Royalty Jurisprudence: A Tale of Two States

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> *It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of Light, it was the season of Darkness, it was the spring of hope, it was the winter of despair, we had everything before us, we had nothing before us, we were all going direct to Heaven, we were all going direct the other way . . . .*[1]

I. INTRODUCTION

Beyond the rules and beyond the doctrine lurk the motivating forces for decision that influence why courts make, or refuse to make, new law. The motivating forces are typically the product of an underlying judicial philosophy that the court may, or may not, care to articulate. Once the judicial philosophy is accurately identified, it can serve as a predictive tool for how the court may resolve the next case on the subject while allowing a more effective critique of the court's decision. It will also instruct counsel on how to plead, prosecute, and defend the next case. In this article, the relevant judicial philosophies of the Supreme Court of Colorado and the Supreme Court of Texas are identi-

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1. CHARLES DICKENS, A TALE OF TWO CITIES 1 (Oxford University Press 1987) (1859).

fied and examined to illustrate how they impact the resolution of basic property and contract issues regarding the calculation of oil and gas royalties. The contrast in approaches taken by these courts is fundamental, representing differing judicial philosophies concerning the oil and gas lease and the lessor/lessee relationship. Multi-billion-dollar royalty-calculation issues are being decided through application of the judicial philosophies these courts pursue.

Today, litigants addressing royalty-calculation issues in other states will typically seek to have courts follow the law of Colorado or Texas. Royalty owners will point to Colorado law as stating the proper rule while oil and gas developers will cite Texas law. Another court's willingness to accept either the Colorado or Texas analysis will depend, in many cases, on its willingness to embrace the same motivating philosophies that prompted the Colorado and Texas courts to adopt their respective rules. Regardless of which approach is taken, once the issue is raised it will generally be a winner-take-all proposition because the court is being asked to take, or not to take, production revenue away from one party and give it to another.

II. THE ZERO-SUM GAME OF CONTRACT INTERPRETATION

In most royalty calculation disputes, the basic judicial task is interpretation of a contract—the oil and gas lease.[2] Each party's rights under the contract constitute that party's "property." The contract terms define each party's property rights. When dealing with royalty-calculation issues, the property rights of the lessor and lessee are typically mutually exclusive: to recognize rights in one party means the rights of the other

2. The oil and gas lease is both a contract and a conveyancing document. The conveyance aspect of the document is best illustrated by the way it is executed: Typically, only the lessor (grantor) signs the document. The document becomes binding on the lessee through the process of delivery and acceptance. JOHN S. LOWE ET AL., CASES AND MATERIALS ON OIL AND GAS LAW 307-08 (5th ed. 2008). Similar interpretive issues arise with a royalty that is not associated with the landowner's royalty under an oil and gas lease. In addition to the landowner's royalty, there can be conveyances of a right to receive royalty directly out of the mineral interest (non-participating royalty) and assignments of royalty carved out of the lessee's leasehold or working interest under an oil and gas lease (overriding royalty). David E. Pierce, *Exploring the Origins of Royalty Disputes*, 23 PETROLEUM ACCT. & FIN. MGMT. J. 72, 73-75 (2004). Although the nonparticipating royalty and overriding royalty relationships are fundamentally different from the lessor/lessee relationship, the same sort of calculation issues are encountered. Courts are split on whether the same analysis that is applied to the landowner's royalty under an oil and gas lease should be applied to nonparticipating royalty and overriding royalty. *Compare* XAE Corp. v. SMR Prop. Mgmt. Co., 968 P.2d 1201, 1202 (Okla. 1998) (rejecting application of oil and gas lease implied covenant law to in-kind overriding royalty), *with* Garman v. Conoco, Inc., 886 P.2d 652, 659 n.23 (Colo. 1994) (applying implied covenant law developed under the oil and gas lease to an overriding royalty). Commentators are split on the issue as well. *Compare* Owen L. Anderson, *Royalty Valuation: Should Overriding Royalty Interests and Nonparticipating Royalty Interests, Whether Payable in Value or in Kind, Be Subject to the Same Valuation Standards as Lease Royalty?*, 35 LAND & WATER L. REV. 1, 1 (2000) (applying oil and gas lease law to overriding royalty and nonparticipating royalty interests in an attempt to ensure uniformity of outcome), *with* Pierce, *supra* at 106-07 (rejecting uniformity for the sake of uniformity and instead focusing on applying basic contract interpretation principles in an effort to ascertain the intent of the parties).

party will be correspondingly diminished. Therefore, litigation of royalty-calculation issues is a zero-sum game, and proper interpretation is critical to ensure the mutually exclusive rights are credited to the correct parties. Litigation of royalty-calculation issues is merely a re-slicing of the finite production pie.

Contrast royalty calculation litigation with litigation to compel further development of the leased land. If the lessee is allowed to proceed with development, and is successful, the lessor and lessee each share in a "new pie" that did not exist before the litigation. As noted above, royalty litigation merely re-slices the old pie without bringing anything new to the table. In some instances, the prospective effect of a state's royalty jurisprudence can result in a smaller "old pie" with all parties worse off. This could occur when a lessee, fearful of its ability to deduct or defend downstream costs, elects to enter into an arm's length sale at the wellhead instead of investing additional capital to pursue downstream markets.

In this context, we are not dealing with a "taking" as that term is commonly used. Although a court's re-slicing of the finite production pie will always have the practical effect of taking property from one party and giving it to another, the court will be operating in a "pre-taking" context in which it exercises the omnipotent power of defining what "is" and what "is not" a right.

III. JUDICIAL CREATION OF RIGHTS

Courts wield their greatest power when operating at the rights-recognition stage of judicial inquiry. Whether in the arenas of tort, contract, or property, the court is often in the position of making the critical foundational decision that will determine whether a tort or contract right exists, or the extent of a person's property rights. For example, in *Coastal Oil & Gas Corp. v. Garza Energy Trust*,[3] the court considered whether hydraulic fracturing is a trespass when it creates a fissure in reservoir rock that crosses the property boundary. Justices joining the majority opinion avoided addressing whether the act constitutes a trespass by holding that, in this case, no damages could be shown because any drainage resulting from the alleged trespass was protected by the rule of capture.[4] In his concurrence, Justice Willett concluded that regardless of whether damages exist, the act of hydraulic fracturing under the facts was not a trespass.[5] Justice Willett noted the role of the court

3. 268 S.W.3d 1 (Tex. 2008).

