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Production, Production, What Is Production? Diamond Shamrock v. Hodel

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Production, Production, What Is Production? *Diamond Shamrock v. Hodel*

I. Introduction

Diamond Shamrock Exploration Corp. v. Hodel[1] (*Diamond Shamrock II*) was a case of first impression before the Fifth Circuit Court of Appeals. The issue before the court was whether the federal government, under the terms of federal offshore oil and gas leases, could collect royalties on take-or-pay payments made to a lessee-producer by a pipeline-purchaser.[2] A take-or-pay clause, contained in gas sales contracts, commits a natural gas purchaser (generally a pipeline) to take (purchase) a minimum volume of natural gas each year from the lessee-producer or else pay for the gas not taken.[3] A payment made pursuant to the operation of this clause is the take-or-pay payment.[4] Royalties collected on these payments would represent a significant amount of revenue to the lessor.

The present market glut of natural gas makes it likely that pipeline-purchasers will be forced to make take-or-pay payments in accordance with their purchase contracts.[5] The importance of the issue will diminish as demand for natural gas becomes equal to or exceeds the available supply because pipeline-purchasers will then be able to take all of the gas they have available to them under their purchase contracts. Until then, issues concerning rights and liabilities under take-or-pay agreements will continue to be litigated.

In Part II of this note, the federal government's policies concerning the leasing of public lands, the natural gas industry's

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1. 853 F.2d 1159 (5th Cir. 1988) [hereinafter cited as *Diamond Shamrock II*]. This case is a consolidation of two separate appeals. *See infra* notes 29-31 and accompanying text.

2. *Diamond Shamrock II*, 853 F.2d at 1161.

3. H. Williams & C. Meyers, Manual of Oil and Gas Terms 750-51 (5th ed. 1981); Comment, *The Lessor's Royalty and Take-or-Pay Payments and Settlements Under Gas Sales Contracts in Louisiana*, 47 La. L. Rev. 589, 589 (1987) [hereinafter *Lessor's Royalty*].

4. *Lessor's Royalty*, *supra* note 3, at 589.

5. Some have estimated that the liability of pipeline-purchasers to producers from take-or-pay obligations may be as high as fifteen billion dollars. Lowe, *Current Lease and Royalty Problems in the Gas Industry*, 23 Tulsa L.J. 547, 560 (1988).

development, and the reasons for take-or-pay commitments will be discussed. Part III will present the facts behind *Diamond Shamrock II* decision, and part IV will discuss the Fifth Circuit's reasoning in *Diamond Shamrock II.* Part V analyzes the Fifth Circuit's reasoning and explores options available to lessors allowing them to collect royalties on take-or-pay payments.

II. Background

A. *The Mineral Policies of the Federal Government*

As a consequence of growing concerns over the disposition of the United States' public lands early in the 20th century, Congress began to develop a new policy of leasing public lands for oil and gas exploration. In 1920, Congress passed the Mineral Lands Leasing Act (MLLA)[6] which established the governing standards for leasing federal and Indian lands for oil and natural gas development.[7] In 1953, Congress passed the Outer Continental Shelf Lands Act (OCSLA)[8] which established the governing standards for leasing outer continental shelf areas for mineral exploration.[9]

Under both MLLA and OCSLA, the federal government requires royalty payments based on the production of minerals from the leased land.[10] For oil, production royalties can be paid either according to the value of the production or in kind.[11] In kind payment of royalties is allowed because oil, being a fungible material, can be easily delivered to the royalty interest owner.

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6. 30 U.S.C. §§ 181-287 (1982).

7. 30 U.S.C. § 226(b) (1982).

8. 43 U.S.C. §§ 1331-1356 (1982).

9. 43 U.S.C. § 1334 (1982).

10. Section 1337(a)(1)(A) states: "cash bonus bid with a royalty at not less than 12 ½ per centum fixed by the Secretary in amount or value of the production saved, removed, or sold." 43 U.S.C. § 1337(a)(1)(A) (1982).
Section 226(b)(1) states:

> If the lands to be leased are within any known geological structure of a producing oil or gas field, they shall be leased . . . upon the payment by the lessee of such bonus as may be accepted by the Secretary and of such royalty as may be fixed in the lease, which shall be not less than 12 ½ per centum in amount or value of the production removed or sold from the lease.

30 U.S.C. § 226(b)(1) (1982).

11. "In kind" means the lessee delivers to the lessor a portion of the production that is subject to royalty, in an amount that represents the royalty percentage of the production. Harrell, *The Obligation to Market Prudently and the Current "Market Value" Royalty Controversy*, 34 Ann. Miss. L. Inst., Oil & Gas L. & Transactions 143, 151 (1982).

Natural gas, however, is not fungible and cannot be easily delivered to the royalty interest owner. Gas royalties, therefore, are generally paid according to the value of the production.[12]

B. Development of the Natural Gas Industry

To supply natural gas to its customers, a natural gas purchaser needs a transportation system from the producing well to the customer. Unlike oil, natural gas cannot be easily stored above ground, and therefore, the most commercially reasonable means to transport the natural gas is by pipeline from the producing well to the customer.[13]

Due to the unique transportation needs of natural gas, the natural gas industry from the 1930s until the 1950s found itself in a monopsony[14] since the purchasers, who controlled the transportation system, could control the sale of the natural gas.[15] However, the construction of the interstate pipeline system created competition among the gas purchasers; this, combined with a general increase in the demand for natural gas, gave the producers increased leverage in negotiating their gas sales contracts which effectively broke the monopsony.[16]

Under these new conditions, producers were able to require take-or-pay clauses in their gas sales contracts.[17] A gas sales contract which contains a take-or-pay clause generally has three obligations. First, the producer is required to retain a certain portion or percentage of the producing well's potential production for the pipeline-purchaser at a negotiated price. Second, the

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12. *See* 30 C.F.R. §§ 206.150-.159 (1988).

