Oil & Gas Law

Class 13: OGL (5 / 7) –

Royalties

Royalties

- … where the "big money" (if any) will come from
  - = **many** disputes / lawsuits; ***Why?***
- ***Where does the term "royalty" come from?***
  - ***What other business arrangements use royalties?***
- **3 kinds mentioned in text:**
  - ***Landowner's royalty***
  - ***Overriding royalty***
  - ***Non-participating royalty***

Landowner's Royalty

- Express provision in the OGL – not left to implication
  - Taking in kind contemplated, Lessee usually takes the production … **uses it / sells it …**
  - … and pays the Lessor the appropriate **share [fraction] of** … **something** …
- Oil vs. gas: diff royalties → phys. differences
- **Inherent conflict btwn L'or and L'ee**
  - Pierce's **"royalty value theory"**: when compensation based on a percentage of something's value, each party will try to minimize or maximize that value.

<u>Royalty Clause Language</u>

- TX Form:
  - Paragraph 3
  - The royalties to be paid by Lessee are:
    - On oil, **<u>1/8 of that produced</u>** and saved from said land, to be delivered at the wells or into the pipeline into which the wells are connected …
    - On gas, 1/8 of the **<u>market value at the well</u>** …

- KS Form
  - Paragraph 4
  - Lessee agrees to pay Lessor a royalty …
    - In the pipeline to which Lessee may connect it wells, the equal 1/8 part of all oil produced from the leased premises, or at Lessee's option, 1/8 of the **<u>market price</u>** for oil of like grade and gravity prevailing on the day such oil is run into the pipeline or into storage tanks
    - On gas marketed from each well, 1/8 of the proceeds if sold at the well, or if marketed by Lessee off the Leased Premises, 1/8 **<u>the market value at the well</u>**

Piney Woods v. Shell

- Product?
  - T/f, Shell had to ________ in order to sell the gas at all!!
  - What did Shell do?
- What is the time frame of this dispute?
  - Notice – p. 302 distinction between intrastate prices and interstate prices
  - Gas regulation and deregulation:
    - up to the mid-1980s, some gas had to be sold under older, long-term Ks …
    - … while other gas could be sold at higher, unregulated prices

The Two Rules

- What is the Vela Rule?
- What is the Tara Rule?
- ==================================
- Which is the majority rule?
- Which is the minority rule?
- ==================================
- Which one does TX follow?
- Which one does OK follow?

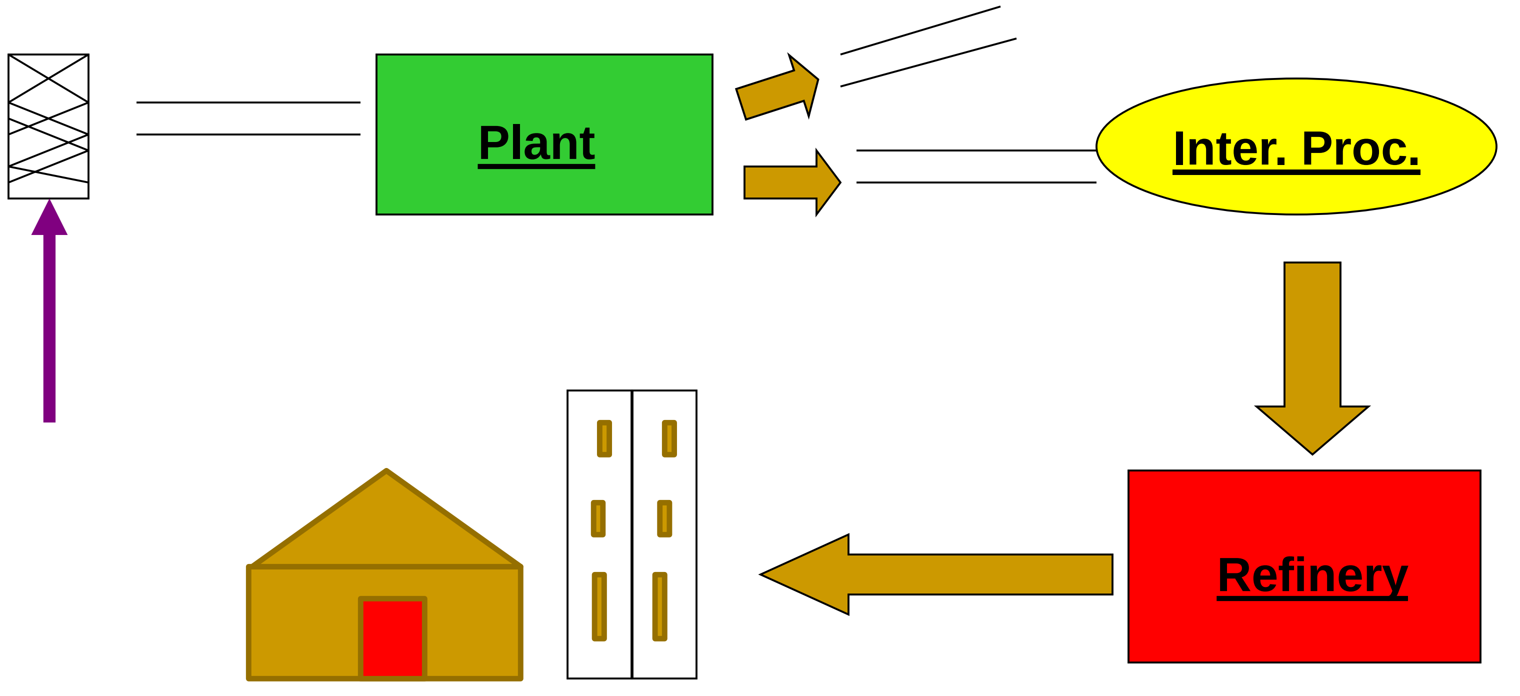
The Two Rules (cont'd.)

