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Oil and Gas - Royalties on the Take or Pay Clause in Wyoming - Has the Issue Been Adequately Decided - State v. Pennzoil

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OIL AND GAS—Royalties on the "Take or Pay" Clause in Wyoming—Has the Issue Been Adequately Decided? *State v. Pennzoil,* 752 P.2d 975 (Wyo. 1988).

In 1984, Pennzoil Company and Marathon Oil Company sought a declaratory judgment regarding their obligations to the State of Wyoming on certain oil and gas leases.[1] Pennzoil and Marathon were assignees of the original lessee on a State of Wyoming oil and gas lease.[2] The pertinent lease provisions stated that the lessees would pay royalties on gas and oil produced and sold from the leased property.[3]

Pennzoil and Marathon both entered into gas purchase contracts with Colorado Interstate Gas (CIG).[4] Each contract included a "take or pay" clause.[5] The gas purchase contracts also contained "make up" gas provisions with a five-year limitation period.[6] The take or pay provision of each gas sales contract provided that CIG would take a specified minimum quantity of gas each year or pay Pennzoil or Marathon the amount of the deficiency multiplied by the price in effect at the time of the deficiency.[7] The contract further provided for the buyer (CIG) to "make up" volumes paid for but not received in subsequent years and credit the value of the "make up" volumes toward the take or pay payments.[8]

The Board of Land Commissioners (Board) asserted that royalties were due the state on these advance payments for natural gas according to the terms of the oil and gas lease.[9] The Board, through the State Auditor

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1. State v. Pennzoil Co., 752 P.2d 975 (Wyo. 1988).
2. Joint Brief of Appellees at 4, State v. Pennzoil Co., 752 P.2d 975 (Wyo. 1988) (No. 86-211) [hereinafter Joint Brief of Appellees].
3. The royalty clause section 2(d) of the state oil and gas lease provided:

   > (d) ROYALTIES. The royalties to be paid by lessee are: (i) on oil, one-eighth of that produced, saved, and sold from said land, the same to be delivered at the wells or to the credit of lessor into the pipe line to which the wells may be connected; (ii) on gas, including casinghead gas or other hydrocarbon substance, *produced from said land saved and sold or used off the premises* or in the manufacture 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.*

   Pennzoil, 752 P.2d at 976 (emphasis in original).
4. Joint Brief of Appellees, *supra* note 2, at 4 app. A.
5. Joint Brief of Appelles, *supra* note 2, at 7. A take or pay contract is:

   > A contract whereby a purchaser agrees to take a minimum quantity of oil or gas over a specified term at a fixed price (or at a fluctuating price which cannot be reduced below a specified level) or to make minimum periodic payments to the producer even though oil and gas is not being delivered to the purchaser.

   8 H. Williams & C. Meyers, Oil and Gas Law Manual of Oil and Gas Terms at 979 (1987).
6. Make-up gas is:

   > (1) Gas that is taken in succeeding years having been paid for previously under a Take-or-pay clause in a Gas purchase contract. The contract will normally specify the number of years after payment in which the purchaser can take delivery of make-up gas without paying a second time.

   8 H. Williams & C. Meyers, *supra* note 5, at 539.
7. Joint Brief of Appellees, *supra* note 2, at 4 app. A.
8. *Id.*
9. Brief of Appellant at 2, State v. Pennzoil Co., 752 P.2d 975 (Wyo. 1988) (No. 86-211) [hereinafter Brief of Appellant].

issued a letter stating that both Pennzoil and Marathon had failed to pay royalties on the take or pay obligations with respect to their gas sales contracts with CIG.[10]

Marathon agreed to pay the royalties, but Pennzoil refused and sought a declaratory judgment against the State of Wyoming, including the Board of Land Commissioners, in the First Judicial District Court of Wyoming.[11] Marathon filed a similar action against the state and shortly thereafter the two actions were consolidated.[12] Both sides moved for a summary judgment on the issue of whether or not royalties were due on the "take or pay" obligations.[13] The district court determined that actual production was required before the state was entitled to royalties and therefore granted summary judgment to the companies.[14]

