THE MISSING LINK IN ROYALTY ANALYSIS: AN ESSAY ON RESOLVING VALUE-BASED ROYALTY DISPUTES

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INTRODUCTION

The oil and gas lease is intended to document a business transaction between the landowner[1] and oil and gas developer. The developer obtains the right to enter the landowner's property to search for, develop, produce, and take title to oil and gas. The landowner is compensated with a royalty on oil and gas produced from the land.[2] The royalty may be an actual share of the oil and gas produced, or it may be a payment of money. A combination of the two occurs frequently: a share of oil production for oil royalty and a payment of money for gas royalty.[3]

In most cases, if production is obtained from the leased land, the royalty will become the primary source of landowner compensation under the leasing transaction. Once the oil and gas lease is entered into, and production has been obtained, there are only two ways a lessor can maximize his royalty income: (1) increase the *volume* of production; (2) increase the *value* of production. The situs of the lessor's volume- and value-enhancing efforts is often a courthouse. This article focuses on the value-enhancing issues associated with the oil and gas lease[4] and offers what the author believes is a frequently applied, but previously unarticulated analysis for resolving value-based royalty disputes. This "missing link" analysis focuses on a fundamental issue courts must address to properly resolve lessor/lessee value disputes. When does the lease relationship come to an end? The analysis is neutral as to which party should prevail.[5] The analysis merely asks the critical question that should assist in resolving many collateral royalty value disputes when answered.

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1. The term "landowner" is being used to encompass severed mineral interest owners as well as persons owning the surface and mineral estates.

2. *See* EUGENE O. KUNTZ ET AL., OIL AND GAS LAW 220, 355-58 (3d ed. 1998). Other landowner compensation may include a cash bonus, delay rental, shut-in royalty, minimum royalty, and compensatory royalty.

3. *See infra* note 11 and accompanying text.

4. The volume enhancing issues relate to the lessee's diligent development of the lease. I have reviewed the inherent lessor/lessee conflicts associated with volume-enhancing disputes in previous writings. *See* David E. Pierce, *Rethinking the Oil and Gas Lease*, 22 TULSA L.J. 445, 459-60 (1987); David E. Pierce, *Coordinated Reservoir Development—An Alternative to the Rule of Capture for the Ownership and Development of Oil and Gas:* Part I, 4 J. ENERGY L. & POL'Y 1, 33-49 (1983).

5. However, a failure to apply the analysis of when a lease relationship comes to an end typically works to the detriment of the lessee and in favor of the lessor.

I. The Missing Link Analysis

The "life" and "death" on an oil and gas lease is fairly easy to identify. Once the lease is signed and delivered by the lessor, and is accepted by the lessee, an oil and gas lease relationship is formed. The life of the lease will typically terminate when there is a failure to pay delay rentals, commence operations, or when there is an inability to produce in paying quantities. Although there may be disputes concerning whether a lease-terminating event has occurred, the judicial analysis is fairly well defined for resolving these disputes. However, courts have not articulated an analysis for determining when in the life of the lease the lease "relationship" ends. At what point in the oil and gas development and production process are the lessor and lessee no longer contractually obligated to one another? When has the relationship run its course?

Although the parties' rights and obligations continue under the oil and gas lease, courts must define the limits of the document's sphere of influence. Only then can courts make accurate decisions concerning value-based royalty disputes. When a challenged activity falls outside the scope of the lease relationship, the analysis is at an end. There will be no contractual basis for asserting rights or imposing obligations on the parties. There can be no rights or duties if there is no contractual relationship. Similarly, there can be no implied obligations which of necessity must emanate from some sort of contractual relationship if there is no contractual relationship. Unfortunately, courts, litigants, and commentators have attempted to define and enforce contractual rights in "enhanced value" royalty disputes without addressing the basic question—is there even a contractual relationship to define and enforce? The basic task is to define, relying upon the express terms of the lease, where the parties intended their lease relationship to end.

A. *Missing Link Analysis in "Enhanced Value" Disputes*

In many royalty value disputes the litigants, and therefore the courts, attempt to resolve issues concerning the lease relationship without first defining its legal boundaries. This is best illustrated by the current flurry of oil "posted price" cases and analogous natural gas value cases. It is ironic that courts and commentators have for years lauded the simplicity of oil royalty calculation as compared to gas royalty. However, as natural gas became deregulated and took on marketing patterns similar to oil, instead of simplifying royalty calculation and reducing the number of royalty disputes, the deregulation has triggered parallel litigation concerning gas and oil.