4. *Id.* at 17 ("[W]e hold that damages for drainage by hydraulic fracturing are precluded by the rule of capture.").

5. *Id.* at 29 (Willett, J., concurring) ("Such encroachment isn't just 'no actionable trespass'; it's no trespass at all."). His desire is no doubt motivated in part by the three dissenting justices who also wanted the court to address the trespass issue head-on but suggested that hydraulic fracturing could

in declaring what is, and is not, property and, therefore, what can constitute the tort of trespass to property, stating:

> To many people, a subsurface intrusion of fissures, fluid, and proppant invites a simple application of rudimentary trespass principles. Why not call a tort a tort? Well, *we* affix that common-law label, and not every technical intrusion, no matter how small, warrants damages, no matter how large. Trespass is a court-defined doctrine, and it falls squarely on this Court's shoulders to decide what is actionable.[6]

Recognizing the nexus between the tort of trespass and property, Justice Willet indicated how he would address the property issue by stating: "I would confront Lord Coke's maxim directly and decide whether land ownership indeed 'extends to the sky above and the earth's center below,' or alternatively, whether that ancient doctrine 'has no place in the modern world.'"[7]

In the property arena, the court's role is at its zenith when addressing "new property," such as ownership of "wind rights" or subsurface structures for the sequestration of carbon.[8] The court's powers are also considerable when engaging in the interpretation of conveyancing documents to determine what was, and was not, conveyed.[9] Similar in-

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constitute a trespass. *Id.* at 42 (Johnson, J., dissenting) ("I would not address whether the rule of capture precludes damages when oil and gas is produced through hydraulic fractures that extend across lease lines until it is determined whether hydraulically fracturing across lease lines is a trespass.").

6. *Id.* at 36 (Willett, J., concurring) (emphasis in original).

7. *Id.* at 29 (footnotes omitted).

8. For example, consider the court's analysis of wind as property in *Romero v. Bernell*, 603 F. Supp. 2d 1333 (D.N.M. 2009). Cotenants sought to partition their interests in a section of land. *Id.* at 1334. Another cotenant sought to block partition, arguing that dividing the land would destroy the principal value of the land "for a wind farm development." *Id.* at 1334. The objecting cotenant sought to rely upon cases involving mineral development in which courts had been reluctant to grant partition-in-kind because it might result in an inequitable distribution of the underlying mineral wealth. *Id.* at 1334-35. This invited the comparison of wind to minerals. The court began to define what it viewed as the confines of rights in wind, stating:

> "Strictly speaking, the ownership of wind is a misnomer. Wind, in and of itself, does not appear to be susceptible of any ownership. It is not like oil and gas in place where there is a deposit of hydrocarbons which can be reduced to possession by one or more mineral owners of the tracts under which the hydrocarbon deposit resides. Wind itself is more akin to a wild animal or percolating waters which must first be reduced to possession before they have value. To reduce wind to 'possession' appears to require that it be focused on driving the fins of a windmill which turn a generator and ultimately generates electricity. Then and only then can wind a) be reduced to possession and b) have value."

Id. at 1335 (quoting Terry E. Hogwood, *Against the Wind*, STATE BAR OF TEX.: OIL, GAS AND ENERGY RES. L. SEC. REP., VOL. 26 NO. 6 Dec. 2001). "The right to 'harvest' wind energy is, then, an inchoate interest in the land which does not become 'vested' until reduced to 'possession' by employing it for a useful purpose. Only after it is reduced to actual wind power can wind energy then be severed and/or quantified." *Id.* (citations and footnote omitted). Contemplate for a moment the raw power that resided with the court as it declared what is, and what is not, property.

9. For example, the Kansas Supreme Court, in *Central Natural Resources, Inc. v. Davis Operating Company*, 201 P.3d 680 (Kan. 2009), interpreted a 1924 conveyance of "all coal . . . together with the right to mine and remove the same." *Id.* at 682. The issue was ownership of coalbed methane gas found within the conveyed coal. Rejecting the ownership claims of the coal owner, the court, relying largely upon the fact that coal is a hard black rock and gas is not, concluded that the parties to the 1924 conveyance could not have intended to convey a hazardous gas contained within the coal. *Id.* at 690. This presumed intent was adopted by the court even though it was undisputed that, in 1924, deep mining was the primary means to extract coal in the area; methane gas in the area had killed many miners; the grantee had also lost miners in methane gas accidents; and the statutes and the common law at the time of the conveyance required coal mine operators to destroy methane

terpretive powers are applied to define the existence and scope of contract rights. These are also areas in which a number of readily manipulable rules exist to ensure courts do not have to share their power with others, such as juries.[10] The Parts that follow examine the processes by which courts select interpretive rules to arrive at desired outcomes, recognizing that the selection process is impacted by the ultimate goals the court seeks to achieve.[11] In the process of selecting and applying interpretive rules, courts can order, or re-order, property rights without concern for takings repercussions. Before examining the approaches courts have taken in this area, the basic rights that are the object of royalty jurisprudence must be identified.

IV. THE RIGHTS AT ISSUE

Most royalty disputes focus on the proper calculation of the royalty due. Past disputes can be placed into four general categories: (1) Basic *measure* for the royalty obligation, either based upon what the lessee actually receives for the oil and gas, the "proceeds," or based upon the "market value" of the oil and gas;[12] (2) Proper *location* for determining the royalty "proceeds" or "market value";[13] (3) Revenue received by a lessee that is subject to royalty;[14] and (4) Volume of production.[15] To-

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found in coal mines by ventilation or other management techniques. *Id.* at 685-86. The practical effect of the court's holding and analysis is that for the vast majority of coal conveyances in the state, somebody other than the coal owner will own the methane gas intimately associated with, and residing within, the coal. Note: the author was one of the attorneys representing the coal grantee in this case.

10. Most notable is the ambiguity analysis in which courts have the exclusive authority to determine whether a document is ambiguous and then, if they find it unambiguous, have the exclusive authority to determine what it means. In the *Central Natural Resources* case, the author challenged the Kansas Supreme Court's rigid adherence to the ambiguity analysis. The court commented on the argument as follows:

> Central challenges the efficacy of our long-standing rules of interpretation, declaring that "[t]he most fickle of the analytical tools used to 'interpret' documents is the declaration that a document is either 'ambiguous' or 'unambiguous.'" It argues that extrinsic evidence is always necessary to establish a context for ascribing a meaning to the words the parties employed.