In *State v. Pennzoil*,[15] the Wyoming Supreme Court affirmed the district court's decision that actual production was essential before any royalty payments were due under the state's standard oil and gas lease.[16] The court determined that actual production meant the physical severance from the ground.[17] Thus, since such severance had not taken place, the court held that no royalties were due on "take or pay" obligations.[18]

This casenote will examine the royalty elements of the state's oil and gas lease and the court's interpretation of that lease, within the framework of its decision. It will further explore the court's failure to adequately distinguish a prior analogous decision in *Cheyenne Mining and Uranium Co. v. Federal Resources Corp.*[19] In *Cheyenne Mining*, the court addressed a fact pattern similar to that of the principal case but reached a different result. The court should have overruled the *Cheyenne Mining* decision in *Pennzoil* in order to clarify whether royalties are owed before actual production, before physical severance from the ground.

BACKGROUND

The question in the principal case was whether royalties were due on "take or pay" obligations.[20] Thus, a review of decisions from other jurisdictions will be helpful.

The Fifth Circuit has had two identical cases with opposite results regarding royalties on "take or pay" obligations. In *Mesa Petroleum Co.*

10. Joint Brief of Appellees, *supra* note 2, at 2.
11. *Id.* at 2-3.
12. *Id.*
13. *Id.*
14. Pennzoil Co. v. State of Wyoming; Marathon Co. v. State of Wyoming, Nos. 104-39, 104-44, slip op. (1st Jud. Dist. Ct. of Wyo. Mar. 27, 1986) (available on Lexis) (citing Monsanto Co. v. Tyrrell, 537 S.W. 2d 135 (Tex. 1976) (the court found that production is the actual physical severance of the mineral from the soil)).
15. 752 P.2d 975.
16. *Id.* at 982.
17. *Id.* at 979.
18. *Id.* at 982.
19. 694 P.2d 65 (Wyo. 1985).
20. *Pennzoil*, 752 P.2d at 976.

v. U.S. Dept. of Interior,[21] facts similar to those of the principal case were involved. Mesa, a lessee of offshore lands from the United States, sought a declaratory judgment regarding lessor's (Department of Interior (DOI)) request for royalties on take or pay payments received from the gas contract purchaser.[22] Mesa sold its production exclusively to the Tennessee Pipeline Company.[23] The court stated that the purpose of the take or pay provision was to ensure Mesa a constant source of revenue to meet its operation and maintenance costs.[24] The Mesa gas purchase contract also had a "make-up" gas provision enabling Tennessee Pipeline Company, as purchaser, to recoup against any take or pay obligations incurred during the contract period of seven years.[25]

The contract between Mesa and the DOI stated that royalties were due on the "amount or value of production saved, removed or sold from leased area."[26] Further support for this language was found in the DOI's own regulations. That regulation stated royalties were due on actual production.[27] Those regulations persuaded the court that "the DOI . . . [had] no statutory, regulatory, or contractual authority to collect royalties on take or pay payments."[28]

In *Diamond Shamrock Exploration Co. v. Hodel*,[29] the United States District Court for the Eastern District of Louisiana interpreted the same language in a different lease and applicable statutes and reached the opposite decision from the *Mesa* court.[30] In that case, the court looked at the Outer Continental Shelf Lands Act (OCSLA),[31] and determined that production and royalty had broader definitions under that Act.[32] The court stated that take or pay payments were "part of the total consideration for the purchase and sale of gas under the contract."[33] The court further relied on the DOI's interpretation of the "value of production" to determine the amount of royalties due.[34] The court reasoned that the take or pay payments were being used to finance future production.[35] This financing of future production was considered part of the overall "value of production" and hence royalty payments were due.[36]