- Vela (TX → majority)
  - "market value" when the ***gas is produced*** and delivered, not when the gas contract entered into
  - strict view of OGL language: what L'or and L'ee intended when OGL signed
- Tara (OK; Ark; LA; KS → minority)
  - "market value" = K price; determined when the ***gas is sold***
  - more flexible: considers market realities
- ***Which do you think is more correct?***
- ***Why do we study this case?***

Valuation Methods

- Evidence of “market value”: alternatives
  - Sale price in contemporaneous arm’s length transaction, w/ sale being at the valuation point
  - Comparable sales
  - Pricing Index
  - “Net back”
- **What is “market value”?**
  - **contract price or the theoretical value?**
  - **=====================================**
  - **price under a long-term contract or current market price?**

Oil & Gas Marketing



- ***Does "market value" = "market price" = sales proceeds? And where is that determination made?***

Price Scenarios

- Contract price > Market price
- Market price > Contract price
- ***Can the Lessor keep changing its mind as circumstances change?***
- ==================================
- ***What if the K price isn't an arm's length transaction?***
  - ***Between related companies***
  - ***Based on some other transaction***

Royalty Payment Questions

- ***T/F: L'or's royalty is a share of L'ee's profits.***
- ***T/F: L'or's royalty is free of all costs.***


WARNING


END OF
WORLD
AHEAD


DANGER

… numbers, FRACTIONS and calculations ahead !!!!

Calculating Royalties

- ***Why?***
- ***How?***
  - **Schwartzenberger v. Hunt Trust Estate –**
    - **CL 10/ p. 209**
    - ***"mineral acres" → "Net Mineral Acres"***
      - **EX: 40 acres, but only ½ the minerals = 20 net min. ac.**
  - **EX:**
    - **you and a relative jointly own 20 net mineral acres**
    - **the 40-ac. tract is pooled into 160-acre pooled unit**
    - **royalty = 1/8**
    - **40/160 = 1/4 x 1/2 = 1/8 x 1/8 = 1/64 x 1/2 = 1/128 each**
    - **[20 / 160] = 1/8 …**

<u>What Happens if Royalty Is Not Paid?</u>

- <u>Cannon</u>, p. 388
- <u>***Why are production royalties handled differently than delay rentals or shut-in royalties?***</u>
- **Reasons:**
  - **Royalty clause severable from the habendum clause – not keeping the OGL alive**
  - **Adequate remedy at law**
  - **Royalty clause lang: covenant; not “unless”**
  - **Equitable reasons re risk and expense**

Misc. Royalty Issues

- "Free Gas" Clause
- Casinghead Gas
- Processed Gas
- ==
- 2 New Issues (not in the book):
  - What information the royalty holder is entitled to (vs. what they want) when conducting an audit
  - Shell v. Ross (TX Sup. Ct. 12/16/11):
    - alleged underpayments of royalties
    - Shell counterclaims that royalty holder's claims are time-barred by statute of limitations
    - Royalty holder claims that Shell's actions constituted "fraudulent concealment", thereby tolling the statute of limitations
    - Jury and App. Ct. agreed w/ royalty holder
    - Sup. Ct. – because the pricing information that the royalty was based on was "publicly available" from other sources, Shell's actions are irrelevant and don't constitute fraudulent concealment; royalty holder's claims barred

Next Class …

- Implied Covenants (Pt. 1 of 2)
  - Ch. 3 Sec. E3 (a)
  - Text pp. 449 - 480