Gas deregulation most likely triggered the oil royalty litigation of today. Lessors and their counsel have always been conditioned to look for more value in the gas context. When gas was deregulated,

the royalty owner could readily observe transactions in which gas was being sold to an affiliate or division of the lessee in the field and then subsequently marketed for a higher price somewhere downstream of the field.[6] This gave the lessor a bigger price to shoot for in their quest to maximize royalty income under their existing contract. Oil, which has been the object of a more vertically integrated industry since its inception, offered the lessor a similar opportunity. In contrast, the gas industry, at least from the 1940s[7] through the 1980s, has not been vertically integrated. Following deregulation, it became possible for the gas industry to integrate the exploration and production function with downstream value-added aspects of the natural gas business. Previously such integration was not possible because access to essential natural gas pipeline networks was not available.[8] However, varying degrees of vertical integration have always been possible with oil and have been a common practice since the industry began.

Consider the following hypothetical to appreciate how the missing link analysis can be used in the enhanced value situation: If we accept the notion that a barrel of oil in a stock tank is worth $X, and that the same barrel of oil, when aggregated with other volumes and delivered at some distance to another purchaser is worth $X+, how do we calculate royalty? Assuming a 1/4th royalty, does the lessor get 1/4th of $X or 1/4th of $X+? In this situation the lessor may even be willing to voluntarily share in the transportation cost to get the oil to the ultimate purchaser if $X+ minus transportation costs is still more than $X. The motivation of the lessor is evident: they will always seek 1/4th of $X+ when it yields them a greater royalty. The motivation of the lessee is evident: Since the additional royalty revenue will come out of the lessee's funds, they will oppose the lessor's demands unless the result is dictated by their lease agreement.

The missing link analysis requires that the court evaluate where the lease relationship ends. Does the oil and gas lease contemplate that

6. *See* Judith M. Matlock, *Payment of Gas Royalties in Affiliate Transactions*, 48 INST. ON OIL AND GAS L. & TAX'N 9-1 (1997) (comparing oil and gas transactions before and after deregulation).

7. The event which made vertical integration unlikely in the gas industry was the United States Supreme Court's decision in *Interstate Natural Gas Co. v. Fed. Power Comm'n*, 331 U.S. 682 (1947), holding that sales of natural gas from wells owned by an interstate pipeline were subject to the cost-of-service ratemaking authority of the Federal Power Commission under the Natural Gas Act of 1938. The practical effect of this case was to cause interstate pipelines to get out of the exploration, development, and production aspects of the gas industry. If they could only be compensated through a regulated rate of return for their exploration, development, and production activities, there was no incentive to engage in these riskier components of the gas industry. The compensation they could obtain under the public utility regulatory process would seldom approach the sort of returns necessary to finance high-risk upstream activities.

8. Unlike natural gas pipelines, interstate oil pipelines have been operated as common carriers since 1906. Pub. L. No. 337, § 1, 34 Stat. 584 (1906) (enacting the "Hepburn Amendment" to the Interstate Commerce Act).

the rights and obligations of the parties, their "relationship," will end at the wellhead, stock tank, field, main transportation pipeline, regional market center, national market center, refinery, bulk gasoline distribution terminal, or retail gas station? In the past, the implied covenant to market has been relied upon by lessors to try to extend the limits of the relationship to include the lessee's downstream activities.[9] However, the implied covenant should only operate within the limits of the relationship. Therefore, if the *relationship* ends at the field, no *implied covenant* should operate beyond the field level. If there is no longer a contractual relationship between the parties, then there will be no basis to attach implied obligations.[10] There is no underlying obligation to which it can attach.

B. *Defining the Limits of the Relationship*

The express terms of the oil and gas lease should define the scope of the contractual undertaking of the parties, and thereby define the limits of their relationship. Often the most useful defining language will be found in the royalty clause. The "last act" in the production process is typically the lessee's disposition of production. The lease relationship, pertaining to that barrel of oil or thousand cubic feet of gas, is at an end once such a royalty-defining event has taken place. Although the relationship continues with regard to oil and gas still in the ground and in the production process, once it progresses through the royalty-defining stage, the parties are no longer contractually bound regarding the production. There may be issues concerning whether the lessee has complied with express and implied terms of the lease leading up to the royalty-defining event, but those inquiries should not be impacted by what each party does with his share of the lease benefits following the royalty-defining event.

To illustrate the analysis, consider the following royalty clause:

> The royalties to be paid by Lessee are as follows: On oil, one-eighth of that produced and saved from said land, the same to be delivered at the wells or to the credit of Lessor into the pipe line to

9. *See* Wood v. TXO Prod. Corp., 854 P.2d 880 (Okla. 1992).