These decisions, which focused the issue of royalties on take or pay payments, were consolidated on appeal to the Fifth Circuit Court of

21. 647 F.Supp. 1350 (W.D.La. 1986), *aff'd*, 853 F.2d 1159 (5th Cir. 1988).
22. *Id.* at 1352.
23. *Id.*
24. *Id.*
25. *Id.*
26. *Id.*
27. Mineral Resources, 30 C.F.R. § 206.151 (1986) (when coupled with the definition of production in an oil and gas lease on public lands at 43 U.S.C. § 1331(m)).
28. *Mesa*, 647 F. Supp. at 1355.
29. No. 86-537, slip op. (E.D.La. Jan. 23, 1987) (available on Westlaw), *rev'd*, 853 F.2d 1159 (5th Cir. 1988).
30. *Id.* at 13.
31. 43 U.S.C. §§ 1331-1356 (1982).
32. *Diamond Shamrock*, No. 86-537, slip. op., at 12.
33. *Id.* at 9 (quoting the Administrative Record, Volume 1, document 1, Opinion of the Assistant Solicitor (Jensen Memorandum) at 6).
34. *Id.* at 19.
35. *Id.* at 14.
36. *Id.*

Appeals in August of 1988. In that decision, the court held that no royalty payments were due before actual production.[37]

In *State v. Moncrief*,[38] the Wyoming Supreme Court interpreted the royalty clause[39] in question in the principal case. In that case, the State of Wyoming sought payment for oil production at the highest price received by any working unit in the field as opposed to what the producer actually received at the well.[40] The state's desired interpretation specifically contradicted section two (g) of the Wyoming oil and gas lease.[41] The court held the language of the lease unambiguously established when and for what royalties were due.[42] In *Moncrief*, the court held that royalties were payable on actual production sold off of the land.[43] The court declared that the market-value or amount realized from the actual sale of produced gas was the applicable standard for royalty payments.[44]

In *Cheyenne Mining and Uranium Co. v. Federal Resources Corp.*,[45] a factually similar case to that of *Pennzoil*, Cheyenne Mining and Uranium (CMU) sold unpatented mining claims to the Vitro Minerals Corporation (Vitro) but retained a forty percent royalty interest in the annual net profits of the claim.[46] Vitro later assigned the purchased interest to Federal Resources Corporation doing business as Federal-American Partners (FAP).[47] FAP then entered into two agreements with the Tennessee Valley Authority (TVA).[48] The first agreement granted TVA the exclusive right to mine uranium from the property.[49] The second agreement

37. Diamond Shamrock Exploration Co. v. Hodel, 853 F.2d 1159, 1168 (5th Cir. 1988) (holding royalty payments were not due when a lessor received take or pay payments from a purchaser under a federal oil and gas lease).

38. 720 P.2d 470 (Wyo. 1986).

39. *Id.* at 472.

40. *Id.*

41. Section 2(g) of the lease stated when royalties were due:

> (g) MONTHLY PAYMENTS AND STATEMENTS. Unless the time of payment is otherwise extended by the Commissioner of Public Lands, [the lessee agrees] to make payment on or before the twentieth (20) day of the calendar month *succeeding the month of production and removal and sale of oil and gas from said land*, and to furnish sworn monthly statements therewith showing in detail the quantity and quality of the production . . .

Pennzoil, 752 P.2d at 976-77 (emphasis in original).

42. *Moncrief*, 720 P.2d at 475.

43. *Id.* at 474.

44. *Id.*

45. 694 P.2d 65 (Wyo. 1985).

46. *Id.* at 67. The pertinent provisions of the royalty interest stated:

> 4. OWNER'S PARTICIPATION: For and in consideration of the Assignment and Conveyance to Purchaser of Owner[']s interest, *the Purchaser covenants and agrees to pay to the Owner, its successors, assigns or legal representatives, a sum constituting forty per cent (40%) of the annual net profits* from all uranium, vanadium and other associated minerals and ores mined, produced and sold from the property, *computed in accordance with and under the terms and conditions hereinafter set forth.*

Id. (emphasis in original).