Cent. Natural Res., 201 P.3d at 688. Although the court concluded "[w]e are not prepared to abandon that analytical tool[,]" it nevertheless held that even when the deed is unambiguous, the

> court puts itself as nearly as possible in the situation of the grantors when they made the deed and, from a consideration of that situation and from the language used in each part of the deed, determine as best it can the purpose of the grantors and the intentions they endeavored to convey.

Id. (citations omitted).

11. The seminal work on this judicial practice is Professor Kramer's article examining canons of construction. *See generally* Bruce M. Kramer, *The Sisyphean Task of Interpreting Mineral Deeds and Leases: An Encyclopedia of Canons of Construction*, 24 TEX. TECH L. REV. 1 (1993).

12. Frequently, there are many permutations of these two measures that will be encountered from lease to lease. For example, the lease may speak in terms of "amount realized," "net proceeds," "gross proceeds," "market price," "value," or some other variation.

13. Location language can be defined as "at the well," "at the mouth of the well," "on the lease," at the "plant tailgate," at the "gathering system," at the "transmission pipeline," or some other variation, including no specified location.

14. In most cases, this issue is addressed in the context of items (1) and (2). However, from time-to-time, issues arise that are not directly tied to royalty measure or location, such as whether a

day, the major issues litigated are associated with royalty "measure" and "location"; resolving those issues has prompted courts to pursue varying jurisprudential paths.

A. The Realities of Royalty-Calculation Disputes

The author has previously espoused two basic principles that can be stated as "realities" that underlie oil and gas royalties and royalty disputes. First, is what has been termed the "royalty value theorem," which states: "When compensation under a contract is based upon a set percentage of the value of something, there will be a tendency by each party to either minimize or maximize the value."[16] As noted previously, because the exercise is a zero-sum game, each party will seek to maximize her rights under the relevant contract as the parties compete with one another for their piece of the finite production pie.

The second reality is what the author has termed the "linear enhancement of production value," which describes the basic fact that as oil or gas moves downstream away from the wellhead and toward the point of consumption, it increases in value.[17] The principle is further explained as follows: "This increase in value is comprised of two components: (1) investments made in the production either by the lessee providing a facility or service or purchasing the service from others; and (2) the increased value of the production in a particular form at a particular location."[18]

When the royalty value theorem is considered in conjunction with the linear enhancement of production value, the goals of the parties become well-defined. From the lessor's perspective, she can obtain an increased royalty if she can push the royalty calculation point downstream away from the wellhead. The lessor can obtain an even greater royalty if she can force the lessee to carry all the costs associated with obtaining the downstream price. From the lessee's perspective, royalty should be calculated at the wellhead because that is the point at which the lessor/lessee relationship, as to the extracted production, ends. If, for administrative ease or other reasons, the lessee allows the lessor to share in downstream values, royalty should be calculated after any costs asso-

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lessor is entitled to royalty on "take-or-pay" payments received by their lessee. *See* OWEN L. ANDERSON ET AL., HEMINGWAY OIL AND GAS LAW AND TAXATION 348-52 (4th ed. 2004).

15. An essential element of accurate royalty calculation is accurate measurement of the oil and gas being extracted under the lease to determine the volume on which a royalty is due. *See generally* Michael J. Heydt, *Overview of Natural Gas Measurement Litigation*, 47 ROCKY MTN. MIN. L. INST. 16-1 (2001).

16. David E. Pierce, *The Royalty Value Theorem and the Legal Calculus of Post-Extraction Costs*, 23 ENERGY & MIN. L. INST. 151, 151-52 (2002); *see* 8 PATRICK H. MARTIN & BRUCE M. KRAMER, WILLIAMS & MEYERS OIL AND GAS LAW 930 (2009) (discussing the "Royalty value theorem" proposition as advanced by Professor Pierce).

17. Pierce, *supra* note 2, at 77-78.

18. *Id.* (footnote omitted).

ciated with obtaining the downstream values are subtracted from downstream revenues. The answer to these issues will often turn on the extent to which courts are willing to give effect to express terms, such as "at the well," found in the lease contract.

B. The Underlying Issues

The underlying issues are fairly simple. First, at what location can or must the royalty be calculated? Can it be "at the well" where the gas is first extracted from the ground? Or, must it be at some point downstream from the point of extraction? Second, if the calculation must be made at some point downstream of the point of extraction, where? Third, if the calculation must be made at some point downstream of the point of extraction, can the downstream revenue be adjusted to reflect the costs required to move the gas to the downstream revenue point? The focus of this article is on why some courts will, and others will not, give effect to express language in the oil and gas lease that indicates royalty should be based upon the market value or proceeds "at the well." More precisely, to what extent will "at the well" language be used by courts to define the location at which gas *can be* marketed and at which royalty *should be* calculated? For purposes of comparison in this article, the varying judicial philosophies—the "two states"—are analyzed by evaluating each court's interpretive process and classifying it as either "art" or "science."

V. THE ART AND SCIENCE OF CONTRACT INTERPRETATION

Webster's defines "art" as "the quality, production, expression, or realm, according to aesthetic principles, of what is beautiful, appealing, or of more than ordinary significance."[19] As a jurisprudential principle, "art" can be viewed as a court's use of "aesthetic principles, of what is . . . appealing" to resolve issues, such as what does the contract mean.[20] Defining the "aesthetic principles" becomes all-important to determining the outcome of an interpretive dispute.

"Science" is defined as "a branch of knowledge or study dealing with a body of facts or truths systematically arranged and showing the operation of general laws."[21] Instead of aesthetic principles, science relies upon facts and pre-established rules to determine the "appealing" outcome. The end result in some situations may not be pretty, but it is predictable under the facts or truths in existence at the time the contract was created. Even under the scientific approach to contract interpreta-

19. WEBSTER'S NEW UNIVERSAL UNABRIDGED DICTIONARY 117 (1996).
20. *Id.*
21. *Id.* at 1716.

tion, if the resulting picture is too "unappealing," there are other limiting doctrines that can be applied, in a scientific manner, to police the situation—the main policing doctrine being unconscionability.[22] However, if the policing doctrine does not, when properly applied, permit courts to achieve the outcome they believe is fair—the aesthetically appealing outcome—some courts will resort to the art of contract interpretation to paint the picture they desire.

The differing approaches by the supreme courts of Colorado and Texas vividly demonstrate the contrasting jurisprudence of art and science in defining the royalty obligation under an oil and gas lease. Colorado has pursued an "artful" approach to defining the royalty obligation. As the next section reveals, Texas has pursued "science."

