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Chapter 10

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Royalty Valuation: Calculating Freight in a Marketable-Product Jurisdiction

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Synopsis

§ 10.01. Introduction.

In an article published in 1994, I safely predicted that royalty payment disputes, particularly those involving gas, would continue to be a chief source of oil and gas litigation.[2] One purpose of that article was to illustrate the difficulties encountered in the use of a work-back or net-back approach to royalty valuation, commonly used to calculate royalty where the first sale of gas occurs downstream of the wellhead. These difficulties arise because appellate courts have been quick to bless the use of the work-back approach while neglecting to offer guidance concerning the details of the actual work-back calculation. Indeed, appellate courts offer little if any consistent guidance on a number of royalty-related issues:

1. Although there is universal agreement that royalty is generally payable on "production," when and where does production actually occur? Stated conversely, what specific activities and facilities are post-

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1 Professor Anderson acknowledges the able research assistance of Jolisa Melton and Brent Newcombe.

2 Owen L. Anderson, "Calculating Royalty: 'Costs' Subsequent to Production – 'Figures Don't Lie, But .... ,'" 33 *Washburn L.J.* 591, 591 (1994)(hereafter Anderson I).

production? Do their locations, whether at the well, on the leased premises, off the leased premises, within the field, or away from the field, affect their classification as production or post-production? Do their purposes matter – *i.e.*, whether to make raw gas a marketable product or to enhance gas regardless of its prior marketability?

2. If particular pre-sale activities and facilities are classified as post-production, how is the net royalty payable to be determined? Should upstream comparable sales be used to determine net royalty payable? If there are no comparable sales, should upstream value be determined by a work-back or net-back approach? If so, should the calculation begin with the actual downstream sales price, the downstream spot-market value, or some other value?[3] If the actual downstream sales price is generally to be used, is there nonetheless some limit on how far downstream one should or must go to start the calculation?[4] If the first sale is to an affiliate, should that sale be skipped for purposes of determining a starting point, or should that sale constitute the starting point if it appears to be an arm's-length equivalent sale?

3. Once a starting point has been identified, what specific categories of costs can the lessee proportionately deduct from royalty as post-production costs? Should every post-wellhead expense, including the initial separation of the oil, gas and brine and the disposal of any salt water, be

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[3] *Cf.*, Piney Woods Country Life Sch. v. Shell Oil Co., 726 F.2d 225 (5th Cir. 1984)(holding that market value royalties are ordinarily payable on current values at time of production, which may be determined by reference to contemporaneous comparable sales of similar wellhead gas, to contemporaneous comparable sales of similar downstream gas less post-wellhead costs, or to the actual contract price of gas less post-wellhead costs); Tara Petroleum Corp. v. Hughey, 630 P.2d 1269 (Okla. 1981)(holding that market value royalties are ordinarily payable on the contract price of gas); and Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866 (Tex. 1968)(holding that market price royalties are payable on current values at the time of production).

[4] Perhaps the most extreme example of beginning a work-back calculation far downstream is illustrated in *Marathon Oil Co. v. United States*, 604 F. Supp. 1375 (D. Alask. 1985), *aff'd* 807 F.2d 759 (9th Cir. 1986). The court affirmed the Mineral Management Service's valuation of gas by working back from the sales price of gas that was produced in Alaska but sold in Japan. The gas at issue constituted 16 percent of Marathon's share of gas produced in the Kenai Field Unit and was liquefied in Alaska and then shipped by LNG tanker to Japan. Both Marathon and other producers sold other comparable gas in Alaska.