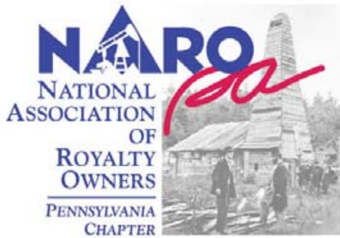

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The Need for Royalty Accounting Standards and
The Issue of Improper and Excessive Royalty Payment Deductions

I. Check Stubs

Every royalty owner needs simple, straightforward means to verify that his production-royalty payments are made properly. He needs the means to perform this verification himself, and to do it quickly and inexpensively, because (a) royalties are paid each month, (b) his lease is likely unitized to more than one production unit, and (c) royalties on a given unit are likely to be paid pro rata by more than one company. Consequently, he needs certain minimum information respecting his interest in production, production volumes, sales prices, deductions and adjustments, and the like. He needs the presentation of this information to be concise, accessible, and uniform.

Most of the major oil- or gas-producing states have enacted statutes to guarantee the delivery of minimum production information on the monthly check stub. The Commonwealth would do her royalty owners a service to follow suit. There is presently a bill in the Senate (SB 259) and a bill in the House (HB 1414) which would impose minimum requirements for production-royalty check stubs. NARO-PA has drafted its own check-stub bill. The proposed NARO PA Royalty Standards Bill is attached which includes further detail regarding check stub detail, division orders and inspection of records.

II. Division Orders

The law of the Commonwealth is that execution of an oil and gas lease gives the lessor the right to receive royalties. Few leases require the royalty owner to execute a division order as a condition precedent to payment of royalties. Nevertheless, the practice of obtaining division orders is acceptable to royalty owners as long as it doesn't divest a royalty owner of vested rights under the lease.

A division order may legitimately serve four purposes: (1) it confirms the identity of the royalty owner; (2) it confirms the address to which payment should be mailed or the institution where payment should be deposit to the royalty owner's credit; (3) it acts as a stipulation between the royalty owner and the payee what the royalty owner's decimal interest in a well or unit is; and (4) provides the royalty owner's tax-identification number, to avoid backup withholding.

The problem with modern division order practice in the Commonwealth are: (1) the division order is frequently fails to state the information used to calculate the royalty owner's decimal interest, making it impossible for him to verify the accuracy of the interest stated; (2) the division order sometimes removes rights secured to the royalty owner by the lease, or grants rights to the payor not given him by the lease, and (4) is the browbeating or outright railroading of royalty owners into execution of a division order by suspending royalty payment until the royalty owner remits a division order in the form demanded by the payor. Again many of the major oil- and gas producing states have enacted statutes to address these ills.

III. Inspection of Records

NARO-PA supports legislation which would require payors to allow royalty owners reasonable access, at reasonable places and times, to such documentation as may be necessary to verify royalties are paid properly. Such documents would include statements from the sale of gas, transportation contracts, purchase agreements, marketing agreements, meter readings, meter calibration reports, and the like.

IV. Deductions in Contravention of the Market-Enhancement Clause

Some payors take deductions for costs coded on royalty owners' check stubs as gathering and "third party." As this practice applies to leases with the market-enhancement royalty clause, it is an unlawful attempt to apply the net-back method of calculating royalties in contravention of the language of the leases. *Kilmer v. Elexco Land Services Inc.,* 605 Pa. 413, 900 A.2d 1147 (2010), does not govern this situation. *Kilmer* merely holds that applying the net-back method to one-eighth-royalty leases does not violate the Guaranteed Minimum Royalty Act.

In Pennsylvania, parties are free to contract as they please. Here, the parties have agreed to change the contract from the default net-back regime to a first-marketable-product regime. Under a first-marketable-product regime, *Mittelstaedt v. Sante Fe Minerals,* 1998 OK 7, 954 P.2d 1203 (1998), and its related cases, control. *Mittlestaedt* holds that gathering is required to transform the product into marketable form. Thus, deductions for these costs are disallowed.

"Third party" costs are also disallowed, because the implied duty to market the gas requires fixing the sales price on the first sale to a non-affiliated party. *See generally, Direct Sales: Royalty Problems for the Producer,* 46 Okla.L.Rev. 235 (1993). Otherwise, the lessee has the burden of proving that the price paid by its marketing affiliate was the best possible price obtainable.

In light of the foregoing, the language of the market-enhancement clause is unambiguous. But even if the language was ambiguous, all the rules of contract interpretation align in favor of the lessors: interpretation in favor of rationality and reasonableness, which is to change the default treatment of post-production costs; construction against the drafter or his successor, which is the payor; construction in favor of the layman, which is the royalty owner; and construction according to the parties' intent, which was to prevent the deduction of the costs specifically enumerated in the market-enhancement clause. The idea that the parties to an oil and gas lease would negotiate into a lease a clause confirming the net-back method of calculating royalties—which was already irrefutably established under Pennsylvania law and by the plain language of the printed lease—mere surplusage—is untenable.

This is more than a contract-interpretation issue. It is a matter of applying common sense: lessors' obvious intent in negotiating modifying the lease with the market-enhancement clause was to prevent deductions for gathering, transporting, marketing, and the other charges enumerated in the market-enhancement clause. Landmen actively promised royalty owners that the market-enhancement clause barred all post-production costs except for the costs of actually transforming the product produced through the wellbore into different chemical compounds, e.g., cracking wet gas; at the least, landmen knowingly allowed royalty owners to be influenced by a fundamental misunderstanding of what was being negotiated.