A. Texas: The "Science" of Contract Interpretation

The Texas Supreme Court treats royalty issues as just another exercise in contract interpretation. The Texas approach to lease interpretation is more science than art because the Texas Supreme Court has established a set of rules that will yield the meaning of a disputed lease term. Sometimes the resulting picture may not seem all that pretty,[23] but at least it is pretty predictable.[24] Aesthetic principles do not factor into the equation.

Unless the court deems the language ambiguous, the court will look to the language contained within the oil and gas lease to determine the parties' rights and obligations. On many occasions the court has noted that "the intent of the parties is determined from what they actually expressed in the lease as written, not what they may have intended but failed to express."[25]

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22. *See* David E. Pierce, *Exploring the Jurisprudential Underpinnings of the Implied Covenant to Market*, 48 ROCKY MTN. MIN. L. INST. 10-1, 10-6 to 10-9 (2002) (examining the role of unconscionability in policing the "unfair" oil and gas contract).

23. For example, in *Heritage Resources, Inc. v. Nations Bank*, 939 S.W.2d 118, 129-30 (Tex. 1996), the court held the lessee could deduct from gas sales proceeds costs incurred to move and market the gas downstream of the wellhead, despite the following language: "provided, however, that there shall be no deductions from the value of the Lessor's royalty by reason of any required processing, cost of dehydration, compression, transportation or other matter to market such gas." *Id.* at 120. The court arrived at this result because the preceding language called for a royalty equal to "the market value at the well of 1/5 of the gas so sold or used." *Id.* Because none of the deductions reduced the royalty below the "market value *at the well*," the court held the no-deductions clause did not apply. *Id.* at 123 (emphasis added).

24. Justice Owen, concurring in *Heritage*, commented:

> In construing language commonly used in oil and gas leases, we must keep in mind that there is a need for predictability and uniformity as to what the language used means. Parties entering into agreements expect that the words they have used will be given the meaning generally accorded to them.

Id. at 129-30 (Owen, J., concurring).

25. *Id.* at 130.

1. We Know What "Market Value" Means

The Texas approach is demonstrated by cases in which the court interprets the term "market value." For example, in *Yzaguirre v. KCS Resources, Inc.*,[26] the royalty owners argued the implied covenant to market reasonably required their lessee to pay royalty based upon the higher contract proceeds it received instead of the lower market value of the gas.[27] The willingness of the court to venture beyond the express language and recognize "implied" covenants is limited to situations in which it is shown to be a "necessary" implication required by, and defined by, the available express contract terms.[28] Rejecting the royalty owners' implied covenant theory, the court held "there is no implied covenant when the oil and gas lease expressly covers the subject matter of an implied covenant."[29] In this case, the lease required a royalty based upon "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."[30] The lessee, in 1979, had entered into a twenty-year gas purchase agreement that specified a point of sale at the tailgate of a processing plant several miles away from the leased land.[31] Because the gas was not "sold at the wells," the "amount realized" portion of the royalty clause did not apply. Instead, the court held that royalty on the gas must be based upon its "market value at the well."[32]

In *Yzaguirre*, the lessee was able to keep the much higher gas sales proceeds and tender to the lessor the lower amount reflecting the current market value of the gas.[33] This result was based upon the court's

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26. 53 S.W.3d 368 (Tex. 2001).

27. *Id.* at 370.

28. The court in *Danciger Oil & Refining Co. v. Powell*, 154 S.W.2d 632 (Tex. 1941) lays the groundwork for Texas implied covenant law, stating:

> An implied covenant must rest entirely on the presumed intention of the parties as gathered from the terms as actually expressed in the written instrument itself, and it must appear that it was so clearly within the contemplation of the parties that they deemed it unnecessary to express it, and therefore omitted to do so, or it must appear that it is necessary to infer such a covenant in order to effectuate the full purpose of the contract as a whole as gathered from the written instrument. It is not enough to say that an implied covenant is necessary in order to make the contract fair, or that without such a covenant it would be improvident or unwise, or that the contract would operate unjustly. It must arise from the presumed intention of the parties as gathered from the instrument as a whole.

Id. at 635. The Texas Supreme Court has reaffirmed the *Danciger* implied covenant principles on numerous occasions. *E.g.*, *Yzaguirre*, 53 S.W.3d at 374 (rejecting the argument that "the entire body of implied covenant law has been aimed at . . . making sure the royalty owner gets the best deal"); HECI Exploration Co. v. Neel, 982 S.W.2d 881, 888-89 (Tex. 1988) ("A court cannot imply a covenant to achieve what it believes to be a fair contract or to remedy an unwise or improvident contract . . . .").

29. *Yzaguirre*, 53 S.W.3d at 373.

30. *Id.* at 372.

31. *Id.* at 370.

32. *Id.* at 372. "[T]he plain language of this lease requires the lessee to pay royalties based on fair market value, not on the price the lessee actually receives for selling the gas." *Id.* at 370.

33. The amount in excess of the current market value represents the current value of the lessee's independent rights and obligations under the gas purchase agreement. This value is not associ-

interpretation of the term "market value" and its rejection of any sort of implied covenant that would give the royalty owners the benefit of the lessee's long-term gas sales agreement. The royalty owners argued that the implied covenant to market imposed upon the lessee the obligation to share the contract proceeds derived from gas sold from the leased land.[34] This would result in an obligation to pay royalty based upon either market value or contract proceeds, whichever netted the lessor the greatest royalty.[35]

When faced with the royalty owners' implied covenant theory, a theory designed to take the edge off the express lease terms, the court responded, stating:

> In this case, the parties entered into a lease requiring a market-value royalty. Because the lease provides an objective basis for calculating royalties that is independent of the price the lessee actually obtains, the lessor does not need the protection of an implied covenant. Depending on future market behavior, this may be financially beneficial to the lessor . . . or it may be less advantageous, as here. In either event, the parties have received the benefit of their bargain.[36]

Just because the lessee is subsequently able to sell the gas at more than its current market value, the court will not intervene to modify the lease to give the royalty owners "the benefit of a bargain they never made."[37] The Texas Supreme Court has taken a similar approach to the "at the well" language found in lease royalty clauses.

