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Part B: The economic underpinning of royalty interests

This part considers the essential economic arrangements which underpin the principal forms of royalty interest.

The first major distinction to note in the classification of royalty interests is that which exists between a royalty in kind and a cash royalty.

A royalty agreement could recite both of the royalty in kind and cash royalty options in favour of the royalty holder, subject to a requirement of the royalty holder to make an election as to which formulation it requires (in which case the royalty agreement would need to contain all the drafting for a royalty in kind and a cash royalty, to be applied according to whichever election the royalty holder makes). The royalty agreement could also permit the royalty holder to change the election which it has made from time to time.

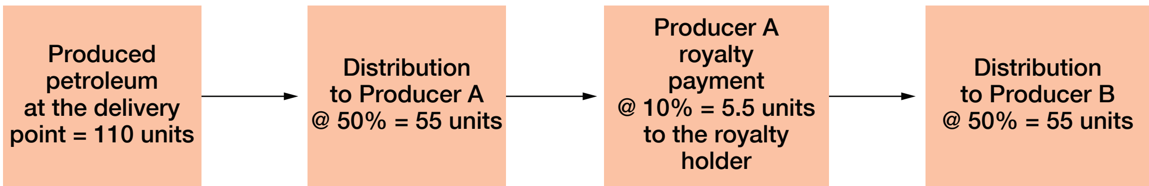
The ability to make these elections could be of value to the royalty holder where, for example, the royalty holder starts off with a cash royalty but later elects to take a royalty in kind when the royalty holder has a physical need for petroleum for in-country purposes such as refining; or where the royalty holder has established a petroleum trading function and has built up its own petroleum marketing competencies, and believes it could do better than the producer in selling its petroleum entitlements.

B1 The royalty in kind

In principle, this should be the most straightforward form of royalty interest to document and to apply. Under the terms of the JOA, the producer is entitled to lift and dispose of a defined share of the total quantity of produced petroleum (A4), further distinguished between crude oil and natural gas for the following example, and a defined percentage of that share is provided to the royalty holder in kind by the producer. The royalty agreement could say little more than that really:

> *In respect of each month the Producer will deliver and the Royalty Holder is entitled to receive, take delivery of at and dispose of from the Delivery Point the following percentages of Produced Petroleum:*
>
> *(a) Crude Oil – 10%*
>
> *(b) Natural Gas – 10%*

Structurally, this would appear as follows:



The concern of the royalty holder will be to ensure that the producer does all it can to maximise the rate of production of petroleum from the concessionary interests, and that the producer does so for as long as possible. The various mechanisms by which the royalty holder might be able to compel these objectives against a producer are considered in Parts C and D.

As a further refinement, a royalty agreement could apply a sliding scale to the definition of the royalty interest, with lower percentage royalty rates to apply as an offset to greater volumes of produced petroleum:

> *In respect of each month the Producer will deliver and the Royalty Holder is entitled to receive, take delivery of at and dispose of from the Delivery Point the following percentages of Produced Petroleum calculated by reference to the following rates (on the right).*

A royalty in kind gives the royalty holder a share of the produced petroleum to which the producer is entitled, which is typically made available to the royalty holder at the wellhead (A4) as the delivery

Produced petroleum per month	Royalty rate
Natural Gas – up to • million standard cubic feet (mscf)	10%
Natural Gas – • mscf to • mscf	9%
Natural Gas – greater than • mscf	8%
Crude Oil – up to • Barrels	10%
Crude Oil – • Barrels to • Barrels	9%
Crude Oil – greater than • Barrels	8%

point. To make the royalty holder's rights effective, the royalty agreement could recognise the necessary rights for the royalty holder to access the delivery point and to effect the removal of its in kind petroleum quantities, for transportation to a point of sale. Alternatively, the producer could carry out these functions for the royalty holder, subject to the royalty holder's commitment to pay the producer for the associated costs which are incurred in doing so.

The royalty holder will sell the petroleum which it receives from the producer in order to realise a monetary value. In the first instance, the producer could purchase the royalty holder's entitlements at the delivery point; but beyond that, the royalty holder could have no inclination for, and no means of, selling the petroleum which it is due to receive. The producer could therefore act as an agent for the sale of the royalty holder's entitlement (at market prices), and would account to the royalty holder for the sales proceeds.[20] The producer could charge an *ad valorem* marketing fee to the royalty holder for performing this sales agency function. Such agency sales would need to be managed carefully where there is a risk that the producer could sell the royalty holder's petroleum quantities to an affiliated or an associated person at an undervalue (B2).