13. *See* Harrell, *supra* note 11, at 151.

14. Monopsony is defined as "a market situation in which there is a single buyer for a given product or service from a large number of sellers." WEBSTER'S NEW THIRD INTERNATIONAL DICTIONARY 1463 (1969).

15. *Lessor's Royalty*, *supra* note 3, at 589-90.

16. *See id.*

17. *See id.* at 590. *See also* Comment, *Take or Pay Provisions: Major Problems for the Natural Gas Industry*, 18 ST. MARY'S L.J. 251, 274-75 (1986) [hereinafter *Major Problems*]. Prior to the construction of the interstate pipeline system, producers were limited by the monopsony conditions which prevailed in the industry. *Lessor's Royalty*, *supra* note 3, at 589-90. Because of this,

> producers were obligated under gas contracts to sell gas for indefinite or long terms at fixed prices. At the same time, pipelines had the prerogative to forego purchases under conditions of diminished demand, since early contracts contained no minimum take provisions. As a result, pipelines were able to, and in fact did, shut in wells when the demand for gas was depressed, leaving lessors and their lessee-producers with little or no revenue.

Id. at 590 (footnotes omitted).

take-or-pay clause obligates the pipeline-purchaser to take a minimum volume of gas during a certain time period,[18] usually one year, or if the gas is not taken, pay for the untaken amount up to the minimum volume.[19] Third, the pipeline-purchaser is given an opportunity to recoup any take-or-pay payments by allowing the pipeline-purchaser to take make-up gas for a set time in the future.[20] Make-up gas is natural gas taken during a year within the make-up period which exceeds the minimum contract volume for that year.[21] The make-up gas volume is credited to the volume of gas which the purchaser failed to take. When make-up gas is taken, the take-or-pay payment is reduced accordingly and the purchaser either receives a credit or pays for any price differential between the untaken gas and the make-up gas.[22] Some gas sales contracts provide for a refund of any take-or-pay payments not recouped during the make-up period; but others allow the lessee-producer to retain any money not recouped.[23]

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18. *Lessor's Royalty*, *supra* note 3, at 590. These clauses became useful after the construction of the interstate gas pipeline network. *Major Problems*, *supra* note 17, at 260.

The volume "may be set according to either percentages of fixed amounts or the capacity of the wells to which the contract applies to deliver gas." Arbaugh, *Take or Pay Clauses: Pandora's Box Reopened?*, 5 E. MIN. L. INST. 11-1, 11-4 (1984) (footnotes omitted).

19. For example, if the contract called for the purchaser to purchase a minimum volume of 80% of the well's maximum production and the purchaser during the contract year only took 70% of the maximum production, the pipeline would have to pay for the 10% of the production that was not taken. The price paid for the untaken production is determined by "the weighted average price per million cubic feet (mcf) for the contract year in which the payments are made . . . ." Sullivan, *To Pay or Not to Pay—The Fifth Circuit Divided: The Issue of Gas Royalties on Take-or-Pay Payments*, 62 TUL. L. REV. 297, 303 (1987).

20. "In contracts for gas sold subject to the Natural Gas Act jurisdiction of the Federal Energy Regulatory Commission (FERC), gas sales contracts which have take-or-pay provisions must have make up provisions of not less than five years." Arbaugh, *supra* note 18, at 11-8 (footnotes omitted). *See* 18 C.F.R. § 154.103 (1988).

21. *Lessor's Royalty*, *supra* note 3, at 592.

22. Sullivan, *supra* note 19, at 303-04. During the Mesa litigation, the amount of royalties claimed to be due to the government because of subsequent takes of make-up gas was reduced from $1,001,849 to $27,488. Mesa Petroleum Co. v. U.S. Dept. of Interior, 647 F. Supp. 1350, 1352 (W.D. La. 1986). If the make-up gas costs more than the gas paid for by the take-or-pay payment, the difference in price would also need to be paid to the producer by the purchaser. If the make-up gas costs less than the take-or-pay gas, then a refund would be due to the purchaser from the producer.

23. *Diamond Shamrock II*, 853 F.2d 1159, 1164 (5th Cir. 1988). The long term gas sales contracts involved in *Diamond Shamrock II* contain both refund and non-refund clauses concerning unrecouped make-up gas. *Id.*

Both lessee-producers and pipeline-purchasers receive benefits from the take-or-pay agreements:[24]

> The producer realizes two principal benefits from these provisions. First, by requiring the purchaser to take the minimum quantity or pay as if he had taken it, the take-or-pay clause assures the producer a minimum annual income over the term of the gas sales contract. . . . Second, the clause may prevent possible drainage to the reservoir by encouraging the pipeline to purchase at a relatively constant level, thus maximizing ultimate recovery and deriving the optimum economic benefit for the lessee-producer and his lessor.
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> The concomitant benefits to the pipeline are basically twofold. The take-or-pay clause enables the pipeline to meet its objectives relative to its gas supply needs by ensuring a constant supply of gas, while allowing flexibility in terms of the amount of gas it must actually take. Furthermore, take-or-pay clauses generally contain a "make-up" provision, whereby the purchaser may, during a specified period of time following a take-or-pay payment, receive gas paid for but not taken.[25]

Lessees are under an implied duty to the lessor to produce and market the product.[26] This duty is to "market or dispose of the product in a reasonable and prudent way to secure the maximum benefit possible for both parties."[27] Entering into a long-term gas sales contract which includes a take-or-pay clause has been held to fulfill the lessee's duty to market.[28]

III. Facts of the Case

Diamond Shamrock II arose out of the consolidation of two similar cases which were before the Fifth Circuit.[29] The two underlying cases were initially filed in the eastern[30] and western[31]

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24. *Lessor's Royalty*, *supra* note 3, at 591.

