THE ATTORNEY GENERAL OF TEXAS

AUSTIN, TEXAS 78711

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ATTORNEY GENERAL

August 23, 1971 Overruled WW 196 in Part

Honorable Bob Armstrong
Commissioner
General Land Office
Austin, Texas 78701

Opinion No. M-943

Re: Whether a proportionate cost of preparing natural gas from State leases for market may legally be deducted from the State's royalty interest.

Dear Commissioner Armstrong:

Your request sets out the following facts. The lease operator holds several State oil and gas leases in the Gulf of Mexico upon each of which it has drilled several wells that produce natural gas. On each lease one of the wells is a platform well or production deck well upon which are heaters, gas production separators, dehydrators, and metering devices for gas, condensate, and water. Each lease also contains one or more satellite wells upon which are a heater, meter, regulator, valves, and flow lines running from the satellite well to the platform well. After the gas has been processed through the above mentioned facilities, it is sold by the operator to the gas gatherer-purchaser at the platform well.

You further state that the lease operator seeks to deduct from and thus charge against the State's 1/6th royalty a proportionate part of the amortization of the costs of the above mentioned facilities, a 6% return on the investment, and the costs of operating these facilities.

Against this background you specifically request that this office ". . . review Opinion No. WW-196, along with our past and current oil and gas lease forms and advise us whether the charges asked for by the companies can be legally justified."

The statutory authority pursuant to which the royalty provision of the State oil and gas lease in question must conform is Sec. 8 and Sec. 10 of Art. 5421c, Vernon's Civil Statutes. Section 8 reads in part:

> "All islands, salt water lakes, . . . and
> that portion of the Gulf of Mexico within

> the jurisdiction of Texas . . . shall be subject to lease by the Commissioner of the General Land Office . . ., in accordance with the provisions of all existing laws pertaining to the leasing of such areas of oil and gas; . . . ; provided further, that the royalty reserved to the state shall be not less than one-eighth (1/8) of the gross production or value of oil, gas and sulphur. . . ." (Emphasis added)

Section 10 reads in part:

> "The areas included herein shall be leased for a consideration, in addition to the cash amount bid therefor, of not less than one-eighth (1/8) of the gross production of oil, or the value of same, that may be produced and saved, and not less than one-eighth (1/8) of the gross production of gas, or the value of same, and not less than one-eighth (1/8) of the gross production of sulphur, or the value of same that may be produced, that may be produced and sold off the area, and not less than one-sixteenth (1/16) of the value of all other minerals that may be produced, and an additional sum of twenty-five cents an acre per year for each year thereafter until production is secured. . . ."

The gas royalty provision contained in the State lease in question reads as follows:

> "3. When production of oil and/or gas is secured, the Lessee agrees to pay or cause to be paid to the Commissioner of the General Land Office at Austin, Texas, for the use and benefit of the State of Texas, during the term hereof; . . .
> (B) As royalty on any gas, . . . produced from any well and sold by Lessee, or used by Lessee for purposes which are not exempted from royalty payments . . . (1/6) *of the value of the gross production*, but in no event shall the royalty be based on a price of less than the highest market price

> paid or offered for gas in the general area, or the price paid or offered to the producer, whichever is the greater; . . ." (Emphasis added)

Analysis of the statutes and the State lease is light of the case law and former opinions of this office dealing with these leases and statutes provides the basis for the re-examination of Opinion WW-196.

Sections 8 and 10 of Art. 5421c, were originally promulgated by Acts 1931, 42nd Leg., p. 452, ch. 271. Sec. 10 has remained unchanged to date, but Sec. 8 has been amended several times, the most recent and important being by Acts 1957, 55th Leg., p. 434, ch. 209, §1, effective May 10, 1957, which added the proviso underlined in the above quoted portion of Sec. 8. In addition, Acts 1957, supra, stated that "All laws or parts of laws in conflict herewith are expressly repealed." Therefore, Sec. 8, on and after May 10, 1957, is the statutory authority for the clause in the State lease specifying the royalty reservation to the State. Prior to this amendment, however, Sec. 10 was the controlling statutory provision insofar as the royalty reservation clause in the State lease is concerned.