2. We Know What "At The Well" Means

In *Judice v. Mewborne Oil Co.*,[38] the court interpreted a royalty clause requiring payment measured by "the market value at the well of all gas produced, and saved from said leased premises."[39] The trial court and court of appeals both held the language was ambiguous and allowed the jury to determine whether compression costs could be deducted to

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ated with the gas so much as it is associated with the lessee's long-term obligations to deliver gas under the terms of the gas purchase agreement. As the court noted, had the contract price fallen below the current market value of gas produced from the lessor's land, the lessee would be obligated to pay royalty based upon the higher current market value even though it exceeds what the lessee is able to sell the gas for under its gas purchase agreement. *Id.* at 369. This was the situation that gave rise to the Texas definition of "market value" in *Texas Oil & Gas Corp. v. Vela*, 429 S.W.2d 866, 871 (Tex. 1968) and *Exxon Corp. v. Middleton*, 613 S.W.2d 240, 245 (Tex. 1981).

34. *Yzaguirre*, 53 S.W.3d at 374.

35. The court described the royalty owners' argument as follows:

> Essentially, the Royalty Owners wish to use an implied marketing covenant to negate the express royalty provisions in the leases and transform the "market value" royalty into a "higher of market value or proceeds" royalty. The Royalty Owners conceded as much at oral argument, stating that "the entire body of implied covenant law has been aimed at . . . making sure the royalty owner gets the best deal."

Id. at 374.

36. *Id.*

37. *Id.*

38. 939 S.W.2d 133 (Tex. 1996).

39. *Id.* at 135.

determine the royalty due.[40] The supreme court reversed, stating: "We hold that the provision is unambiguous and the jury's finding regarding the parties' intent should be disregarded."[41] The court explained that:

> The royalty is to be determined based on "market value at the well." This phrase means value at the well, net of any value added by compressing the gas after it leaves the wellhead. . . . Mewbourne [lessee] is entitled to allocate to the Judices [lessors] their proportionate share of the reasonable cost of post-production compression under these leases.[42]

The court refused to find the language "at the well" ambiguous and instead interpreted it literally to mean value "at the well" as opposed to a location downstream of the well after the gas had been compressed.

The court took a similar approach in *Heritage Resources, Inc. v. NationsBank*,[43] in which the court gave literal effect to the "at the well" language in the face of an express "no deductions" clause.[44] Because the deductions that were taken related to costs incurred to move the gas *beyond the wellhead*, as opposed to costs associated with bringing the gas *to the wellhead*, the court held the lessee complied with its obligation to pay royalty based upon "market value at the well."[45] Justice Owen, in her concurring opinion, explained the interpretive process applied by the court:

> The starting point in construing the leases is the language chosen by the parties. We first must ascertain the meaning of "market value at the well," which the agreements set out as the initial benchmark for valuing the royalty. "Market value at the well" tells us how and where the value of the royalty is measured, subject to any other provisions that bear on valuation.[46]

With regard to the implied covenant to market, Justice Owen noted:

> While Texas recognizes that the lessee has an implied duty to market gas . . . we have never determined who bears the cost of marketing gas beyond the wellhead in the absence of an express agreement. There is an express agreement in this case as to how and where royalty will be determined. The implied duty to market gas cannot override that agreement. The words "at the well" should be given their straightforward meaning. Market value "at the well" means the value of gas at the well, before it is transported, treated, compressed or otherwise prepared for market.[47]

Therefore, the Texas Supreme Court held that "at the well" is unambiguous contract language that addresses the location where royalty will be calculated. Because the royalty measure is fully described in the language "market value at the well," there is no need to resort to an im-

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40. *Id.*
41. *Id.*
42. *Id.* (citations omitted).
43. 939 S.W.2d 118 (Tex. 1996).
44. *Id.* at 121.
45. *Id.* ("The critical clause in all three leases is the requirement that Heritage pay the royalty interest owners their fractional interest of 'the market value at the well' of the gas produced.").
46. *Id.* at 124-25 (Owen, J., concurring).
47. *Id.* at 129.

plied covenant. Contrast this approach with that taken by the Colorado Supreme Court.

B. Colorado: The "Art" of Contract Interpretation

The Colorado Supreme Court's landmark decision in *Rogers v. Westerman Farm Co.*[48] is the essence of "art" in the art/science dichotomy described in this article. Lessors under several oil and gas leases, all with some form of "at the well" language, sought a court ruling that the gas at issue was not in a marketable condition until it was made available for sale at an interstate pipeline.[49] Some lessees elected to sell their gas to third parties at the wellhead. Their lessors challenged these arms-length wellhead sales, asserting that the lessees were obligated to take the gas downstream to obtain higher prices available at an interstate pipeline.[50] Some lessees elected to move their gas downstream and sell it at interstate pipelines.[51] These lessees paid royalty using a work-back formula by taking the downstream price and then subtracting expenses associated with moving the gas from the wellhead to the interstate pipeline.[52] Their lessors challenged any sort of work-back formula, contending that because the lessee had the obligation to market at the interstate pipeline, the lessee also had the duty to put the gas in a marketable condition so it was available for delivery to the interstate pipeline.[53]

Therefore, this case presents the classic royalty value theorem situation in which the lessor is seeking to capitalize on the linear enhancement of production values as gas moves away from the wellhead towards the point of consumption. When this issue was addressed by the Texas Supreme Court, the "at the well" language in the lease played the major role in fixing the precise location where production would be valued and the royalty calculation made.[54] The Colorado Supreme Court choose a different path but still had to deal with the "at the well" language.

1. We Do Not Know What Anything Means

For judicial art to flourish, the artist (the court) must not be con-

48. 29 P.3d 887 (Colo. 2001).

49. *Id.* at 894 ("The lessors suggest that these costs are required in order to place the gas in a marketable condition, and therefore, these costs should be borne solely by the lessees.").

50. *Id.* at 893 ("[T]he lessors contend that the royalty payments were improper because the gas was not marketable at the well, and therefore, should not have been sold at the well.").

51. *Id.*

52. *Id.* at 893-94.

53. *Id.* at 894 ("The lessors argue that these deductions were improper and that their royalties should have been paid based on one-eighth (1/8th) of the proceeds received from the sale of the gas, with no deductions for gathering, compression, and dehydration.").

54. *See supra* text accompanying notes 38-47.

strained by existing structure. Therefore, when faced with whether "at the well" language in an oil and gas lease provided guidance regarding the location for calculating royalty, the court in *Rogers* held that this language was "silent."[55] This cleared the canvas for the court to paint its own picture regarding the issues that would otherwise be controlled by "at the well" language in states like Texas. The court first selected from its palette the implied covenant to market, which will allow the court to paint a more aesthetically pleasing picture.[56]

Although the court concluded the "at the well" language was silent regarding the "allocation of costs," that conclusion did not explain why it ultimately gave no effect to the "at the well" language. To explain the nullification of the express "at the well" language, the court turned to the implied covenant to market, which it held "controls the lessee's duty to make the gas marketable."[57] The final step in this rather disjointed metamorphosis was to create the content of the implied covenant that will supplant the "at the well" language.

