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Chapter 12 Market Value Royalties—Yesterday, Today and Tomorrow

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§ 12.01. **Why this Topic? Aren't the Issues Behind Us?**

During the pre-NGPA era of gas sales pursuant to long-term contract dedications and bifurcated markets with unregulated intrastate prices frequently at substantial premiums over Natural Gas Act¹ regulated interstate prices, disputes arose over whether royalties under market value royalty leases were to be governed by the terms of the lessee's long-term gas sales contract with prices substantially below current market prices or, by some higher value, representative of the current market. This resulted in a split among jurisdictions on that issue.

Subsequent to the gas market structure that existed at the time of these decisions, natural gas markets and natural gas marketing changed substantially. The former paradigm no longer exists. The Natural Gas Policy Act in 1978² ushered in a hodgepodge of multi-tiered pricing, and in some cases, free market pricing. There followed an early-on substantial fly-up in unregulated prices and to a lesser extent, in regulated prices, to be succeeded by a free-fall of gas prices in the mid-1980s, and the complete deregulation of gas prices effective January 1, 1993.³ In the meantime initiatives of the FERC, pursuant to FERC Order 436 in 1985 and Order 636 in 1992, and a policy fostering the spin-down and spin-off of gas gathering systems previously owned and regulated as a part of interstate pipeline facilities completely restructured the natural gas market. This resulted in the prevalence of spot market and short-term gas sales, price indices and the pricing of gas based thereon. Further, the marketing of gas at locations distant from the wellhead as a response to FERC's open access and unbundling initiatives has revealed previously invisible post-wellhead costs that enhance the value of the gas—costs that producers quite naturally assert should not be royalty bearing, thus adding another

¹ 15 U.S.C. § 717 (2004) *et seq.*

² Pub. L. No. 95-621, 15 U.S.C. § 3301, *et seq.*, repealed in part, Pub. L. No. 101-60, 103 Stat. 157 (July 26, 1989).

³ Natural Gas Wellhead Decontrol Act of 1989, Pub. L. No. 101-60, § 2(b).

dimension to market value determinations. This chapter begins with the issues that arose and the case law decisions made under a gas marketing structure from a different era, and considers whether and to what extent those same decisions are applicable today in the new market environment. Further, that new market environment presents other issues that did not previously exist.

§ 12.02. Some Basics.

[1] — Royalty and Types of Royalty Clauses.

This chapter is concerned with a species of royalty clause that is found in the oil and gas lease.⁴ It does not deal with the so-called stand-alone royalty interest.

⁴ Market value and market value royalty clauses have been addressed in a number of papers over the years, usually as a part of a broader discussion about royalty issues. A representative, but by no means exhaustive, list is: Robert B. Allen, "Royalty Administration in Volatile Energy Markets," 23 *Energy & Min. L. Inst.* ch. 7 (2002); Owen L. Anderson, "Royalty Valuation: Should Royalty Obligations be Determined Intrinsically, Theoretically, or Realistically, Part 2," 37 *Nat. Resources J.* 611 (1997); Ashabranner, "The Oil and Gas Lease Royalty Clause – One-Eighth of What?," 20 *Rocky Mt. Min. L. Inst.* 163 (1975); Earl A. Brown, "Royalty Clauses in Oil and Gas Leases: Their Nature, Construction and Remedies for Breach Thereof," 16 *Oil & Gas Inst.* 139 (Sw. Legal Fdn. 1965); Fischl, "Ascertaining the Value or Price of Gas for Purposes of the Royalty Clause," 21 *Okl. L. Rev.* 22 (1968); Hardwick and Hayes, "Gas Royalty Issues Arising From Direct Gas Marketing," 43 *Oil & Gas Inst.* ch. 11 (Sw. Legal Fdn. 1992); Hardwick and Hayes, "Gas Marketing Royalty Issues in the 1990's, Paper No. 2," *Special Institute on Oil & Gas Royalties on Non-Federal Lands* (Rocky Mt. Min. L. Fdn. 1993); Bruce Kramer, "Interpreting the Royalty Obligation by Looking at the Express Language: What a Novel Idea?," 35 *Tex. Tech. L. Rev.* 223 (2004); Bruce Kramer, "Royalty Interest In the United States: Not Cut From the Same Cloth," 29 *Tulsa L.J.* 449 (1994); John S. Lowe, "Defining the Royalty Obligation," 49 *SMU L. Rev.* 223 (1996); Richard C. Maxwell, "Oil and Gas Royalties – A Percentage of What?," 34 *Rocky Mt. Min. L. Inst.* ch. 15 (1988); Daniel M. McClure, "Royalty Valuation and Payment Issues: Where Are We and Where Are We Headed?," 48 *Rocky Mt. Min. L. Inst.* ch. 11 (2002); Joseph W. Morris, "The Gas Royalty Clause – What is Market Value?," 25 *Oil & Gas Inst.* 63 (Sw. Legal Fdn. 1974); David E. Pierce, "Royalty Calculation in a Restructured Gas Market," 13 *Eastern Min. L. Inst.* ch. 18 (1992); Kevin L. Sykes, "The Royalty Clause, A Guide for the Commoner," 11 *Eastern Min. L. Inst.* ch. 22 (1990). *See also*, Kramer and Martin, *Williams & Meyers Oil & Gas Law* § 650.2; E. Kuntz, *The Law of Oil and Gas*, § 40.4 (1989).