Comparison of the Sec. 8 royalty provision with that contained in Sec. 10 leads us to the conclusion that a material change was effected with respect to royalties on oil and sulphur. In effect, by the 1957 amendment, Sec. 8 deleted from Sec. 10 the qualifying language ". . . that may be produced and saved, . . ." as this pertains to the royalty payable on oil and the language ". . . that may be produced, that may be produced and sold off the area, . . ." as this pertains to sulphur. However, the absence of such modifying language in Sec. 10 and Sec. 8 in regard to the royalty provision pertaining to gas demonstrates a distinguishably consistent statutory standard. The various gas royalty reservations, i.e., that ". . . gross production of gas, or the value of same. . ." as used in Sec. 10 of Art. 5421c, and ". . . gross production or value of . . . gas . . ." used in Sec. 8 of Art. 5421c, and ". . . value of gross production . . ." used on the State lease form, are synonomus in meaning. We are of the opinion that with respect to gas, the State must receive its fractional interest based on the value of the entire production of gas without any deductions from the gas volume produced (Attorney General Opinion V-475) (1948), or the value thereof. In this we are fully supported by the authorities and the language of the State lease, as will be pointed out below.

We are supported by way of analogy with Article 5368, Vernon's Civil Statutes, commonly referred to as the Relinguishment Act, which specifies, in part, that:

> ". . . No oil or gas rights shall be sold or leased hereunder for less than ten cents per acre per year plus royalty . . . and in case of production shall pay to the State the undivided one-sixteenth of the value of the oil and gas reserved herein, and like amounts to the owner of the soil." (Emphasis added)

This language was construed in the case of Greene vs. Robison, 117 Tex. 516, 8 S.W.2d 655, 660 (1928), to mean:

> ". . . We interpret the Act to fix a minimum price of 10 cents per acre per annum and the value of one-sixteenth of the gross production free of cost to the state, for which the state is willing to sell the oil and gas, . . ." (Emphasis added)

It is our opinion, and we are supported by Attorney General's Opinion 0-6398 (1945), that within the phrase "the value of one-sixteenth of the gross production free of cost . . .," the term "free of cost" must be given the same meaning as the term "free royalty" used in Sec. 4, Art. 5421c, and defined in the case of Wintermann vs. McDonald, 129 Tex. 275, 102 S.W.2d 167, 173 (1937), that is:

> ". . . The term 'free royalty' introduced into this Act must mean that the interest reserved to the State in the minerals produced on school land sold under the terms of the Act must not bear any part of the expense of the production, sale, or delivery thereof." (Emphasis added)

We do not recognize any material distinction between the language delineating the basis for gas royalty to the State used in Sec. 8 and Sec. 10, Art. 5421c, and the language of Art. 5368, previously construed by the Court. Our conclusion is that the phrase in Sec. 8, Art. 5421c, to the effect that ". . . the royalty reserved to the state shall be not less than one-eighth (1/8) of the gross production or value of oil, gas and sulphur . . ." must be construed to mean that the royalty interest of the State must not bear any part of the expense of the production, sale or delivery of production of gas, and oil and sulphur for that matter, from a State lease. The State lease conforms to the statutory language and, therefore, is to be given the same meaning and effect.

In the case of California Company vs. Udall, 296 F.2d 384, (D.C.Cir. 1961), the Court had before it a statute and lease issued under the Mineral Leasing Act, Sec. 17, Mineral Leasing Act as amended, 41 Stat. 443 (1920), as amended, 60 Stat. 951 (1946), 30 USCA §226(c). The statute provides, in part, that the:

> "Leases shall be conditioned upon the payment by the lessee of a royalty of 12-1/2 per centum in amount or value of the production removed or sold from the lease."