25. *Id.* at 591-92 (footnotes omitted).

26. 5 E. Kuntz, Law of Oil and Gas, § 60.1 (1978); Harrell, *Developments in Nonregulatory Oil and Gas Law*, 30 Inst. on Oil & Gas L. & Tax'n 311, 334 (1979). The standard applied to the lessee is that of "an ordinary prudent operator having regard for the interests of both the lessor and lessee." 5 E. Kuntz, *supra*, at § 60.3.

27. Harrell, *supra* note 26, at 334.

28. Miller v. Nordan-Lawton Oil & Gas Corp., 403 F.2d 946, 948-49 (5th Cir. 1968) (this case considered whether the well was shut in, which if found to be, the lessor could have cancelled the lease). *See* 5 E. Kuntz, *supra* note 26, at § 60.3.

29. *Diamond Shamrock II*, 853 F.2d 1159, 1161 (5th Cir. 1988).

30. Diamond Shamrock Exploration Co. v. Hodel, No. 86-537 (E.D. La. Jan. 23, 1987) (WESTLAW, Allfeds database), *rev'd*, 853 F.2d 1159 (5th Cir. 1988) [hereinafter cited as *Diamond Shamrock I*].

federal district courts of Louisiana. The district courts split on the issue of whether the federal government could collect royalties on the take-or-pay payments which were being collected by the producers who were producing natural gas from leases issued by the federal government. The facts and the district courts' disposition of each case are discussed in the following sections.

A. *Diamond Shamrock I*

Diamond Shamrock I was a consolidation of cases brought by Diamond Shamrock Exploration Co., Cities Service Oil and Gas Corp., Exxon Company, U.S.A., Mobil Exploration & Producing Services Inc., Mobil Exploration & Producing Southeast Inc., Texaco Producing Inc., and Texaco Inc.[32] Each company held offshore oil and gas leases located on the Outer Continental Shelf of Louisiana.[33] The lessees had all entered into long-term gas sale contracts which included take-or-pay clauses.[34] Each lessee-producer had received take-or-pay payments from the pipeline-purchasers and did not pay any royalties on these payments until make-up gas was taken.[35] Mineral Management Service[36] (MMS) ordered the lessee-producers to pay royalties on the entire take-or-pay payments.[37] The lessee-producers appealed the order to the Director of MMS, who affirmed the decision that royalties were due. On appeal to the Eastern District Court of Louisiana, the district court consolidated the appeals of the various companies.[38] The district court, on cross motions for summary judgment, held that the payment of royalties upon re-

31. Mesa Petroleum Co. v. U.S. Dept. of Interior, 647 F. Supp. 1350 (W.D. La. 1986), *aff'd sub. nom.* Diamond Shamrock v. Hodel, 853 F.2d 1159 (5th Cir. 1988).

32. *Diamond Shamrock II*, 853 F.2d at 1162.

33. *Id.* Mobil and Texaco also held onshore leases governed by the MLLA. *Id.* at 1162 n.5. The *Diamond Shamrock I* court held that the claims by the producers that royalties were not due on take-or-pay payments received in connection with the onshore leases were time barred. *Diamond Shamrock I.*

34. *Diamond Shamrock I.*

35. *Diamond Shamrock II*, 853 F.2d at 1162. The producers would pay the royalties once make-up gas was taken but they claimed that until that time, they were not obligated to pay royalties.

36. Mineral Management Service is the section in the Department of Interior which collects royalties due from lessees.

37. *Diamond Shamrock II*, 853 F.2d at 1162. When the case came before the district court the parties agreed that if the court found in favor of the government that $4,882,372.00 in royalties were due. *Diamond Shamrock I.*

38. *Diamond Shamrock II*, 853 F.2d at 1162. *See supra* text accompanying note 32.

ceipt of take-or-pay payments was proper.[39] In reaching its conclusion, the district court treated the take-or-pay payments as advanced payments for natural gas. The district court likened the payments unto an interest free loan to the producers. The court concluded that since these payments raised the price of the natural gas to the consumer, they should be accounted for in determining the value of the gas, and therefore, royalties could be collected.[40]

B. *Mesa Petroleum*

In 1973, Mesa Petroleum Co. (Mesa)[41] entered into an offshore lease with the federal government covering areas on the Outer Continental Shelf.[42] The lease was issued under OCSLA.[43] Mesa entered into a long-term gas sales contract with Tennessee Gas Pipeline Company (Tennessee Gas).[44] The contract committed Mesa's share of the production from the lease to Tennessee Gas.[45] The contract also contained a take-or-pay clause.[46] Mesa received take-or-pay payments from Tennessee Gas and MMS subsequently ordered Mesa to pay royalties on the payments.[47] Mesa appealed the order to the Director of MMS and filed an action in the Western District Court of Louisiana seeking injunctive relief, declaratory relief, and a writ of mandamus to enjoin the Department of Interior (DOI) from collecting the claimed royalties.[48] The Director of MMS affirmed MMS's authority to collect royalties on take-or-pay payments.[49] On cross

39. *Diamond Shamrock II*, 853 F.2d at 1163.

40. *Id.*

41. Three other oil and gas exploration companies also entered into the lease. Mesa Petroleum Co. v. U.S. Dept. of Interior, 647 F. Supp. 1350, 1351 (W.D. La. 1986).