10. *See* HECI Exploration Co. v. Neel, 42 Tex. Sup. Ct. J. 93, No. 97-0403, slip op. 1998 WL 750977 (Oct. 29, 1998) (not released for publication at this time). Here the Supreme Court of Texas observed:

> This Court has not lightly implied covenants in mineral leases. . . . Our decisions have repeatedly emphasized that courts "cannot make contracts for [the] parties." . . . A covenant will not be implied unless it appears from the express terms of the contract that "it was so clearly within the contemplation of the parties that they deemed it unnecessary to express it," and therefore they omitted to do so, or "it must appear that it is necessary to infer such a covenant in order to effectuate the full purpose of the contract as a whole as gathered from the written instrument." . . . A court cannot imply a covenant to achieve what it believes to be a fair contract or to remedy an unwise or improvident contract . . . .

Id. at 7.

> which the wells may be connected. Lessee shall have the option to purchase any royalty oil in its possession, paying the market price therefor prevailing for the field where produced on the date of purchase. On gas, including casinghead gas, condensate or other gaseous substances, produced from said land and sold or used off the premises or for the extraction of gasoline or other products therefrom, the market value at the well of one-eighth of the gas so sold or used, provided that on gas sold at the wells the royalty shall be one-eighth of the amount realized from such sale.[11]

Assuming there is no other language in the lease expressly defining the scope of the parties' relationship, the royalty clause will be of paramount importance—particularly with regard to an enhanced value dispute. Under this royalty clause the following possibilities exist:

1. The relationship ends once production is delivered "at the wells."
2. The relationship ends once production is delivered to "the pipeline to which the wells may be connected."
3. The relationship ends once production leaves the "field where produced."
4. The relationship ends once production is "off the premises" of the lease.
5. The relationship ends at different locations depending upon the substance being marketed and the specific facts surrounding the marketing transaction.

Although a court will often have to resolve various factual and interpretive issues, the missing link analysis should establish the absolute outer limits[12] of the relationship. Under the foregoing clause the outer limits of the relationship would in most cases be the "field where produced." Therefore, if the lessee produces a barrel of oil or a thousand cubic feet of gas that is valued at $X in the "field where produced," it should make no difference to the lessor that the lessee, its affiliated marketing company, or an unrelated third party, obtained $X+ for the production somewhere beyond the "field where produced." By defining the scope of the relationship, the missing link analysis also defines the exploration, development, and production business in which the lessor and lessee participate. It also serves as the line of demarcation for lessee businesses in which the lessor is not entitled to participate.

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11. A.A.P.L. FORM 675—MODEL FORM OPERATING AGREEMENT (Am. Ass'n of Petroleum Landmen 1993).

12. The phrase "outer limits" is being used to indicate that the actual limit under a certain set of facts may be something less than the "field where produced," but it will not be anything greater than, or beyond, the "field where produced." In many instances the dispute may not require any greater precision than defining the outer limits of the relationship.

The missing link analysis does not define the royalty due. Instead, it defines the limits under which the express and implied covenants of the oil and gas lease will operate. For example, under the previously-quoted royalty clause the lessee will have an implied covenant to seek out markets for gas, casinghead gas, condensate, and other gaseous substances produced from the lease so as to trigger a royalty obligation. The outer limits of the lessee's marketing obligation for oil will be within the "field where produced." The outer limits of the lessee's obligation for gas will not extend beyond the wellhead or leased premises. In any event, if a sale is made off the leased premises for $X+, the royalty due will be governed by the express royalty clause provisions requiring royalty at the market value "at the well." The location for determining the scope of the relationship would not change the express lease clauses concerning location for royalty valuation purposes.

II. Traditional Analysis In Enhanced Value Disputes

Enhanced value disputes arise whenever the lessee elects to try to capture some of the potential post-production profit associated with aggregating, transporting, treating, packaging, and reselling oil and gas. The lessee's view is that once it pays the royalty on the produced oil and gas, it can then do whatever it wants with the full production stream. However, lessees have been willing, for administrative convenience, to permit the lessor to share in some downstream enhancement value so long as the lessee can deduct a share of the enhancement costs attributable to the lessor's share of the benefits. Such gratuitous acts on the part of the lessee have proven most unwise. For example, if the oil and gas lease provides for a royalty equal to "the market value at the well of one-eighth of the gas," a lessee may choose to pay royalty based upon the market value at a central delivery point in the field less the cost of gathering and compressing the gas to get it to the central delivery point. Assuming the gas is worth more at the central delivery point, less costs, than it is at the wellhead, an overpayment of royalty to the lessor will result.

