CHAPTER 18

Royalty Calculation in a Restructured Gas Market

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Synopsis

[1]--Lessor Strategies.

[2]--Lessee Strategies.

§ 18.07. Conclusions.

§ 18.01. Introduction.

The mere structure of a gas sales transaction can significantly impact the royalty due the producer's lessor.[(2)] In appropriate cases, courts have been willing to ignore the transaction structure created by the producer and the producer's gas purchaser when that structure adversely impacted the lessor's royalty rights under the oil and gas lease.[(3)] Since about 1985, fundamental regulatory changes have caused a restructuring of the natural gas industry and created previously unknown marketing opportunities for gas producers.[(4)] With new marketing options, a myriad of uniquely structured sales transactions, having an equally unique impact on a lessee's royalty obligations, are occurring. These new marketing opportunities create new royalty calculation issues under the oil and gas lease.

This Chapter examines the pre-restructuring jurisprudence developed to interpret common forms of royalty clauses and suggests how this law might be applied to post-restructuring transactions. The issues include determining how production will be valued to calculate royalty[(5)] and identifying expenses the lessee can properly deduct before calculating the lessor's royalty.[(6)] Each issue can be impacted by judicial treatment of the implied covenant to market and the degree to which the implied marketing covenant is circumscribed by the express terms of the royalty clause.

This Chapter also introduces a new concept for the oil and gas bar to consider: an implied covenant to *sell* production as opposed to an implied covenant to *market*. In many instances, the lessee's implied "marketing" obligations begin, and end, once oil or gas is sold. The terms of the initial sale, or subsequent resales, may be irrelevant to the royalty calculation when the royalty clause is tied to market value or proceeds at the well. This may help to simplify royalty calculations and protect the interests of all parties concerned, when gas is sold into the restructured gas market.[(7)]

§ 18.02. The Restructured Gas Market.

Royalty calculation problems arise when dealing with gas largely because the lessor is not a party to contracts that can impact the lessor's interests. The lessor and lessee define their relationships through the oil and gas lease[(8)] and, in some instances, a division order.[(9)] However, to effectively maintain its lease rights, the lessee is required to enter into various contracts with third parties to market gas produced from the leased land. Even the simple sale of gas to a purchaser in the vicinity where the gas is produced can trigger extensive litigation and the transfer of hundreds of millions of dollars in damages from lessees to lessors.[(10)] Therefore, it is certain that lessors will be scrutinizing the more complex contemporary transactions in an attempt to maximize their return under the oil and gas lease. Lessees will be scrutinizing contemporary transactions to try and obtain the best deal possible for their gas while ensuring the lessor shares only in income properly classified as "royalty" under the oil and gas lease. The lessee will also be concerned that the lessor "pays its way" when the lessee's marketing efforts extend beyond the traditional wellhead sale.

[1]--Traditional Marketing Scenario.

Under most forms of royalty clause, the lessee takes title to 100% of the gas production.[(11)] The lessor does not own any of the produced gas, having only a contractual right to receive payment for a fractional share