42. *Diamond Shamrock II*, 853 F.2d at 1161.

43. 43 U.S.C. §§ 1331-1356 (1982).

44. *Diamond Shamrock II*, 853 F.2d at 1161.

45. *Id. See Mesa Petroleum Co.*, 647 F. Supp. at 1352.

46. *Diamond Shamrock II*, 853 F.2d at 1161; *Mesa Petroleum Co.*, 647 F. Supp. at 1352.

47. *Diamond Shamrock II*, 853 F.2d at 1161-62. Mesa had been making royalty payments to MMS on all gas which was being delivered to Tennessee Gas' pipeline, but it was not paying royalties on take-or-pay payments until make-up gas was taken by Tennessee Gas. *Id.* The amount of royalty due, according to MMS, was $1,001,849.00. *Mesa Petroleum Co.*, 647 F. Supp. at 1352. By April 18, 1986, Mesa has reduced the royalties which MMS claimed to be due to $27,488.19 because of the taking of make-up gas by Tennessee Gas. *Id.* The Department of Interior, however, was still claiming $1,194,459.53 in interest on the late royalties. *Id.*

48. *Mesa Petroleum Co.*, 647 F. Supp. at 1352.

49. *Id.*

motions for summary judgment, the district court granted summary judgment in favor of Mesa.[50] The district court held that royalties were not due until production had occurred and defined production as the severance of the natural gas from the ground.[51] The district court reasoned that since a take-or-pay payment is made in lieu of production, no royalty payment was due under the lease since no actual production had occurred.[52]

The government appealed the western district's finding in *Mesa Petroleum* and the various lessee-producers appealed the eastern district's finding in *Diamond Shamrock I* to the Fifth Circuit Court of Appeals, which consolidated the appeals.[53] The Fifth Circuit in *Diamond Shamrock II* ruled in favor of the producers, holding that no royalty is due until natural gas is actually produced.[54] In defining production, the court followed the western district's reasoning that production means the severance of the minerals from the ground.[55]

IV. Reasoning of the Court in *Diamond Shamrock II*

The main issue before the Fifth Circuit was whether the federal government, as lessor, could collect royalties on take-or-pay payments.[56] In dealing with this issue, the court discussed in detail the value the government could place on the natural gas when calculating any royalties due under the lease.[57] The lease established a royalty of 16 ⅔% of the "amount or value of 'production saved, removed or sold . . . .' "[58] In determining the "value" of the natural gas for royalty purposes, the court explored three main issues: (1) what is production; (2) what is the value of production; and (3) how should the take-or-pay payments be characterized in relation to the first two factors.[59] The following analysis will consider how the Fifth Circuit dealt with

50. *Id.* at 1351.

51. *Diamond Shamrock II*, 853 F.2d at 1162. The district court relied on the fact that the purposes of the take-or-pay clauses were to ensure a steady cash flow to the producers to provide revenue for maintenance and operation costs.

52. *Id.*

53. *Id.* at 1161.

54. *Id.*

55. *Id.* at 1168 & n.39.

56. *Id.* at 1161.

57. *Id.* at 1165-68.

58. *Id.* at 1161.

59. *Id.* at 1165-68.

these three issues and discuss the conclusion reached by the court.

A. *What is Production?*

In defining what "production" meant in the leases, the court first set forth the three different meanings given to the word production in the oil and gas industry.[60] The court then discussed in detail the two definitions relied on by the district courts in the underlying cases.[61] First, the court considered the definition relied upon by the district court in *Diamond Shamrock I.* This is the definition of "production" found in section 1331(m) of OCSLA.[62] This section defines production as the act or process of producing after the completion of the well.[63] The *Diamond Shamrock II* court stated that applying this definition of production to the royalty clauses "makes little sense."[64] In coming to this conclusion the court stated that "this Court cannot accept the conclusion that §1331(m) was intended by the Congress to define production to exclude all other accepted meanings in industry, including . . . the actual products of an oil and gas well."[65]

Instead, the court embraced the *Mesa Petroleum* court's definition, "adopt[ing] as a legal definition of the word 'production,' as used in the context of calculating royalty payments, the actual physical severance of the minerals from the formation,"[66] stating that "production does not occur until the minerals are physically severed from the earth."[67]

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60. *Id.* at 1166. The three definitions considered by the court were: (1) the act or process of producing; (2) the products of an oil and gas well; and (3) the well itself. *Id.*

61. *Diamond Shamrock I*, No. 86-537 (E.D. La. Jan. 23, 1987) (WESTLAW, Allfeds database); Mesa Petroleum Co. v. U.S. Dept. of Interior, 647 F. Supp. 1351 (W.D. La. 1986). The third definition was not considered by the court since it meant only the production well itself and had no application to the case. *Diamond Shamrock II*, 853 F.2d at 1166.

62. *Diamond Shamrock II*, 853 F.2d at 1166. *See* 43 U.S.C. § 1331(m) (1982).

63. Section 1331(m) provides, "The term 'production' means those activities which take place after the successful completion of any means for the removal of minerals, including such removal, field operations, transfer of minerals to shore, operation monitoring, maintenance, and work-over drilling." 43 U.S.C. § 1331(m) (1982).

64. *Diamond Shamrock II*, 853 F.2d at 1166.

65. *Id.* (footnote omitted).

66. *Id.* at 1168. For other cases applying the same definition of production, see *id.* at 1168 n.39.

67. *Id.* at 1168.