47. *Id.* at 67.

48. *Id.* at 68.

49. *Id.* The mining lease agreement between FAP and TVA stated:

> A. For and in consideration of good and valuable consideration and of the covenants and agreements herein contained, Lessor (FAP) hereby grants to

was for FAP to assume the role of contractor and to perform the exploratory work, the mining and extraction and the milling on TVA's behalf and at TVA's expense.[50]

In the first agreement, designated a lease by the parties, TVA paid FAP seven million dollars for the estimated uranium ore reserves.[51] The agreement called for these advance royalty payments to be paid before any actual production.[52] The agreement stated that the payment was for production costs and allowed TVA to make up the seven million dollar advance payment by subtracting the value of actual uranium ore delivered.[53]

CMU, as the original owner of the claim, still held a forty percent royalty interest in the annual net profits of uranium ore mined, produced and sold from the property.[54] When FAP began mining operations, it paid the minimum payments to CMU as required.[55] CMU was dissatisfied with the accounting information given by FAP and filed suit.[56] It was then that CMU learned of the agreements between FAP and TVA.

The trial court held that CMU was entitled to forty percent of the annual net profits of uranium ore actually produced and sold.[57] The court based its determination on the contract for purchase and sale,[58] and on FAP's method of calculation presented at trial.[59]

The Wyoming Supreme Court reversed and held that CMU was entitled to its pro rata share of the seven million dollars paid to FAP as advance royalties.[60] The court found that the agreement between FAP and TVA was a sale of ore, not a lease.[61] After determining that the agreement was a sale, the court stated that FAP was then obligated to mine and produce uranium ore for TVA. Although actual production had not

> the Lessee (TVA) and the Lessee's successors and assigns for the term hereinafter provided the exclusive right to explore, develop, mine, extract and remove from the Mining Properties all uranium and other fissionable source materials, including associated minerals, in, on, under, or upon the said properties and thereafter to retain all right title and interest in and to all such severed minerals.

Id.

50. *Id.* at 69.
51. *Id.* at 68-69.
52. *Id.* at 68.
53. *Id.* at 71. The court stated:

> The nature of these payments as advance royalties is made clear in Article IIIC of the mining lease agreement, which specifies that the $7,000,000 is to be amortized as a "production cost" in computing the proceeds owed to FAP on each pound of delivered U_3O_8 concentrate.

Id.

54. *Id.* at 67.
55. *Id.* at 69.
56. *Id.*
57. *Id.*
58. *Id.* Section 4f. of the leasing agreement referred to producing and marketing commercial ores, and recognized physical severance as the basis for computing royalty payments. *Id.* at 68.
59. *Id.* at 69-70.
60. *Id.* at 70.
61. *Id.* at 71-72.

taken place, the contract required FAP to pay CMU its pro rata share of the advance royalties.[62] The court stated that physical performance of these obligations was immaterial to determine whether royalty payments were due CMU.[63] The court also determined the method for calculating net profits in relation to the royalty payments.[64]

Justice Rooney, in dissent, stated the majority ignored the unambiguous language of the contract regarding the terms "mined, produced and sold" for determination of royalties due.[65] Justice Rooney also stated that the finding of a sale was unconvincing for two reasons: first, the minerals in place were the property of the United States, and secondly, the mining lease agreement gave " 'the exclusive right to explore, develop, mine, extract and remove' minerals from the claim and '*thereafter* to retain all right title and interest in and to all such *severed* minerals' "[66] (emphasis in original).

Justice Rooney and the majority in *Cheyenne Mining* both assumed that production meant physical severance of the mineral from the ground. However, it was at this point that the majority stated the lease agreement constituted a sale and not a lease. This led the majority to the conclusion that production, i.e. physical severance from the ground, was immaterial to the determination of royalties due to the lessor.

