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Chapter 7

Royalty Administration in Volatile Energy Markets

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Synopsis

§ 7.01. Introduction.

In the Byrd's 1960s hit *My Back Pages* (the quasi title song on the album *Younger than Yesterday*), Roger McGuinn sang one of Bob Dylan's more puzzling refrains, "Ah, but I was so much older then, I'm younger than that now."[1] Although these lyrics clearly present a chronological challenge, in comparing the natural gas market to that existing in the mid-70s, it would appear the concept of *Younger than Yesterday* may be an appropriate description. The natural gas markets then were stable, with very limited options and opportunities, adjectives which might describe older, more mature persons. Yet now, the natural gas markets are less stable and more chaotic, presenting producers with a significantly wider variety of gas marketing options.

1 "My Back Pages" recorded first by Bob Dylan, *Another Side of Bob Dylan*, released May 1, 1964, Columbia.

Not surprisingly, these options are accompanied by risks. One of the risks is legal exposure to the royalty owner. For if we consider the calculation of royalties as an equation, the key components of that equation are the royalty provisions of the lease and the value of the production or the proceeds received from the sale of that production. Even though royalty provisions have remained relatively constant, the volatility of the gas markets and of the marketing options have made the royalty calculation equally volatile. The numerous cases dealing with this degree of volatility have on balance neither been consistent nor particularly helpful. This chapter describes the old stable market and legal principles formulated in that time, compares the marketing options then available to those existing under current market conditions, and the problems for a lessee attempting to apply those principles to current reality, and somewhat tentatively makes suggestions on charting a course through the minefield so created.

For much of the time since the enactment of the Natural Gas Act (NGA) in 1938,[2] and perhaps more importantly since the United States Supreme Court determined in *Phillips Petroleum Co. v. Wisconsin*[3] that the Natural Gas Act applied to gas sales by producers in interstate commerce and required such sales to be at just and reasonable rates, gas markets have been dominated by interstate pipelines. The interstate pipelines purchased the gas at or near the wellhead, at low prices regulated under the "just and reasonable" standard by the Federal Power Commission (FPC), the predecessor to the Federal Energy Regulatory Commission (FERC). Gas once dedicated to interstate commerce by a sale to an interstate commerce could not be freed from the burden of that dedication without a formal abandonment order issued by the FPC, which required a finding that such abandonment was permitted by "public convenience and necessity."[4]

The pipelines purchased the gas at the wellhead or central points in the field and transported it to end users, including the local distribution

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2 Natural Gas Act of 1938, 15 U.S.C. §§ 717-717w (1997).

3 Phillips Petroleum Co. v. Wisconsin, 347 U.S. 672 (1954).

4 California v. Southland Royalty Co., 436 U.S. 519, 60 *Oil & Gas Rep*. 445 (1968).