Such lessee benevolence creates expectations that are often contrary to the terms of the oil and gas lease. Also, once there is a departure from the terms of the royalty clause to calculate royalty, lessor expectations can rise to include demands that they share in enhanced values beyond the central delivery point, that no costs be deducted, or that the costs being deducted are excessive. Many lessee royalty problems are self-inflicted because lessees have been willing to let their lessors share in the benefits of downstream activities when it is not required by their oil and gas leases.

When interpreting the "market value at the well" royalty measure, many courts will seek to use a work-back method to calculate market value when the lessee has been paying royalty on downstream pro-

ceeds less post-wellhead costs.[13] However, this will typically result in an overpayment of royalty because the lessor will be receiving a share of the downstream "profit" in addition to the wellhead value of the gas. Instead, lessees should attempt to structure the royalty calculation so that a wellhead value is identified as the gas emerges from the ground. This would require a defensible valuation of the gas at the well at the time it is produced. It may require actually selling some gas at the wellhead from time-to-time to establish comparable sales for use in determining wellhead market values.[14] Although affiliate transactions will be challenged, it would seem prudent to use a separate legal entity to purchase gas at the wellhead at all times. The affiliate nature of the relationship can be mitigated by using the same entity to make wellhead purchases of gas from unaffiliated third parties. This would also provide a third party comparable sales benchmark.

The enhanced-value issues are becoming even more interesting as lessees begin taking gas in the field and using it to generate electricity in the field.[15] If the lessee's electricity proceeds less generating costs are greater than the wellhead value of the gas used to generate the electricity, will the lessor be entitled to more royalty based upon the electricity sales? In this situation the separate lessee business is more pronounced, but not that much different from running the gas through a processing plant to market residue gas and gas liquids. The missing link analysis will be useful in all of these situations by defining the point at which the lessee ceases to be a "lessee" and becomes an independent oil industry entrepreneur.

CONCLUSION

The bulk of royalty litigation today concerns lessors seeking to share in benefits generated by their lessees' downstream activities. The traditional response to such disputes has been to classify the activities as either "production" or "post-production" and allow the les-

13. *See* Piney Woods Country Life School v. Shell Oil Co., 726 F.2d 225, 242 (5th Cir. 1984).

14. Comparable sales in the relevant area are generally regarded as the best evidence of market value. In *Heritage Resources, Inc. v. NationsBank*, 939 S.W.2d 118 (Tex. 1996), the Supreme Court of Texas observed:

> Market value at the well has a commonly accepted meaning in the oil and gas industry. Market value is the price a willing seller obtains from a willing buyer. There are two methods to determine market value at the well. The most desirable method is to use comparable sales. A comparable sale is one that is comparable in time, quality, and availability of marketing outlets. Courts use the second method when information about comparable sales is not readily available. This method involves subtracting reasonable post-production marketing costs from the market value at the point of sale.

Id. at 122 (citations omitted).

15. *In-Field Generator Opens Opportunity*, 41 AM. OIL & GAS REP. 72 (DEC. 1998).

sor to share in "production" activity benefits—unless their lease provides otherwise.[16] Some courts in recent years have relied upon the implied covenant to market to push "post-production" activities into the "production" category.[17]

These enhanced-value disputes should be approached by first defining the scope of the parties' relationship under the oil and gas lease. In most instances the oil and gas lease contemplates a relationship that begins, and ends, at the leased premises. The Texas Supreme Court has recognized that the lessee's implied obligations must be defined as though the lessee has only one lease, divorced from all other business relationships and the lessee's broader business concerns.[18] This same concept would seem to operate with regard to lessee rights and lessor obligations under an oil and gas lease, whether it is the product of an express or implied covenant. Therefore, the lessor will not suffer the burdens of the lessee's extra-lease businesses nor will the lessor enjoy the benefits.

The missing link analysis provides a contract-based approach to defining the point at which the lessee can freely engage in value-enhancing activities without fear of having its actions questioned or its profits taken. The lessor, in turn, gets what it bargained for: the value of production as it is produced, without regard for the lessee's extra-lease businesses or concerns.

16. *See* David E. Pierce, *Incorporating A Century of Oil and Gas Jurisprudence into the "Modern" Oil and Gas Lease*, 33 WASHBURN L.J. 786, 819-28 (1994) (discussing the various production and post-production business activities).

17. I have referred to this in prior writings as the "marketable product" game. *See* David E. Pierce, *Developments in Nonregulatory Oil and Gas Law: The Continuing Search for Analytical Foundations*, 47 INST. ON OIL AND GAS L. & TAX'N 1-1, 1-43 to 1-48 (1996).

18. *See* Amoco Prod. Co. v. Alexander, 622 S.W.2d 563, 569 (Tex. 1981).