In *Monsanto Co. v. Tyrrell*,[67] the Court of Civil Appeals of Texas was asked to interpret an oil and gas lease and gas purchase contract.[68] Monsanto, as lessee, contracted for an advance payment from the purchaser for future delivery of gas.[69] The lower court ruled that Tyrrell, as lessor, was entitled to its royalty share of the advance payment because it was "recovery from production."[70] The appeals court regarded this judicial interpretation as a violation of the accepted terms of the oil and gas lease.[71] It held that the term "production" as used in the lease had a definite legal meaning, namely, the actual physical severance of the mineral from the soil.[72] This interpretation of the term "production" in the oil and gas context was consistent with many jurisdictions and the standards in the industry.[73] *Pennzoil* presented the Wyoming Supreme Court with a similar issue, which had divided the Fifth Circuit, of whether royalties were due when payments under a "take or pay" obligation were made before actual production.

62. *Id.* at 72.
63. *Id.*
64. *Id.* at 73. In determining annual net profits the court then decided on the proper method of determining the value of uranium ore and such value shall be subtracted from CMU's share of advance royalties on a proportionate royalty per pound basis. *Id.*
65. *Id.* at 79 (Rooney, J., dissenting).
66. *Id.* at 81.
67. 537 S.W.2d 135 (Tex. 1976).
68. *Id.* at 136.
69. *Id.*
70. *Id.* at 137.
71. *Id.*
72. *Id.*
73. Union Oil Company of California v. Touchet, 229 La. 316, 86 So.2d 50 (1956); Gulf Oil Corp. v. Reid, 337 S.W.2d 267 (Tex. 1960).

THE PRINCIPAL CASE

In *Pennzoil*, the court had to determine whether the State of Wyoming as lessor was "entitled to royalty on payments made by a purchaser from the lessee, who was required to make minimum payments for gas even though the gas was not received".[74]

The Board argued that the royalty clause was ambiguous and extrinsic evidence was needed to determine the meanings of the terms mined, produced and sold.[75] The Board further contended that since *Cheyenne Mining* also involved a sale between a lessee and a purchaser and contained similar contractual language, the court was bound to follow that case's expansive interpretation of production.[76] The court rejected numerous other arguments advanced by the Board as inapplicable and unpersuasive.[77]

In reaching its decision, the court focused on the royalty clause of the oil and gas lease, finding that the terms were clear and unambiguous.[78] Royalties were to be paid by the lessee on gas "produced from said land saved and sold or used off the premises."[79] The court stated that the oil and gas lease was a contract and that the general principles for the construction of contracts and their interpretation applied.[80]

The court indicated that the contract was to be interpreted within the context in which it was written, by examining surrounding circumstances as in *Cheyenne Mining*.[81] This was to determine the intent of the parties involved at the time of the agreement.[82] The court found no ambiguity

74. *Pennzoil*, 752 P.2d at 976.
75. *Id.* at 978-79.
76. *Id.* at 980.
77. The Board also advanced the following arguments:
The language of the contract was to be construed within the context in which it was written. *Id.* at 978. The true intent of the Board as lessor and Pennzoil and Marathon as lessees was not effectuated. *Id.* The Board could not violate the federal floor pricing minimum which stated that royalties paid to the state could not be less than that received by the United States for its royalties in the same field. *Id.* at 981. The Board stated that common sense and good faith required a finding that the Board would not enter into a contract where the Board would have precluded itself from a portion of the proceeds on an oil and gas lease. *Id.* The Board argued that as trustee of these leased lands they had to obtain the highest return from the trust property dedicated to educational institution support. *Id.*
The court rejected these arguments and stated that: The context in which the contract was written did not involve any ambiguity so the court would not go outside the express language of the contract to create an ambiguity. *Id.* at 979, 980. The intent of the parties involved must come from the language of the contract. Here the language was clear as to the parties intent. *Id.* at 979. The court dismissed the federal floor pricing argument because the state failed to show any federal leases in the field. *Id.* The court dismissed the common sense and good faith argument as well as the trustee argument, as being the Board's own poor judgment in constructing the lease. The court stated it would not rewrite the terms of the contract. *Id.* at 981.
78. *Pennzoil*, 752 P.2d at 979.
79. *Id.* at 976.
80. *Id.* at 978 (citing Wolff v. Belco Development Corp., 736 P.2d 730 (Wyo. 1987), State v. Moncrief, 720 P.2d 470 (Wyo. 1986)).
81. *Id.* at 978.
82. *Id.*

