. v. Hyder, 483 S.W.3d 870, 872-73 (Tex. 2016).

[4]*See* Heritage Res., Inc. v. NationsBank, 939 S.W.2d 118, 125 (Tex. 1996) (Owen, J., concurring). Justice Owen's concurring opinion later became the Texas Supreme Court's plurality opinion in *Heritage Resources*. *See Hyder*, 483 S.W.3d at 875 & n.25.

[5]Tittizer v. Union Gas Corp., 171 S.W.3d 857, 860 (Tex. 2005).

[6]*See, e.g.*, XTO Energy Inc. v. Smith Prod. Inc., 282 S.W.3d 672, 676 (Tex. App.—Houston [14th Dist.] 2009, pet. dism'd); Stewman Ranch, Inc. v. Double M Ranch, Ltd., 192 S.W.3d 808, 810-11 (Tex. App.—Eastland 2006, pet. denied); TSB Exco, Inc. v. E.N. Smith Energy Corp., 818 S.W.2d 417, 421 (Tex. App.—Texarkana 1991, no writ).

[7]*See infra* text accompanying notes 25-60.

the wellhead" is different from a royalty clause which entitles the lessor to "1/8 of the amount realized on the sale of any oil or gas production at the point of sale."[8]

As a general rule, most royalty clauses specify that the lessee must calculate its royalty payments "free of [the] expenses of production."[9] The rationale for that rule is that as between the lessor and the lessee, the lessee should bear the risk and cost inherent in drilling for oil or gas, including the risk that an oil or gas well may be a dry hole.[10] But precisely because of that risk, a lessee who drills a successful well typically receives a greater share of the production than the lessor or royalty owner who provided the mineral interest in the first place. That is why royalty interests usually range from 1/8 to 1/3 — almost never more than 1/2.[11]

Nonetheless, there is no standard or uniform royalty clause.[12] As with most other states, Texas has "long recognized" a "strong public policy in favor of preserving the freedom of contract."[13] The parties to an agreement generally "have the right to contract as they see fit."[14] Thus, the terms of an oil and gas lease, including its royalty clause, are subject to negotiation.[15] The parties to an oil and gas lease may, if they wish, agree to shift some of the costs of production to the lessor

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[8]*See infra* text accompanying notes 61-72.

[9]*Heritage Res., Inc.*, 939 S.W.2d at 121-22.

[10]*See* Gary B. Conine*, Speculation, Prudent Operation, and the Economics of Oil and Gas Law*, 33 WASHBURN L.J. 670, 676 (1994).

[11]*See* Frank L. Cascio, Jr., *A Practical Look at the Major Differences Between Domestic and International Exploration Agreements*, 43 ROCKY MTN. MIN. L. INST. § 12.07 (1997).

[12]Bruce M. Kramer, *Interpreting the Royalty Obligation by Looking at the Express Language: What a Novel Idea?*, 35 TEX. TECH L. REV. 223, 263 (2004); *see* Union Pac. Res. Group, Inc. v. Neinast, 67 S.W.3d 275, 279 (Tex. App.—Houston [1st Dist.] 2001, no pet.).

[13]Fairfield Ins. Co. v. Stephens Martin Paving, LP, 246 S.W.3d 653, 664 (Tex. 2008).

[14]In re Prudential Ins. Co., 148 S.W.3d 124, 129 & n.11 (Tex. 2004).

[15]*See* Jeff King, *Natural Gas Royalties: Lessor vs. Lessee and the Implied Covenant to Market*, 63 TEX. BAR J. 854, 854 (2000) ("Oil and gas leases are negotiated contracts."); Shannon H. Ratliff & S. Jack Balagia, Jr., *Oil and Gas Royalty Class Action Litigation: Pushing the Limits of Rule 23 and Comparable State Class Action Rules*, 46 ROCKY MTN. MIN. L. INST. § 21.01[2][b] (2000) ("[O]il and gas leases are frequently and fiercely negotiated ....").

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