B. *What Is the Value of Production?*

After adopting the physical severance definition of production, the court considered the value of production. The natural gas leases before the court called for royalties to "be paid on 'the amount or value of the production.' "[68] The DOI has listed several factors to be considered in determining what is the fair market value.[69] One criterion used to determine the value is the gross proceeds accruing under comparable arm's-length contracts. In making such comparisons the factors to be considered include: "price, time of execution, duration, market or markets served, terms, quality of gas, volume, and such factors as may be appropriate to reflect the value of the gas."[70] The DOI has defined the value of production to be the fair market value of the natural gas.[71] The fair market value, however, must at least equal the gross proceeds being received by the lessee from the disposition of the produced substances.[72]

In *Diamond Shamrock II*, the government argued that take-or-pay payments were part of the gross proceeds accruing to the lessee from the disposition of the produced substances.[73] The court stated that to follow this interpretation would produce "absurd results."[74]

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68. *Id.* at 1166 (citing 43 U.S.C. § 1337(a)(1)(B) (1982)).

69. *See* 30 C.F.R. § 206.152 (1988).

70. *Id.* at § 206.152(c)(1).

71. *See id.* at § 206.152.

72. *Id.* at 206.152(h).

73. *Diamond Shamrock I*, No. 86-537 (E.D. La. Jan. 23, 1987) (WESTLAW, Allfeds database); Mesa Petroleum Co. v. U.S. Dept. of Interior, 647 F. Supp. 1351 (W.D. La. 1986).

74. *Diamond Shamrock II*, 853 F.2d 1159, 1166 (5th Cir. 1988). The court rationalized its statement by hypothesizing two situations which might arise after the government had collected royalties on the take-or-pay payment. First, if the price of the gas had risen since the take-or-pay payment was made, then when make-up gas was taken, the pipeline-purchaser would have to pay for the difference in the price and a second royalty would be due. Second, if the price of the gas has fallen since the time the government collected royalties on the take-or-pay payment, then when make-up gas is taken, the pipeline purchaser would be due a refund from the lessee-producer. *Id.* The lessee producer would then also be due a royalty refund from the government. *Id.* However, the statute of limitations which governs the time to apply for royalty refunds is typically shorter than the make-up period. OCSLA allows two years to apply for refunds for overpaid royalties. 43 U.S.C. § 1339 (1982). Make-up periods generally are for up to seven years. The make-up period for a contract involving interstate gas cannot be less than five years under the FERC's guidelines. *See supra* note 19. Therefore, unless the lessee-producer applies for a refund within the statute of limitations, he may not be able to receive a refund. *Diamond Shamrock II*, 853 F.2d at 1166.

The *Diamond Shamrock I* court suggested that the producers could file for a refund

In support of this statement, the court examined what would be the value of production if no gas were taken and a take-or-pay payment were collected by the producer. Applying the defined meaning of production to this situation the government would not be able to determine the value of the production on which to base its royalty since absolutely no production has occurred.[75] The court, applying this reasoning, held that the value of production could not be determined until the natural gas was produced. The government, therefore, could not collect royalties on the take-or-pay payments until make-up gas is taken since the natural gas' value could not be determined until that time.[76]

C. *Characterizing the Take-or-Pay Obligation*

Finally, the court analyzed the purpose of the take-or-pay clauses in the gas sales contracts. The court reasoned that the take-or-pay obligation compensates the producer for committing reserves to a purchaser and that a payment under the contract is not automatically applied to the value of the gas.[77] Furthermore, the payment is for gas not taken and merely compensates the producer for the purchaser's failure to take natural gas under the contract.[78] Since the lessor has not taken the risks of production, the value of the take-or-pay payment should not run to him.[79] The court strengthened its reasoning by referring to the Federal Energy and Regulatory Commission's (the FERC) rate-making regulations as applied to take-or-pay payments. The FERC treats such payments as pre-payments for gas that is not taken and does not allow the purchaser to recover these costs from its consumers until make-up gas is taken and sold.[80] In following *ANR Pipeline Co. v. Wagner & Brown*,[81] the court stated

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before the running of the statute of limitations without specifying the amount claimed, which could then be properly determined at a later date. *Diamond Shamrock I*, No. 86-537 at n.8. However, "[s]ection 1339 of the OCSLA authorizes a refund of royalties only if the lessee files a request for the 'amount of such refund' within 'two years after the making of the payment.'" *Diamond Shamrock II*, 853 F.2d at 1166 n.31.

75. *Diamond Shamrock II*, 853 F.2d at 1166-67.

76. *Id.*

77. *Id.* at 1167.

78. *Id.*

79. *Id.*

80. *Id. See generally* Statement of Policy and Interpretative Rule: Regulatory Treatment of Payments Made in Lieu of Take-or-Pay Obligations, FERC Stats. & Regs. [Regs. Preambles 1982-1985] ¶ 30,637 at 31,301 (1985).

81. 44 F.E.R.C. 61057 (1988) (take-or-pay payments not part of price paid for gas

that take-or-pay payments are not to be considered as part of the price of the gas until the gas is made up.[82]

Since royalties are not due until gas is actually produced and the value of the gas cannot be determined until the gas is taken, the court concluded that the government could not collect royalties on take-or-pay payments until make-up gas is taken.[83]

V. Analysis and Proposals

The *Diamond Shamrock II* court correctly analyzed the issues of whether royalties are due on take-or-pay payments. To allow collection of royalties on take-or-pay payments at the time of the payment would not conform with the lease provisions that were before the court.[84] The court, however, left several issues unresolved concerning a lessor's right to collect royalties on take-or-pay payments.