in the lease and therefore no need to go outside the agreement (lease).[83] Here, the court agreed with the district court decision that the lease was not ambiguous as to when royalty payments were due.[84]

Since Wyoming had no statutory definition of production and the term was not defined in the lease,[85] the court accepted the established definition from *Monsanto*[86] and *Moncrief*,[87] that production required the actual physical severance of the mineral from the soil. The court thus stated that physical extraction of the gas was necessary for the royalty clause to apply.[88]

In addressing the Board's contentions that the *Cheyenne Mining* decision was controlling, the court stated that the similar language in the two leases was only coincidental and that the unique facts of *Cheyenne Mining* made it inapplicable.[89] The court then rejected the Board's other analogy to *Cheyenne Mining,* that both cases involved a sale between lessee and purchaser. The court reasoned that Marathon and Pennzoil did not own the gas or gas producing property, whereas in *Cheyenne Mining* the lease was actually a sale of exclusive rights to mine the uranium producing property.[90] The court again cited *Cheyenne Mining* as being a unique situation and not controlling.[91]

The court essentially accepted the district court's opinion as to when royalties were due on a State of Wyoming oil and gas lease by accepting the established definition of the term production as physical severance from the soil.[92] The court then held that no royalties were due because no oil or gas had been extracted from the ground.

ANALYSIS

The Supreme Court of Wyoming has acknowledged the realities of the oil and gas industry with its holding in the principal case. However, the court failed to adequately reconcile the decision with its previous holding in *Cheyenne Mining*. In *Cheyenne Mining,* the court stated that the agreement between CMU and FAP called for FAP to pay CMU forty percent of the annual net profits from the sale of uranium ore mined, produced, and sold from the property.[93] FAP was obligated to pay CMU only upon the sale of mined and produced ore.[94] In order to circumvent the express language of the contract between FAP and CMU, the court stated that actual production was immaterial since FAP was contractually obligated

83. *Id.* at 978-79.
84. *Id.* at 979.
85. *Id.*
86. 537 S.W.2d at 136.
87. 720 P.2d at 474.
88. *Pennzoil,* 752 P.2d at 979.
89. *Id.* at 980.
90. *Id.*
91. *Id.*
92. *Id.* at 981.
93. *Cheyenne Mining,* 694 P.2d at 67.
94. *Id.* at 71. The court stated that under the express language of the contract, FAP was obligated to pay CMU only for sale of mined and produced ore. *Id.*

to mine and produce ore for TVA.[95] The court stated that this contractual obligation on the part of FAP was sufficient to trigger the royalty clause for net profits of ore mined, produced, and sold to CMU.[96]

In fact, the court determined the mining lease agreement to be the equivalent of a sale of minerals in place despite the fact that actual production had not taken place.[97] The court, by not requiring actual production, expansively interpreted the term "produced" in the contract between CMU and FAP.