The foundation for defining the content of the implied covenant to market was established in the court's opinion in *Garman v. Conoco, Inc.*,[58] in which the court held that a lessee[59] has an implied obligation to "transform raw gas . . . into a marketable product" and also pay, solely from its share of production, even "post-production" costs necessary to create a marketable product.[60] However, the court in *Garman* did not have to address the effect of "at the well" language, nor did it attempt to define precisely what would constitute a "marketable product." This is

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55. *Rogers*, 29 P.3d at 897. The court was careful to never use the term "ambiguous" throughout the opinion. Instead, it characterized the critical language as being "silent." *Id.* ("[W]e conclude that all of the leases are, in fact, silent with respect to the allocation of costs.").

56. *Id.* at 896. The court's analysis is reflected by the following sequence of conclusions:

> We review the language of each of the four lease types and conclude that the "at the well" language is silent with respect to allocation of costs. . . . [I]n order to determine allocation of costs where the lease language is silent, we must look to the implied covenant to market, and thus, whether the gas is marketable.

Id.

57. *Id.* at 901. The court examined the "at the well" interpretation applied by Texas and other courts, which use the term to establish the location at which royalty will be calculated. Responding to this rule the court stated:

> We disagree, however, with these jurisdictions because they fail to recognize that the implied covenant to market controls the lessee's duty to make the gas marketable. Instead, these jurisdictions have adopted the rule that the lessee's duty has ended once gas is severed from the wellhead, and thus, any costs incurred subsequent to that physical removal are to be shared by the parties.

Id.

58. 886 P.2d 652 (Colo. 1994).

59. In *Garman*, the court was concerned with the deduction of costs to calculate an overriding royalty. *Id.* at 653 (focusing the certified question on "when the assignment creating the overriding royalty interest is silent as to how post-production costs are to be borne[]"). The court in *Garman*, and again in *Rogers*, made it clear that the same analysis would be applied to a royalty owner under an oil and gas lease. *Rogers*, 29 P.3d at 902 n.16; *Garman*, 886 P.2d at 656-57.

60. *Garman*, 886 P.2d at 661 ("[A]bsent an assignment provision to the contrary, overriding royalty interest owners are not obligated to bear any share of post-production expenses, such as compressing, transporting and processing, undertaken to transform raw gas produced at the surface into a marketable product.").

where *Rogers* continued where *Garman* left off, by first concluding, as noted above, that the "at the well" language had no effect.[61] Second, the court defined what is required to have a "marketable product" and, in the process, further negated any influence associated with the "at the well" language.

The court in *Rogers* explained its new, refined definition of "marketable product," stating:

> [W]e . . . adopt a definition of marketability to include both a physical condition such that the gas would be acceptable for sale in a commercial market, and a location-based assessment, such that it would be saleable in a commercial marketplace. The determination as to when gas is marketable is a question of fact. Once a determination is made that gas is marketable, costs can be allocated accordingly. Costs incurred to make the gas marketable are to be borne solely by the lessees. Alternatively, costs incurred subsequent to the gas being marketable are to be shared proportionately between the lessee and the lessors.[62]

The most notable aspect of this definition is the "location-based assessment." Although it might seem like the express terms of the royalty clause, specifying an "at the well" location, might play a role, instead the court looks for a new location—the location where the gas is "saleable in a commercial marketplace."[63] What this new term means is left for a jury to determine.

2. A Jury Will Tell You What It Means—After We Change the Terms

Perhaps searching for some middle ground in the process of negating "at the well" language,[64] the court in *Rogers* held that whether gas is a "marketable product" is a question of fact for the jury.[65] To ensure the jury is not confused by focusing on contract language, such as "at the well," jurors will not be allowed to hear any testimony regarding the contract terms—although they will apparently be allowed to see the contract.[66] This is probably why the court was careful to avoid declaring

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61. *See supra* text accompanying note 57.

62. *Rogers*, 29 P.3d at 912-13.

63. *Id.* at 912. The court attempted to draw a distinction between "marketing" and "selling" a product. *Id.* at 910-11. The court stated: "For marketing, there must be a market, which has been defined as 'an established demand for an identified product.'" *Id.* at 911. "Thus, the gas must be more than merely sold in order for the lessee to meet the duty to market the gas." *Id.* It would appear, however, that an arms-length transaction by a lessee seeking to maximize its revenue for extracted gas, at any point including the wellhead or any downstream location, would be evidence of a market. Similarly, a sale to an affiliate that is also entering into similar transactions with unrelated sellers in the area would be evidence of a market.

64. When the court of appeals reasoned it must give "some meaning" to the "at the well" provisions in the leases, the supreme court indicated the court of appeals was in error. *Id.* at 895 ("[T]he court of appeals first determined that some meaning must be given to those provisions in the leases containing the 'at the well' or 'at the mouth of the well' language.").

65. *Id.* at 910-11.

66. It is revealing that jurors, at least in form, are being asked to determine whether the lease contract has been breached but apparently must do so without any guidance regarding what the parties, operating within the four corners of the written document, contend the contract means. The supreme court observed: "In light of the leases' silence, the court of appeals concluded that the trial

the language ambiguous. Instead, by default, the court concluded the contract was unambiguous and, therefore, subject to interpretation only by the court. During the interpretation process, the court declared the contract "silent" on the royalty calculation issue, enlisted the assistance of an implied covenant—the contents of which the court carefully defined as a matter of law—and then relied on a jury to determine the meaning of the new, redefined contract term "marketable product." The court's analysis consisted of replacing the term "at the well" with the term "marketable product," so that regardless of what the express terms of the contract state, the jury will be instructed to determine merely the precise point in the production and marketing process where a "marketable product" first became available. This jury-determined marketable product location will then become the point at which royalty will be calculated. The point of the silence/implied covenant analysis is to ensure the jury addresses only the marketable-product issue in an environment unconstrained by any express-location language or any other language found in the lease.