B2 The cash royalty

Under a cash royalty, the producer sells its share of the total quantity of produced petroleum, and accounts to the royalty holder for a defined percentage of the resultant sale proceeds. The particular distinction to note in relation to cash royalties is between the following constructions:

- GOR:[21] The royalty interest is calculated as a defined percentage of the gross proceeds of sale of the produced petroleum which are realised by the producer, without the deduction of any of the costs and expenses which were incurred by the producer in relation to producing that petroleum.

- NPI:[22] The royalty interest is calculated as a defined percentage of the proceeds of sale of the produced petroleum which are realised by the producer, after the deduction of certain of the costs and expenses which were incurred by the producer in relation to producing that petroleum.

A cash royalty could, depending on how it is drafted, fall anywhere in the range between the extremes of the two constructions which are described above. A royalty holder could hold a royalty interest which has the appearance of being a GOR, but which includes provision for the deduction by a producer of at least some of the associated production costs, so that the GOR starts to stray into the territory of being a form of NPI. Alternatively, a royalty holder could hold a royalty interest which is described as being an NPI, but which has a definition of deductible costs and expenses which is relatively restricted, so that the royalty interest is in practical terms closer to being a GOR. The actual substance of the royalty interest will always be more important than whatever its form is professed to be.

Despite making provision for the deduction of costs and expenses, it is not axiomatic that an NPI will be less valuable than a GOR to the royalty holder. An NPI which has a high royalty rate (A7) could, despite the deduction of costs and expenses, have a greater intrinsic value than a GOR with a lower royalty rate.[23]

Several refinements to the basic proposition of the GOR or the NPI could be made in the royalty agreement, as follows.

Payment against revenue: The royalty amount which is due for payment could be determined on the basis of the net sales proceeds which were actually received by the producer, rather than on the basis of the gross sales prices which were invoiced by the producer under the petroleum sales arrangements. This is sometimes represented by the phrase 'royalty based on receipts'. This would protect the producer against the risks of payment failure or the application of price adjustments (including permitted setoffs) which were associated with the sale of petroleum and which would impact the producer's expected revenues from the sale of the produced petroleum (C11).

Floor price protection: To protect the royalty holder from the risk of a reduction in revenue which is caused by falling market prices, the royalty agreement could apply a floor price for the sales of the produced petroleum (although the producer could understandably be reluctant to assume this risk):

> *Gross Values means: (i) for Crude Oil, the greater of: (a) the gross sales prices which were invoiced by the Producer for the sale of the Produced Petroleum (in US$ per Barrel); and (b) US$[•] per Barrel; and (ii) for Natural Gas, the greater of: (a) the gross sales prices which were invoiced by the Producer for the sale of the Produced Petroleum (in US$ per mscf); and (b) US$[•] per mscf.*

Hedging protection: To protect the royalty holder from the risk of a reduction in revenue which is caused by falling market prices, the royalty agreement could provide that the petroleum will be sold under (and the royalty holder will benefit from) a hedging instrument which the producer has put in place:

> *If the Producer (whether itself or through an Affiliate) has at any time put in place or otherwise benefits from a Hedging Instrument then the amounts payable by the Producer to the Royalty Holder under clause x will be paid subject to and with the benefit of the Hedging Instrument in favour of the Royalty Holder where the application of the Hedging Instrument would result in payment to the Royalty Holder of an amount greater than the amount which would otherwise be payable to the Royalty Holder under clause x.*
>
> Hedging Instrument *means any price hedge, commodity swap or other derivative instrument entered into in respect of the sale of Petroleum which is produced from the Concessionary Interests.*

Undervalue petroleum sales: A risk to the royalty holder is that the producer could sell the produced petroleum to an affiliated or an associated person at a price which is an undervalue relative to true market prices in order to reduce the amount of royalty which is payable (with the affiliated or an associated person then on-selling that petroleum at true market prices), or that the producer could exchange petroleum for non-cash consideration in order to evade the royalty interest payment obligation altogether. To preclude these risks, the royalty agreement could provide as follows:

> *If the consideration which is received by the Producer for the Produced Petroleum is not cash (including any exchange of goods or services or any forbearance to sue), or if the Producer has (in the Royalty Holder's reasonable opinion) sold the Produced Petroleum to any person at an undervalue relative to objective market value, then the Gross Values will be deemed to be the Royalty Holder's assessment (acting reasonably) of the objective market value of the relevant Produced Petroleum, based upon the greatest sales price which a willing buyer would pay a willing seller in the open market based on arm's length contract terms.*

The producer could be reluctant to accept the royalty holder's determination of what the market value should be in this situation, and the royalty agreement could instead apply an objective definition of the applicable market value.

