



Chapter 6

The Royalty Value Theorem and the Legal Calculus of Post-Extraction Costs

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§ 6.01. Why There Will Never Be Peace – Under the Oil and Gas Lease.

[1] — The Royalty Value Theorem.

Royalty disputes are the product of the “royalty value theorem”¹ which states:

¹ In 2000 I served as the impartial opening act for a two-day slugfest on royalty valuation issues between oil and gas producers and the United States Department of Interior’s Minerals Management Service (MMS). I tried to capture the essence of the parties’ differences with a single principle on which all parties could agree. My efforts

When compensation under a contract is based upon a set percentage of the value of something, there will be a tendency by each party to either minimize or maximize the value.²

Therefore, lessors will pursue courses of action designed to obtain $1/8\text{th}^3$ of $X+$ instead of $1/8\text{th}$ of X . Because any additional royalty paid to the lessor will come out of the lessee's interest, the lessee will object to paying royalty on $X+$ instead of X , unless required by the express terms of the oil and gas lease. The royalty-based lease relationship, by its very nature, is the classic *uncooperative* venture where each response to changed circumstances creates a new opportunity to pursue royalty value theorem strategies.⁴

resulted in the royalty value theorem. David E. Pierce, "What's Behind the Valuation Controversy Anyway?" *Special Institute on Federal & Indian Oil and Gas Royalty Valuation and Management*, Rocky Mountain Mineral Law Foundation and the Minerals Management Service (April 17, 2000)[hereinafter *Valuation Controversy*].

² *Valuation Controversy* at 1.

³ For illustration purposes I will assume the negotiated royalty is $1/8\text{th}$, realizing that today lessors frequently negotiate for royalties in excess of $1/8\text{th}$.

⁴ One decade ago, speaking at the Eastern Mineral Law Annual Institute, I addressed changing circumstances in the natural gas industry that would create new opportunities for royalty disputes. David E. Pierce, "Royalty Calculation in a Restructured Gas Market," 13 *E. Min. L. Inst.* 13-1 (1993)[hereinafter *Royalty Calculation*]. Ten years later, many of the predictions I offered are now the subject of a state supreme court opinion. For example, in discussing the Kansas/Texas approach to defining "market value" I made the following observation:

As with any limitation on risk, there is a price to pay. Under a market value royalty clause, the lessor gives up any claim to benefits the lessee may receive when the lessee assumes market risks by entering into longer-term contracts or sales transactions beyond the initial marketing point. As the *Vela* line of cases demonstrates, the lessee's market value risk can be substantial in a gas market of escalating prices. However, in a gas market of de-escalating prices, the lessee should be able to reap the full benefit of its contract risk assumption. For example, if the lessee has a contract authorizing collection of NGPA prices of \$3.19/Mcf, the lessee should be able to pay, under a market value royalty clause, royalty calculated from a properly adjusted spot price. For example, using the July 1992 spot price for sales at a designated sales point on Texas Eastern's pipeline, the price for royalty valuation should not exceed \$1.45. This would seem to be the