In contrast, *Pennzoil* held that "produced, saved and sold" had a definite legal and limited meaning.[98] There the court stated that the similar terms "produced, saved and sold," meant that only actual physical severance of the mineral from the ground could trigger the royalty clause.[99] The court attempted to clarify the contradiction between the two cases by dismissing the interpretational differences as merely coincidental language.[100]

In the principal case, the district court stated that if any ambiguity existed in the lease agreement, it would be construed against the state, as scrivener of the lease.[101] The Wyoming Supreme Court agreed with the district court and stated that any ambiguity in the lease would be resolved against the Board as drafters of the lease.[102] Here again, the court contradicted its prior decision in *Cheyenne Mining*. In *Cheyenne Mining*, CMU drafted the contract agreement which was assigned to FAP.[103] In reviewing the agreement the court construed the ambiguous terms "produced and sold" against FAP, although it did not draft the agreement.[104] In interpreting the contracts between the parties, the court expanded the terms in one case (*Cheyenne Mining*), and narrowed the terms in the subsequent case (*Pennzoil*).

The transactions in *Cheyenne Mining* and *Pennzoil* both involved the sale and purchase of future mineral and gas production. In both cases, the lessors drafted the lease agreements which contained similar terms and provisions on which to base royalty payments. Further, the court in *Pennzoil* failed to acknowledge that both contracts explicitly state that actual production was the basis for computing royalties. Both contracts allowed for the make-up of amounts paid in lieu of actual production and the court ignored the same terms which were clear and unambiguous in one case yet unclear in the other.

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95. *Id.* at 72.
96. *Id.*
97. *Id.* at 71-72 (citing Gilbertson Fuels, Inc. v. Philadelphia and Reading Coal and Iron Co., 20 A.2d 217 (Pa. 1941) (where the court found that the transfer of the exclusive right to mine constituted a sale of the hard rock minerals in place)).
98. *Pennzoil*, 752 P.2d at 979.
99. *Id.*
100. *Id.* at 980.
101. Pennzoil Co. v. State of Wyoming, Marathon Co. v. State of Wyoming, Nos. 104-39, 104-44 slip op. (1st Jud. Dist. Ct. of Wyo. Mar. 27, 1986) (available on Lexis).
102. *Pennzoil*, 752 P.2d at 979-80 (citing Kelliher v. Herman, 701 P.2d 1157 (Wyo. 1985)).
103. *Cheyenne Mining*, 694 P.2d at 67.
104. *Id.* at 70-71.

However, the synonymous aspects of the two cases do not end with just similar terminology. In *Cheyenne Mining,* the court decided that the mining lease was a sale of minerals in place.[105] This sale was determined by a payment of advance royalties with production to begin later.[106] In the principal case, the take or pay payments were also advance payments with production to begin at a later date. Take or pay obligations only arise after there is a gas purchase contract between the lessee and the purchaser, i.e., a sale of gas. This sale of gas represents a contractual obligation for the lessee producer to meet the minimum requirements of the gas purchase contract.[107] Both of these situations represent a constructive sale of a product prior to its actual production.

In interpreting the lease agreement in *Pennzoil,* the court ignored the possibility that CIG might never make up gas deficiencies under the take or pay clause.[108] In fact, the court specifically stated that "it is not necessary for us to resolve this issue," since actual production had not taken place.[109]

In ignoring this possibility, the court avoided the precise factual similarity of the *Cheyenne Mining* decision. There the court was concerned with the producer receiving production payments before actual production and thereby precluding the lessor from receiving any royalty. In the principal case, this is precisely what would have happened if the purchaser failed to take his minimum gas purchase amount, since money would then have been paid for no actual production.

Further, both contracts included make-up clauses. In *Cheyenne Mining,* the seven million dollar advance royalty was specified for production costs by FAP's contract in Article IIIC.[110] These production costs were to be recouped by TVA when computing the amounts owed to FAP on each pound of actual production.[111] This provision allowed TVA to make up the production costs when it accepted future production.

In the principal case, the agreement between Pennzoil and CIG specifically allowed a make-up period of five years in section 4.2 of the contract.[112] This provision allowed the purchaser to recover future gas production credited against prior take or pay payments. Thus, both provisions enabled the purchaser to make up advance payments for production after receiving actual production.