A. *Did the Court Apply the Correct Definition of Production?*

The *Diamond Shamrock II* court's decision turned on which definition of production the court chose to follow.[85] The court chose the definition that logically defined production for the purpose of royalty collection.[86] In contrast, the *Diamond Shamrock I* court defined production according to the definition found in the 1978 amendments to OCSLA.[87] This section, however, was not meant to define production for the purpose of roy-

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until gas is made up).

82. *Diamond Shamrock II*, 853 F.2d at 1168.

83. *Id.*

84. *Id.* at 1165. It is the royalty clauses in the leases which appear to govern the question of whether royalties can be collected on take-or-pay payments. Sullivan, *supra* note 19, at 298.

85. The court presented three different definitions for production used in the oil and gas industry: (1) the act or process of producing; (2) the products of an oil and gas well; and (3) the well itself. *Diamond Shamrock II*, 853 F.2d at 1166.

86. *See* Interstate Natural Gas Co. v. FPC, 331 U.S. 682, 690 (1947) (production involves a physical act); Energy Oils v. Montana Power Co., 626 F.2d 731, 738 (9th Cir. 1980); Saturn Oil & Gas Co. v. FPC, 250 F.2d 61, 64 (10th Cir. 1957) *cert. denied*, 355 U.S. 956 (1958) (act of bringing forth gas from the earth); Wyoming v. Pennzoil Co., 752 P.2d 975, 979 (Wyo. 1988) (production requires severance of mineral from ground); Exxon Corp. v. Middleton, 613 S.W.2d 240, 244 (Tex. 1981) (requires extraction of gas); Monsanto Co. v. Tyrrell, 537 S.W.2d 135, 137 (Tex. Civ. App. 1976) (actual physical severance); Christian v. A.A. Oil Corp., 161 Mont. 420, 428, 506 P.2d 1369, 1373 (1973) (withdrawn from land and reduced to possession); Continental Oil Co. v. Landry, 215 La. 518, 524, 41 So. 2d 73, 75 (1949) (requires extraction).

87. *See supra* note 63.

alty collection. OCSLA's definition refers to a "phase of the oil and gas recovery process."[88]

> The definition follows those of "exploration" and "development." The production phase begins after the oil or gas has been discovered (during the exploration phase) and the necessary preparations have been made (during the developmental phase) for the production of the discovered minerals. Production is thus the ongoing process of, and all collateral processes necessary to, actual removal of the minerals from the earth. Royalties are due . . . "only to the extent of that production."[89]

The court did not consider the other definition of production, the production well itself, since there was not a rational relationship between the production well and the value of the royalty.[90]

Thus, the definition used by the court, which is the severance of the minerals from the ground, was proper because it is the only definition that relates to the royalty provisions in the lease.[91]

B. *Should the Lessee be Able to Share in the Windfall?*

Even though the court applied the proper definition of production, another issue remained unresolved. The value of production, from which royalties are calculated, cannot be less than the gross proceeds which the producer receives for the sale of the product.[92] The court correctly answered the question of when the royalty was due, but the court failed to answer the question of whether the lessee-producer is liable for royalties on the entire take-or-pay payment.[93]

When a pipeline-purchaser takes make-up gas, the producer is then liable for any royalties due on that production.[94] The fol-

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88. Sullivan, *supra* note 19, at 302.
89. *Id.* at 302-03 (footnotes omitted).
90. *Diamond Shamrock II*, 853 F.2d 1159, 1166 (5th Cir. 1988).
91. *Id.* at 1168. *See supra* note 83 and accompanying text.
92. 30 C.F.R. § 206.152(h) (1988) provides, "Notwithstanding any other provision of this section, under no circumstances shall the value of production, for royalty purposes, be less than the gross proceeds accruing to the lessee for lease production, less applicable allowances determined pursuant to this subpart."
93. Sullivan, *supra* note 19, *passim*; *Lessor's Royalty*, *supra* note 3, *passim*. *But see* Note, *Oil and Gas: "Take or Pay" Gas Contracts: Are They Subject to Royalty?*, 35 OKLA. L. REV. 150 (1982) [hereinafter *Oil and Gas*] (arguing that lessors should be able to collect royalties on take-or-pay payments).
94. *Diamond Shamrock II*, 853 F.2d at 1168.

lowing analysis will explore whether the government can claim any royalties from a take-or-pay payment in addition to those royalties allowed by the *Diamond Shamrock II* court.

C. *Can the Lessor Claim a Royalty After the Make-up Period?*

Implicit in the Fifth Circuit's decision is the proposition that the federal government can collect royalties on a take-or-pay payment only when make-up gas is taken.[95] The court's final conclusion that "[n]o royalty is due on take-or-pay payments *unless and until* gas is actually produced and taken"[96] implies this limitation. From this language it appears that the lessor can only collect royalties on take-or-pay payments when make-up gas is taken.

At the end of the make-up period, any unrecouped funds are either forfeited or refunded to the purchaser, depending on the gas sales contract.[97] The production capabilities behind most gas sales contracts make it unlikely that a pipeline-purchaser will be able to recoup its entire take-or-pay payment through taking make-up gas.[98] The issue, therefore, is whether a pro-

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95. *Id.* at 1167-68. The court, quoting from ANR Pipeline Co. v. Wagner & Brown, 44 F.E.R.C. 61057 (1988), stated:

> In the context of the gas purchase contract and industry practice, the take-or-pay payment is not intended to be a payment for gas and is not a part of the price of gas until it is applied at the time of sale. The value to the producer of take-or-pay payments forfeited by the purchaser is therefore not treated as part of the price of gas purchased currently. If the gas is made up, there has of course been a first sale and the applicable ceiling price is that in the month of delivery.
>
> We find no basis whatever to conclude that earnings which producers may realize on take-or-pay payments, whether measured by interest actually earned or by value, are part of the price paid for gas.