3. What Motivates the Court to Negate "At the Well" Language?

The court could have easily concluded in *Rogers* that although the lessee has a *Garman*-implied duty to create a marketable product, this implied duty is changed when there is express language in the lease requiring that the royalty be calculated "at the well."[67] Recall that the factual situation in *Garman*, both the certified question[68] and the underlying assignment,[69] did not address the presence of express "at the well"

court had not committed error in prohibiting reference to the leases at trial." *Id.* at 895. The trial court "determined that the leases were silent regarding allocation of costs, and therefore, no testimony or evidence should be presented to the jury regarding the lease language." *Id.* at 894 (footnote omitted). The supreme court noted: "Although no testimony or evidence was allowed at trial regarding the lease language, the actual leases were available to the jury during deliberations." *Id.* at 894 n.6.

67. Such an analysis probably best explains the approach the Kansas Supreme Court took in *Sternberger v. Marathon Oil Co.*, 894 P.2d 788 (Kan. 1995). *See* David E. Pierce, *The Renaissance of Law in The Law of Oil and Gas: The Contract Dimension*, 42 WASHBURN L. J. 909, 928-30 (2003) (discussing the "two" opinions in *Sternberger*: the substantive "at the well" opinion and the procedural "marketable product" class action opinion).

68. The certified question stated: "'Under Colorado law, is the owner of an overriding royalty interest in gas production required to bear a proportionate share of post-production costs, such as processing, transportation, and compression, when the assignment creating the overriding royalty interest is silent as to how post-production costs are to be borne?'" *Garman*, 886 P.2d at 653.

69. The court concluded: "We believe we can respond appropriately to the district court on the law in Colorado without considering the specific assignment terms." *Id.* at 654. The concurring justice quoted the assignment, which provided for:

> [F]our (4) per cent of the market value . . . of all oil, gas, and casinghead gas produced, saved and marketed from any of the above described lands by Assignee under said above described lease.
>
> . . . .
>
> Said overriding royalty shall be computed and paid on the basis of the market price for oil, gas and casinghead gas *prevailing in the field where produced* for oil, gas and casinghead

language. Nor did it address the meaning of terms such as "market value" at the well. The court was faced with both of these issues in *Rogers*.[70] Instead of making any real effort to give meaning to "market value," "at the well," and similar terms, the court engaged in an unconvincing act of non-interpretation to conclude the situation is hopelessly "silent" but not ambiguous so it could rewrite each lease, as a matter of law, by injecting its latest marketable product analysis. The end result is to release lessors throughout Colorado from the express terms of their leases regarding royalty calculation and to turn the exercise into a jury question as to the point at which the gas has arrived at the required "commercial marketplace."

Why does the court find it necessary to negate the "at the well," "market value," and similar royalty-valuation language to make it possible for lessors to share in downstream revenues on a cost-free basis? Something must have triggered the court's desire to fashion a more advantageous deal for Colorado lessors. The court's opinion provides hints of what may have motivated a unanimous court to exercise its collective lawyering skills to try to rewrite artfully every oil and gas lease contract in the state.

The first indication in the court's opinion that something was amiss with the "at the well" language came when it stated: "Notwithstanding an initial *misleading* appearance that the lease language provides for allocation of costs, it is apparent that when scrutinized in depth, each lease clause provision inadequately addresses allocation of costs."[71] How does the court select the term "misleading" to describe this situation? It appears this term may have been chosen as a result of a statement made by Professor Anderson in an article that attributes a somewhat sinister connotation to the term "at the well." As the court observed: "Anderson has suggested that lessees, in order to avoid alerting lessors of their motives, have intentionally used 'at the well' lan-

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gas of like quality.

Id. at 664 (Erickson, J., concurring) (emphasis added). Although there is location language, "the field where produced," the court did not address this language, nor did it address the absence of "at the well" language. *Id.*

70. In the process of considering the "at the well" issue, the court also addressed the term "market value," stating:

> [T]he second clause further confuses the meaning of the lease language as a whole. This clause provides that, for sales not occurring at the well, the royalties are to be paid based on the market value at the well, but in no event shall those royalties total more than 1/8th of the amount actually received for a sale. While this portion of the lease suggests that the royalties be paid based on the market value, there is no indication as to how such value is to be determined. Furthermore, this language does not indicate whether the calculation of market value at the well includes or excludes costs, and does not describe how those costs should be allocated, if at all, between the parties. Thus, because the lease language fails to even describe either the costs or the allowable deductions, it is silent with respect to all deductions.

Rogers, 29 P.3d at 897.

71. *Id.* (emphasis added).

guage to avoid directly stating their objectives in sharing costs."[72] Surely, oil company lawyers in the 1920s could have come up with something better than "at the well" to dupe unsuspecting lessors. It is much more reasonable to conclude that the "at the well" language was used to define the point at which "market value," "proceeds," or any other royalty measure is determined because the parties have no idea what sort of production situation they may ultimately encounter.[73]

The second indication that the court thinks lessors are in need of some judicial art came when it evaluated, in a factual vacuum, the relative bargaining positions of the parties at the time the oil and gas leases were entered. The court observed that "lessors are not usually familiar with the law related to oil and gas leases, while lessees, through experience drafting and litigating leases, generally are."[74] This presumed lack of lessor sophistication is used as the predicate for unsheathing contract law's bluntest of interpretive instruments—the *contra proferentem* rule of construction.[75] The court addressed this issue, stating:

> Finally, in interpreting leases like those in this case, we are mindful of the generally accepted rule that oil and gas leases are strictly construed against the lessee in favor of the lessor. . . . This rule is generally based on the recognition *that the bargaining power between a lessor and lessee is similar to that historically found between an insurance company and its customers*. . . . Thus, the parties are in similar unequal positions.[76]

Although the court cited the interpret-against-the-lessee rule, it did not explicitly apply it as the justification for negating the "at the well" language. Instead, it turned to the implied covenant approach which gives it more flexibility in redefining the parties' rights and obligations.

The court's approach is similar to that taken by the architect of implied-covenant law, Professor Maurice Merrill. Professor Merrill set out in his treatise to build a theory that would enable courts to get away from the express terms of the oil and gas lease.[77] His basic concern was

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72. *Id.* at 899.

73. Arguably, they were simply trying to state that whatever the nature of the production, royalty will be calculated "at the well," and if the lessor is permitted to share in downstream revenues, they will be adjusted to reflect the costs required to obtain the downstream revenues—revenues that reflect royalty values at points beyond the wellhead.

74. *Id.* at 902.

75. Professor Farnsworth has characterized this as a rule of construction that is not designed to ascertain the intent of the parties, and, in any event, "[i]t is not applicable if the language is unambiguous and [even then] it is often denigrated as a rule of 'last resort.'" E. ALLEN FARNSWORTH, CONTRACTS 460 (4th ed. 2004) (footnotes omitted).

