North Dakota Legislative Council

Prepared for Senator Bell
LC# 23.9250.01000
February 2022

DETERMINING ROYALTIES: THE VALUATION POINT OF OIL
A CASE STUDY ANALYSIS OF
BLASI V. BRUIN E&P PARTNERS (2021 ND 86)

This memorandum summarizes the North Dakota Supreme Court case of *Blasi, et al. v. Bruin E&P Partners, et al.*, 2021 ND 86, relating to the valuation point of oil for purposes of determining royalties due to a mineral owner.

BACKGROUND

The plaintiffs (Blasi) sued the defendants (Bruin) in five separate cases in federal district court alleging Bruin underpaid royalties due under the terms of various oil and gas leases. Central to the parties' dispute is the interpretation of the following royalty provision:

> Lessee covenants and agrees to deliver to the credit of the Lessor, free of cost, in the pipeline to which Lessee may connect wells on said land, the equal [fractional] part of all oil produced and saved from the leased premises.

Blasi claimed the royalty provision requires the royalty to be paid "free of costs" and Bruin improperly deducted various costs, such as gathering or moving the oil and other costs from the marketable price of the oil. Bruin moved to dismiss the cases, arguing Blasi's claims fail as a matter of law because the oil is to be valued at the well, which allows for the deduction of postproduction costs.

The United States District Court for the District of North Dakota certified the following question to the North Dakota Supreme Court related to the interpretation of the oil and gas lease: **Whether the instant oil royalty provision is interpreted to mean the royalty is based on the value of the "oil at the well?"** The North Dakota Supreme Court (court) may answer a question of law certified by a federal court if:

1. The legal question may be determinative of the proceeding; and
2. There is no controlling precedent.

If the court determines the valuation point is at the well, the federal district court may dismiss the lawsuits because postproduction costs would be deductible, thereby meeting the first condition. The second condition also was met because there was no controlling precedent in North Dakota on the issue. In *Bice v. Petro-Hunt, L.L.C.*, 2009 ND 124, the court adopted the work-back method which accounts for those costs in a calculation to determine the royalty value of oil or gas at a point in the stream of production. However, because royalties due to mineral owners for the production and sale of oil and gas is governed by contract law, the parties to a lease are free to set a valuation point elsewhere. Blasi claimed the royalty provision set the valuation point somewhere downstream of the well where the oil enters a pipeline. Bruin asserted the valuation point is at the well, where all reasonable postproduction costs may be deducted.

CONTRACT INTERPRETATION

Under North Dakota Century Code Sections 9-07-03 and 9-07-04, contracts are construed to give effect to the mutual intention of the parties at the time of contracting and the parties' intention must be ascertained from the writing alone, if possible. This means extrinsic evidence is not considered when a lease is unambiguous and the parties' intent can be ascertained from the writing alone.

THE COURT'S ANALYSIS

In this case, Blasi focused on the phrase "the pipeline" and argued the phrase referred to the type of pipeline used by the oil and gas industry to transport oil hundreds or thousands of miles to a refinery, not just a pipe at the well location for moving oil a few feet from the wellhead to a tank or truck. The court rejected Blasi's arguments and found the language at issue in the royalty provision unambiguous, stating the language "establishes a valuation point at the well." The court noted the royalty provision itself identified the pipeline that is contemplated. The meaning is based on the pipeline's proximity to the wells, not its physical characteristics--it is "the pipeline to which the lessee may connect wells on said land." The use of "pipeline" connotes a location in relation to the well; it does not designate a specific type of pipe as "the pipeline." After identifying the pipeline in the oil royalty provision based on its "proximity to the wells," the court explained it was to this pipeline the lessee's obligation to deliver produced oil "free of cost" applied.

The court found Blasi's interpretation of the royalty provision would introduce considerable uncertainty. For example, under Blasi's reading: the parties would have to examine the physical characteristics of various pipes to determine whether they are "the pipeline;" based on changes to infrastructure, the valuation point could shift over time; and there is a possibility the oil may be transported by other means and never reach the type of commercial pipeline Blasi envisions. The court found the plain language of the provision did not require the actual existence of a pipeline. The provision describes a pipeline the lessee "may" connect to the wells. A fair reading of the word "may" signifies the lessee cannot avoid the royalty obligation by neglecting to connect a pipeline to the wells. In other words, the royalty obligation exists regardless of whether the lessee constructs a pipeline at the described location.

CONCLUSION

The court found Blasi's interpretation of the royalty provision would reword the provision to say "free of cost in the pipeline" and such an interpretation would disregard the words describing the contemplated location--i.e., the place where the lessee "may connect" a pipeline. That place is at the "wells on said land." Thus, the court held as a matter of law, the royalty provision in this case is unambiguous and established a valuation point at the well and therefore the answer to the question of law certified by the United States District Court for the District of North Dakota, is "**yes**." It is worth noting this decision is an interpretation of a single oil royalty provision. Differently worded provisions may not be interpreted to have the same meaning and effect.