The question before the Court was whether certain cost of conditioning the gas for market were chargeable to the lessor's royalty interest. The Court sustained as reasonable the Secretary of Interior's decision that "production" was the product [gas] in marketable condition as well as sustaining the premise of his decision that ". . . since the lessee was obliged to market the product, he was obligated to put it in marketable condition; . . .". Relevant to our analysis of the State lease in question here is the fact that the Secretary of the Interior had promulgated pursuant to the statutory language quoted above the following regulations governing leasing:

> "221.47 Value basis for computing royalties. The value of production, for the purpose of computing royalty shall be the estimated reasonable value of the product . . . . Under no circumstances shall the value of production. . . be deemed to be less than the gross proceeds accruing to the lessee from the sale [of the product]." 30 C.F.R. §221.47 (1959); and

> "221.35 Waste prevention; beneficial use. The lessee is obligated to prevent the waste of oil or gas and to avoid physical waste of gas the lessee shall consume it beneficially or market it or return it to

> the productive formation." 30 C.F.R. §221.35 (1959)

The latter part of the first regulation reads essentially the same as the phrase following "value of gross production" in the State lease form, that is:

> "but in no event shall the royalty be based on a price of less than the highest market price paid or offered for gas in the general area, or the price paid or offered to the producer, whichever is the greater; . . ."

The second regulation reads essentially the same as the first sentence in provisions 3(F) in the State lease form. Section 3(F) reads as follows:

> "Lessee agrees to use reasonable diligence to prevent the underground or above ground waste of oil or gas, and to avoid the physical waste of gas produced from the leased premises, Lessee shall either market said gas or use same beneficially in operations on the leased premises."

It is our opinion that California Company vs. Udall, supra, clearly sustains our position that the lessee-producer of gas from a State lease, pursuant to the terms of the lease, must pay royalties without any deductions for the cost of producing, sale or delivery of the gas so produced. The same result was reached in Gilmore vs. Superior Oil Co., 192 Kan. 388, 388 P.2d 602.; Skaggs vs. Heard, 172 F.Supp. 813 (S.D.Tex. 1959); California Company vs. Seaton, 187 F.Supp. 445 (D.D.C. 1960).

Our position is further supported in principle by Pan American Petroleum Corporation vs. Southland Royalty Co., 396 S.W.2d 519 (Tex.Civ.App. 1965, error dism.), where on page 524 the Court said:

> "It has long been established that a royalty interest is one that is free of cost of producing, saving and preparing the product for market. Miller vs. Speed, Tex.Civ.App. 248 S.W.2d 250 (n.w.h.)"

To the same effect, Merrill, Covenants Implied in Oil and Gas

Leases (Second Edition), Section 85, Page 214, states that:

> "If it is the lessee's obligation to market the product, it seems necessarily to follow that his is the task also to prepare it for market, if it is unmerchantable in its natural form. No part of the cost of marketing or of preparation for sale is chargeable to the lessor. This is supported by the general current of authority."

Attorney General's Opinion WW-196 (1957) specifically deals with the fact situation where the gas must be transported some considerable distance from the leased premises by the lessee in order to sell the gas to a pipeline purchaser. To that extent, Opinion WW-196 is distinguishable from the present situation on the facts and we do not reconsider that portion of the Opinion. However, in all other regards, Opinion WW-196 is expressly overruled because it is based on an erroneous interpretation of Sec. 10, Art. 5421c, with respect to gas processing charges and after May 10, 1957, it is no longer the controlling statute delineating the mineral reservation to the State. In addition, the rationale and authorities cited in that opinion are generally in point where the lease in question provides that royalties are to be based upon the value of gas at the wellhead and are distinguishable from and not definitive of the applicable statutory language of Sec. 8, Art. 5421c, used in the State lease. This distinction is material as is pointed out by Skaggs vs. Heard, supra, at page 816:

