

Liability to Royalty Owners For Proceeds From Take-or-Pay and Settlement Payments

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§ 14.01. Introduction.

The natural gas industry in the pre-1990's period was predicated on the role of the pipeline as a merchant, not merely a transporter of natural gas. In many cases, pipelines executed gas purchase contracts with lessee/producers that were lengthy in duration and contained take-or-pay provisions committing the pipeline to pay for gas which it did not physically take.⁽¹⁾

Pipeline purchasers were caught in the natural gas price bubble of the 1980's, which restricted their ability to sell gas to end users at prices that would cover their purchase price from producers.⁽²⁾

Pipelines therefore became obligated under their take-or-pay clauses to pay for gas they did not want. This, in turn, led to pipelines refusing to either take or pay for natural gas.⁽³⁾

Producers quite naturally claimed that the pipelines were contractually liable for their take-or-pay obligations.⁽⁴⁾

In the ensuing years, many pipelines and producers either settled or litigated these claims, which in most cases led to the payment of substantial sums of monies to the producers.⁽⁵⁾

Williams and Meyers define a take-or-pay clause as follows:

A clause in a gas purchase contract requiring the purchaser to take, or failing to take, to pay for the minimum annual contract volume of gas which the producer-seller has available for delivery. Under such clause the purchaser usually has the right to take the gas paid for (but undelivered) in succeeding years.⁽⁶⁾

The continued inclusion of this reasonably simple clause was based on a reasonably simple premises: energy prices would continue to rise as shortages in supply would continue into the indefinite future.⁽⁷⁾

Unfortunately, the rising price scenario was displaced by an oversupply of natural gas characterized as the "natural gas bubble," which led to a sharp decline in energy prices generally and natural gas prices specifically. Thus pipelines were in the embarrassing position of agreeing to buy gas at a high price but unable to sell it except at a much lower price.⁽⁸⁾

Pipeline breaches of take-or-pay provisions led to massive payments being made to producers in the late 1980's. The "million dollar" question was whether the royalty owners would share in these payments, be they the result of a settlement agreement or a court judgment.

In analyzing this question, it is helpful to break down the payment into its component parts in order to determine whether a royalty payment is due with respect to each such component. Two active practitioners in the field have suggested that a take-or-pay settlement can be composed of the following four parts:

- 1) Payments to settle past pricing disputes attributable to prior production.
- 2) Payments to settle past take-or-pay obligations not attributable to past production. This component can further be subdivided into payments which are recoupable from future production and payments which are not so recoupable.
- 3) Contract buydown payments whereby the producer receives a lump sum payment to amend the contract to reduce the price on future gas purchases and, in some cases, to also reduce the purchaser's required takes.
- 4) Contract buyout payments whereby the producer receives a lump sum payment to terminate the contract. As a result, the gas is freed of any obligation to the purchaser and thus will be sold to different purchasers.⁽⁹⁾

An interesting issue is whether the royalty owner is entitled to notice of the contents of the agreement for purposes of determining whether royalty is to be owed. For example, payments under component 1 above relating to prior production would clearly be royalty-bearing. Payments relating to components 3 and 4, on the other hand, raise both royalty clause interpretation issues as well as implied covenant to market issues. In any event, it is likely that the characterization placed on the settlement by the lessee and the pipeline/purchaser would probably not be binding on the lessor who was likely not to be a party to either the contract or the settlement agreement.⁽¹⁰⁾

§ 14.02. The Early Decisions Ñ Groping in the Dark.

[1]ÑThe Wyoming Experience.

Wyoming was the first state to decide at the appellate level the merits of a royalty owner's claim to a share of take-or-pay monies received by a producer from a pipeline for gas that was not taken.⁽¹¹⁾

In *State v. Pennzoil Co.*,⁽¹²⁾ two state lessees had entered into a gas purchase contract with Colorado Interstate Gas (CIG). The contract contained a take-or-pay clause with a five-year make up period being given CIG to take the gas paid for but not taken.⁽¹³⁾

CIG was also required to pay the difference between the price it paid under its take-or-pay obligation and the price ultimately received when the gas was actually taken. Pennzoil refused to pay the state a royalty on the monies it received for gas not taken by CIG.