Id. at 1168 (footnote omitted). This statement represents the FERC's position concerning take-or-pay payments.

96. *Diamond Shamrock II*, 853 F.2d at 1168 (emphasis added).

97. *See id.* at 1164. If a contract calls for the unrecouped funds from the take-or-pay contract to be refunded to the purchaser, then the issue of whether any royalty can be collected after the make-up period ends is moot since there will be no funds from the take-or-pay payment which remain in the producers hands which have not been subject to royalty.

98. *See Lessor's Royalty*, *supra* note 3, at 592; *Oil and Gas*, *supra* note 93, at 152. Obstacles that may prevent a pipeline from fully recovering the take-or-pay payment include: (1) maximum quantity provisions within the sales contracts; (2) requirements that the gas be made up within a specific time period; (3) depletion of the reservoir or reduction of the production capacity; and (4) possible state controls on production capacity. *Id.*

ducer who receives a take-or-pay payment which is not completely recouped will have the unrecouped amount considered as part of the consideration for the natural gas which has already been sold, and, therefore, subject this remaining amount to royalty collection. At the end of the make-up period "the producer must settle up with the royalty owner if gas paid for but not taken is not made up, assuming that the producer is not contractually obligated to refund payments for gas not made up."[99] During the make-up period, the producer is committed to hold the gas in reserve to cover future takes by the purchaser.[100] At the end of the make-up period, however, the gas which had been committed to the purchaser is no longer committed, and the producer is at liberty to sell the gas on the open market.[101] Since the producer is no longer obligated to keep the gas in reserve, any part of the take-or-pay payment that has not been recouped is no longer subject to potential royalty collection through the taking of make-up gas. Since the producer is now able to sell the gas elsewhere, the unrecouped proceeds should be considered part of the gross proceeds received for gas taken during the original and make-up period.[102] The issue is whether the producer should be allowed to keep this windfall for its own benefit or should the lessor be able to collect a portion of the remaining take-or-pay payment as royalty.

99. Pierce, *Lessor/Lessee Relations in a Turbulent Gas Market*, 38 INST. ON OIL & GAS L. & TAX'N 8-1, 8-22 (1987).

100. *Major Problems*, *supra* note 17, at 262.

101. The producer may still be under the constraints of the long-term gas sales contract and may only be able to sell to the original purchaser. But the gas which the producer was obligated to have in reserve for the purchaser under the take-or-pay clause is no longer committed to this obligation. *Diamond Shamrock II*, 853 F.2d at 1164.

102. *See* 30 C.F.R. § 206.152(h) (1988). The total price received would be the amount of payments for gas taken under the contract plus any take-or-pay payments made. The total volume would be all gas taken under the contract plus any make-up gas taken during the subsequent make-up period. To help clarify this the following example will look at one year of a long-term gas sales contract that contains a take-or-pay clause. If the contract calls for the purchaser to take a minimum of 150 million cubic feet of gas for $3.00 per million cubic feet, and if during the year the purchaser took 100 million cubic feet of gas he would pay for the gas that was taken and would also be obligated to make a take-or-pay payment for the remaining 50 million cubic feet of gas. If the contract allowed the purchaser seven years to make up the 50 million cubic feet of gas and during the subsequent seven years the purchaser took 30 million cubic feet of make-up gas, the producer would have received $450 for the 130 million cubic feet of gas taken. Therefore, for the year considered in this example, even though the contract price was $3.00 per million cubic feet, the actual price received by the producer was $3.46 per million cubic feet.

1. What is the actual value of the gas?

While the Fifth Circuit's reasoning is sound for the proposition that no royalty can be collected when the take-or-pay payment is made when the same reasoning is applied to the situation that exists at the end of the make-up period, as described above, it becomes evident that the government should be able to collect royalties on any part of the take-or-pay payment that has not been recouped or refunded. At the end of the make-up period, the actual value received by the producer for the gas sold increases if part of the take-or-pay payment is still not recouped.[103] The value of production cannot be less than the gross proceeds received by the lessee as a result of the production.[104] Gross proceeds as applied to natural gas include take-or-pay payments.[105] "The 'gross proceeds' floor is designed to ensure that a royalty is paid on the total consideration received for the disposition of the gas however labelled or structured."[106] In *Wheless Drilling Co.*,[107] the Interior Board of Land Appeals applied the gross proceeds standard to natural gas in holding that "[p]roceeds of a sale . . . means total proceeds."[108]

The federal government, therefore, should eventually be able to collect royalties on a take-or-pay payment, either through make-up gas or through an increase in the value of the production, and will only forego the interest which would have accrued during the interim between the time the payment was made and when the royalty was collected. Since the value of the gas is determined at the time the gas is severed from the ground, the government may be able to claim that the value of the gas includes the increased value which accrues to the gas when the make-up period ends.[109] The government, therefore, would collect royalties twice: first at the time of production, based on the

103. *Lessor's Royalty*, *supra* note 3, at 600 n.35. *See Major Problems*, *supra* note 17, at 274-75. *See also supra* text accompanying notes 99-101.

104. 30 C.F.R. § 206.152(h) (1988).

105. *See* 30 C.F.R. § 206.151 (1988).

106. Muys, *Gas Royalty Valuation Standards and Procedures Applicable to Federal and Indian Leases*, 37 INST. ON OIL & GAS L. & TAX'N 2-1, 2-11 (1986).

107. 13 I.B.L.A. 21 (1973).

108. *Id.* at 30-31 (citation omitted); Muys, *supra* note 106, at 2-11 to 2-12 (footnote omitted).