Fixed price payment: What the royalty holder receives under each of the GOR and the NPI will vary according to realised petroleum sales prices. As a decoupling from price risk, the royalty agreement could provide for a fixed price payment to be made to the royalty holder, to be paid regardless of the level of the realised petroleum sales prices. This takes the royalty interest out of the realm of being an *ad valorem* interest, is essentially a hedging arrangement in favour of the royalty holder and means that the producer is taking the risk of realised petroleum sales prices falling below the fixed price payment level. If this provision is applied, the royalty agreement could also make provision for the periodic indexation and rebasing of the currency component in order to keep pace with inflation over time.

The economic exposure which a fixed price payment gives to the producer is obvious (which the producer could be willing to accept if the fixed price payment is set at a low enough level), and such an arrangement could contribute to the construction of the royalty interest as a *de facto* loan arrangement (A3.1). If this construction is adopted, the royalty agreement should be careful to structure the fixed price payment as a floor price which is payable under the royalty agreement, rather than as a standing amount which is payable in addition to any *ad valorem* royalty payment:

> *The Royalty Holder is entitled to receive and the Producer will pay to the Royalty Holder a guaranteed monthly amount in respect of Produced Petroleum calculated by multiplying each Barrel of Crude Oil which is produced by US$[•] and each mscf of Natural Gas which is produced by US$[•], which payment will be included as part of and offset against any amounts which are otherwise due for payment by the Producer to the Royalty Holder under clause x.*

Because the amount which the royalty holder will receive under a GOR or an NPI depends on the realised prices for the sale of petroleum, the royalty holder could have a particular interest in the terms of the petroleum sales arrangements which the producer enters into, and to this end the royalty holder could require provision in the royalty agreement that:

- the royalty holder can approve the identity of the buyer and the terms of the sales arrangements (which could include addressing matters such as limited payment deferral terms, the price and the management of price review terms, terminability, offsets and deductions, and the provision of collateral support by the buyer);

- the buyer could be required to make a part payment direct to the royalty holder, rather than payment being routed through the producer; and
- the royalty holder could have a right to enforce the terms of the sales arrangements directly against the buyer.

Whether the producer, or the buyer, would be at all willing to allow the royalty holder's involvement in the petroleum sales arrangements in such a manner is another matter.

The sales proceeds from the produced petroleum from which the royalty interest is derived would primarily be the price paid by the buyer under the petroleum sales arrangements, but could also include any take or pay payments which are made by the buyer. In the manner which was suggested in respect of certain quantities of petroleum which are excluded from being a royalty in kind (A5), the royalty agreement could make clear that the sales proceeds which are realised by the producer will not include certain other monetary income which is received by the producer under or in respect of the petroleum sales arrangements (eg, the receipt of insurance proceeds,

"The royalty agreement could make clear that the sales proceeds which are realised by the producer will not include certain other monetary income which is received by the producer under or in respect of the petroleum sales arrangements."

tax rebates, indemnity claims, monetary damages or the outcome of a dispute resolution process with the buyer). These elements might not obviously qualify as sales proceeds, but this might be a point worth making in the royalty agreement for absolute clarity.

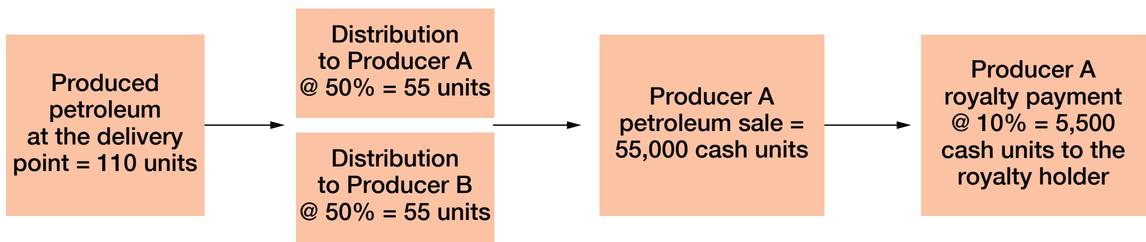
B3 The gross overriding royalty

In this form of royalty interest, a defined percentage of the gross proceeds of sale of the producer's produced petroleum entitlements is provided to the royalty holder by the producer.

In the simplest case, the GOR could be calculated as the product of the gross revenues which result from the sale of petroleum, multiplied by the royalty rate:

> *In respect of each month the Royalty Holder is entitled to receive, and the Producer is obliged to pay, payment in cash in respect of the Produced Petroleum calculated by multiplying the Gross Values by the Royalty Rate.*
>
> Gross Values *means the gross sales prices which were invoiced by the Producer for the sale of the Produced Petroleum (in US$ per Barrel for Crude Oil and US$ per mscf for Natural Gas).*
>
> Royalty Rate *means 10%.*

Structurally, this would appear as follows:



This is an extract from the chapter 'The economic underpinning of royalty interests' by Peter Roberts in the Special Report 'Drafting and Negotiating Petroleum Royalty Agreements', *published by Globe Law and Business.*