> "Plaintiff concedes the general rule that, where a lease provides for royalty on gas marketed or utilized by the lessee, there is an implied obligation upon the lessee to use reasonable diligence in marketing the gas[7] but says that this does not mean that the lessee is to pay all of the costs or expenses of marketing, transporting, processing or treating the gas, citing numerous cases where gas was not sold at the well or on the lease but was carried a great distance to market[8] or was enhanced in value by processing into by-products in expensive plants,[9] or both,[10] or depending on provisions altogether different from those used here.[11] Many other cases are cited

and discussed by counsel on both sides. All are distinguishable on one or the other of the grounds noted above.

7
Cole Petroleum Co. v. United States Gas & Oil Co., 121 Tex. 59, 41 S.W.2d 414, 86 A.L.R. 719; Masterson vs. Amarillo Oil Co, Tex.Civ.App., 253 S.W. 908; 11 Tex.Law Review 401-438.

8
Kretni Development Co. v. Consolidated Oil Corp., 10 Cir., 74 F.2d 497, (where a pipe line was laid 90 miles by the lessee); Scott v. Steinberger, 113 Kan. 67, 213 P. 646; Robert v. Swanson, Tex. Civ.App., 222 S.W.2d 707.

9
Danciger Oil & Refineries, Inc. v. Hamill Drilling Co., 141 Tex. 153, 171 S.W.2d 321; Le Cuno Oil Co. v. Smith, Tex.Civ. App., 306 S.W.2d 190.

10
Matzen v. Hugoton Production Co., 182 Kan. 456, 321 P.2d 576.

11
Cf. Phillips Petroleum Co. v. Johnson, 5 Cir., 155 F.2d 185, calling for 1/8th of the net proceeds derived from gas at the mouth of the well."

The lease in question clearly provides that the basis on which the royalty to the State must be paid can in no event be less than the greater of the price offered to or received by the producer or the highest market price paid or offered for gas in the general area. Generally, the royalty to the State will be based upon the price for gas received by the producer at the point where the producer delivers the gas to the pipeline purchaser. Nothing in the language of the lease contemplates any deductions for gathering, compression or dehydrating the gas by the lessee-producer from the price he receives before computing the State's royalty interest.

Consideration of provision 4 in the State lease form governing the manner and form of payment of royalty to the State further supports our position. The provision reads as follows:

> "4. All royalties shall be paid to the Commissioner of the General Land Office at Austin, Texas, during the life of this lease, on or before the 30th day of each succeeding month, for the month in which the oil and/or gas was produced, and shall be accompanied by a sworn statement of the owner, manager, or other authorized agent, showing the gross amount of oil produced since the last report, and the amount of all dry gas, residue gas, casinghead gas, and other products produced therefrom, sold or used for the manufacture of gasoline, and the market value of the oil, dry gas, residue gas, casinghead gas, and other products produced therefrom, together with a copy of all daily gauges of tanks, meter readings, pipeline receipts, gas line receipts and other checks and memoranda of the amounts produced and put into pipelines, tanks or pools and gas lines or gas storage. In all cases the authority of a manager or agent to act for the Lessee herein must be filed in the General Land Office."

Relevant to the question here, we note that while this provision requires a sworn statement to be submitted detailing the volume and market value of the dry gas produced, sold or used and put into pipelines, tanks or pools and gas lines or gas storage, it does not provide for an accounting of any producing, processing, transporting or marketing charges. Common sense dictates that were it contemplated that the pro rata share of these charges would be deductible from the royalty interest of the State, such charges would be specifically required as part of the sworn statement referred to in provision 4.

SUMMARY

The lessee or operator of a natural gas well located on a State tract may not legally deduct from the royalty due the State a pro rata portion of the cost of

production, gathering, compression, dehydration, sale or delivery of the natural gas produced on the State tract. Attorney General Opinion No. WW-196 (1957) is overruled to the extent necessary to conform with this opinion.

Very truly yours,

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