Pennzoil failed to address these important issues common to both cases. The court in *Pennzoil* should have overruled *Cheyenne Mining* since the court now requires actual production to take place in order to trigger

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105. *Id.*
106. *Id.* at 71.
107. *Pennzoil,* 752 P.2d at 977.
108. 752 P.2d at 982.
109. *Id.*
110. *Cheyenne Mining,* 694 P.2d at 71.
111. *Id.*
112. *See* Joint Brief of Appellees, *supra* note 2, at 4 app. A.

royalty payments.[113] The decision in *Pennzoil* accurately reflects the meaning of the terms "produced and sold." It also takes into consideration the realities of the take or pay clause, which obligates the producer to sell exclusively to the purchaser and cover maintenance and operation costs,[114] and also enables further development and exploration.[115]

In deciding the issue of royalties being due on take or pay obligations, the Wyoming Supreme Court based its holding on the established terms of the oil and gas industry.[116] The court correctly defined production for royalty purposes as the physical severance of the mineral from the ground.[117] Since *Pennzoil*, the Fifth Circuit Court of Appeals agreed in *Diamond Shamrock* and cited *Pennzoil* in holding that royalties were not due on take or pay obligations prior to actual production.[118]

Justice Rooney in dissent in *Cheyenne Mining* expressed a similar view that the term "produced" had a definite legal meaning and the majority opinion had expanded it.[119] Ultimately, *Pennzoil* left unanswered the question of which definition of production is applicable for royalty payment obligations. Does *Pennzoil* overrule *Cheyenne Mining* sub silentio as has been suggested by commentators?[120]

In *Pennzoil*, the Wyoming Supreme Court off-handedly dismissed *Cheyenne Mining* as a unique situation unto itself and not persuasive authority.[121] However, upon a close reading of the two cases, the similarities are clear.[122] The court failed to adequately distinguish the cases and left the oil and gas industry with contradictory signals. The court should have clarified these contradictory signals by expressly overruling *Cheyenne Mining*. Instead, the court left the industry with two different interpretations of production, in two indistinguishable cases.

CONCLUSION

In holding that royalties are due to the state only upon actual production, the *Pennzoil* court failed to distinguish its own previous decision in *Cheyenne Mining*. The court has left the impression that physical severance and extraction may be required in certain cases while not in others. This decision has left us with unanswered questions when attempting to reconcile the two holdings. The holding in *Pennzoil* has adopted the accepted terms of the oil and gas industry without straining to inject

113. *Pennzoil*, 752 P.2d at 979.
114. *Mesa*, 647 F.Supp. at 1354.
115. J.M. Huber Corp. v. Denman, 367 F.2d 104, 116 (5th Cir. 1966).
116. *Pennzoil*, 752 P.2d at 977 (citing 8 H. WILLIAMS AND C. MEYERS, *supra* note 5, at 539, 979).
117. *Id.* at 979.
118. *Diamond Shamrock*, 853 F.2d at 1168.
119. *Cheyenne Mining*, 694 P.2d at 81 (Rooney, J., dissenting).
120. Kramer, *Royalty Obligations Under the Gun - The Effect of Take-or-Pay Clauses on the Duty to Make Royalty Payments*, 39TH ANNUAL INST. ON OIL & GAS LAW & TAXATION, 5-14 (1988).
121. *Pennzoil*, 752 P.2d at 980.
122. Brief of Appellant, *supra* note 9, at 17.

extrinsic evidence or rewrite the terms of the contractual obligations. The *Pennzoil* court correctly defined and interpreted the terms and provisions of the lease agreement in light of prior decisions and the realities of the industry.

However, the court should have clearly explained why it rejected *Cheyenne Mining* so that adequate precedent may be relied upon. The court should have specifically overruled *Cheyenne Mining,* so that the producers in the oil and gas and mining industries would not be left to guess which standard will be used to classify their future royalty obligations. Instead, the court differently interpreted two indistinguishable transactions.

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