109. *See* Jordan & Kahn, *Current Royalty Owner Issues*, 4 E. MIN. L. INST. 19-1, 19-10 to 19-18 (1983).

wellhead value; and second, on the unrecouped take-or-pay payment at the end of the make-up period.[110]

2. *Could the government claim back interest?*

Under the double collection scenario discussed above, the federal government might claim that this increased value relates back to the time when the gas was originally produced. The federal government could then claim the interest which would have accrued on the increased value relating back to the time of production. This would allow the government to collect royalties on the unrecouped take-or-pay payments and on the interest which would have accrued if the royalty could have been assessed at the time of production.[111] This would place the lessor in the position it would have been in if allowed to collect royalties on the take-or-pay payment at the time of payment. It would also prevent the producer from receiving a windfall at the expense of the lessor.

D. *Are the Lessees' Actions a Breach of Their Duty to Market?*

The *Diamond Shamrock II* court held that the collection of take-or-pay payments was not a part of the gross proceeds received by the producer from the produced substances.[112] The lessor, therefore, had no interest in the take-or-pay payment. But the lessee has a duty to market, which duty is implied from the lease.[113] Thus, the lessee has a duty to market the products or possibly lose his rights under the lease. If the lessee is not producing, he needs to show that his lack of production is in the

110. The court claimed that it was unfair to collect royalties twice on the same gas. However, this double collection was in the sense of collecting once when the take-or-pay payment was made and again when the make-up gas was taken. The inherent unfairness of this situation is that if the producer was due a refund, he may not be able to collect it because of the statute of limitations on such claims. *Diamond Shamrock II*, 853 F.2d 1159, 1166 (5th Cir. 1988). To call for double collection in this situation would never subject the producer to the running of the statute of limitations on requesting a refund since collection would only be made when the actual volume of production and the amount of gross proceeds are known.

111. The eastern district likened the receipt of a take-or-pay payment to an interest free loan. *Diamond Shamrock I*, No. 86-537 (E.D. La. Jan. 23, 1987) (WESTLAW, Allfeds database). To allow the government to collect royalties and back interest would reduce some of the windfall the producers are receiving at the lessors' expense.

112. *See Diamond Shamrock II*, 853 F.2d at 1167.

113. 5 E. KUNTZ, *supra* note 26, at § 60.1.

best interests of both the lessee and the lessor.[114] Under the gas sales contracts in question, the lessee is obligated to keep in reserve an appropriate amount of natural gas to satisfy its obligation to the purchaser.

Applying the court's reasoning, if a take-or-pay payment is made under the contract, the lessee is the only party that benefits from the payment. It is unclear if the lessee could claim such a benefit for himself and not violate his duty to market.[115] If the gas sales contract satisfies the lessee's duty, then any benefit which accrues to the lessee under the take-or-pay clause should also flow to the lessor. The lessors, therefore, should be able to collect royalties on take-or-pay payments.

E. *Where Do Lessors Go from Here?*

The final question to be addressed is, what can lessors do, beyond the claims previously discussed, to reap the benefit of take-or-pay payments in the future? The most obvious action is to draft future leases to expressly include royalty payments on take-or-pay payments.[116] This is best accomplished by private lease holders who can draft leases according to their own negotiated terms.[117]

The federal government's leases are governed by MLLA and OCSLA.[118] Both statutes base the collection of royalties according to production.[119] Therefore, in light of the court's decision in *Diamond Shamrock II*, for the federal government to collect

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114. *Id.* at § 60.3.

115. *But see* Frey v. Amoco Prod. Co., 708 F. Supp. 783, 786-87 (E.D. La. 1989) (failure to pay royalties on take-or-pay payment was not a violation of lessee's duty to market). Several courts have held that entering into a long-term gas sales contract that contains a take-or-pay clause is sufficient to satisfy the lessee's duty to market. *See* E. KUNTZ, *supra* note 26, at § 60.1. These cases were decided before *Diamond Shamrock II.*

116. *Oil and Gas*, *supra* note 93, at 153. An example of a possible royalty clause for take or pay minimum payments would be:

> Where gas from a well capable of producing in commercial quantities is not being sold or used, but is subject to a gas sales contract, any payments to lessee under a take or pay type clause will be subject to royalty. If in subsequent periods gas is taken in excess of the contract minimum quantity, pursuant to a make-up type clause, that excess will not be subject to royalty to the extent of the previous payments for gas paid for but not taken.

Id. at 153 n.9.

117. *See* Jordan & Kahn, *supra* note 109, at 19-31 and n.12 (this article was written prior to the present litigation but its advice to the lessor of gas properties is still applicable).

118. *See supra* note 10.

119. Sullivan, *supra* note 19, at 298.

royalties on take-or-pay payments, Congress should amend these statutes to allow for the collection of royalties on take-or-pay payments. State governments, depending on their local statutes and regulations, may have to amend either their controlling statutes or regulations, if applicable, and draft their leases so that they would be able to collect royalties on take-or-pay payments.

VI. Conclusion

Diamond Shamrock II allows for a clear understanding of the allocation of payments made under a take-or-pay clause and whether the federal government under their leases will be able to collect royalties on these payments. The decision, while being sound in its reasoning, allows the lessee-producers to gain an enormous windfall at the expense of the publicly-owned natural resources. To allow the government to collect royalties only when make-up gas is taken allows producers to continue to receive a substantial part of this windfall. Since the Fifth Circuit's opinion has cut off access to these royalties at the time a take-or-pay payment is made, the government should attempt collection under the theories discussed in this note; and, to assure collection of royalties from take-or-pay payments in the future, the government needs to amend its statutes and lease forms.

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