76. *Rogers*, 29 P.3d at 901-02 (citations omitted) (emphasis added). The situation of the parties to an oil and gas lease is fundamentally different from that of an insured under an insurance policy. In an oil and gas lease, only one party controls whether her property will be leased, and on what terms: the lessor. Once a lessor is aware she does not have to lease her property to anyone, she has the power to hold out for the best deal she can negotiate under the circumstances—or elect not to lease. The oil and gas lease is not an adhesion contract. Although landowners may be presented with a developer's printed form, in most cases the resulting lease will be the product of negotiation between the parties. *See* Pierce, *supra* note 67, at 916-17.

77. MAURICE H. MERRILL, THE LAW RELATING TO COVENANTS IMPLIED IN OIL AND GAS LEASES 466-68 (2d ed. 1940).

that because lease terms, more often than not, were selected by the lessee, enforcement of the lease as written generally will not improve the lessor's position under the lease. Professor Merrill called for "radical departures" from traditional contract interpretation rules to refashion the oil and gas lease bargain using implied covenants.[78] A modern Merrill disciple attempted to elevate Merrill's thesis into "rule" status, stating: "One of the best-settled rules in oil and gas law is that courts give royalty owners extra contract protection in order to equalize the balance of power between the royalty owner and the lessee, which usually is an operating oil and gas company."[79] However, Professor Merrill's implied-in-law approach to altering the express terms of oil and gas leases has generally been rejected by the courts[80]—until the Colorado Supreme Court's decision in *Rogers*.

The Colorado Supreme Court chose to negate the "at the well" language in all oil and gas leases in Colorado because it must have concluded the lessors deserved a better deal. Normally, courts lack the power to give one party to a contract a better deal. However, counsel for the plaintiffs, and Professor Merrill, provided the court with the jurisprudential tools it could use to change the result and pursue the more aesthetically pleasing outcome they sought for Colorado royalty owners. At this juncture, it is worth noting a statement the court made in *Davis v. Cramer*,[81] another implied covenant case: "We have previously noted that the law of oil and gas is unlike any other area."[82]

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78. *Id.* at 465.

79. John Burritt McArthur, *The Mutual Benefit Implied Covenant for Oil and Gas Royalty Owners*, 41 NAT. RESOURCES J. 795, 797 (2001) (footnote omitted). Contrast the views of a nonbeliever of Merrill: Pierce, *supra* note 67, at 909; Pierce, *supra* note 22, at 10-6 (Other than the obligation to perform and enforce contracts in good faith, the only time a court should provide extra contract protection to a party is when the agreement is held to be unconscionable, applying standard unconscionability analysis.).

80. *E.g.*, Smith v. Amoco Prod. Co., 31 P.3d 255, 268 (Kan. 2001) (noting that no court had adopted Professor Merrill's implied-in-law doctrine and that the Kansas Supreme Court was rejecting it as well).

81. 808 P.2d 358 (Colo. 1991).

82. *Id.* at 359. This sort of observation was the basis for an article noting that "oil and gas law" is often used as an excuse for ignoring, or misapplying, basic contract and property law. Pierce, *supra* note 67, at 909. The article begins with the following observations:

> After twenty years of scholarly inquiry into the discipline we call "oil and gas" law, it appears many of the flaws associated with this "specialized" body of law relate to its "special" status. Jurisprudential flaws have developed as courts depart from basic contract, property, or tort law in pursuit of "oil and gas law" concepts.

Id. A Kansas jurist follows an approach opposite that of the Colorado courts noting:

> At the outset of our analysis, it is critical to recognize that oil and gas law is not so much a unique body of law as it is a specialized application of contract law. The rights and obligations of those operating in the Kansas oil patch are governed by the terms and conditions of specialized contracts, and each dispute arising in this context can and should usually be resolved by the construction and application of such contracts. Although parties to such disputes often seek to rely on and argue the application of case law, we must decline to blindly apply what may appear to be legal principles within such precedent without a preliminary determination whether the contract provisions at issue in the cited authority are identical to those before us.

Welsch v. Trivestco Energy Co., No. 101,566, 2009 WL 4877715, at *5 (Kan. Ct. App. Dec. 18, 2009)

VI. APPLICATION OF "ART" AND "SCIENCE" IN OTHER STATES

A. The West Virginia "Artist"

To appreciate fully the picture painted by the court in *Tawney v. Columbia Natural Resources, L.L.C.*,[83] the picture presented by the facts in *Wellman v. Energy Resources, Inc.*[84] must be viewed first. In *Wellman*, the lessee received $2.22 per thousand cubic feet (Mcf) for gas produced from the leased land but used $0.87/Mcf as the figure on which it calculated royalty.[85] Although the royalty clause required a royalty of "1/8th of the proceeds from the sale of gas as such at the mouth of the well,"[86] it was unclear where the gas was sold. Because the lessee offered no evidence regarding its marketing activities,[87] the court relied upon the following testimony of the gas purchaser: "[A] bookkeeper for Mountaineer Gas Company, the purchaser who bought the gas produced by Energy Resources, Inc., stated that Mountaineer Gas Company had paid Energy Resources, Inc., $2.22 per thousand cubic feet of gas sold by Energy Resources, Inc., from the Wellman['s] well."[88] Although Energy Resources did not dispute that it received $2.22/Mcf and paid royalties on $0.87/Mcf, it did not care to share with the court why it deducted $1.35/Mcf to calculate the Wellman's royalty.[89] This state of affairs suggested that Mountaineer Gas Company may have been purchasing the gas at the wellhead for $2.22/Mcf, which it paid the lessee, but the lessee was deducting $1.35/Mcf before it calculated the Wellman's royalty. If this was in fact the case, it is difficult to conceive of any legitimate reason for the $1.35/Mcf reduction of the purchase price to calculate the royalty on a wellhead sale. The court was equally wary of the situation, noting the trial court had concluded that Energy Resources, Inc. "in effect, short-changed the Wellmans by improperly charging them with the expenses."[90] The facts as reported in the court's opinion suggest there may not have been any expenses.

(opinion by Judge Richard Greene).

83. 633 S.E.2d 22 (W. Va. 2006).

84. 557 S.E.2d 254 (W. Va. 2001).

85. *Id.* at 258. The *Wellman* court stated:

> For the gas taken from this well, Energy Resources, Inc., paid the Wellmans one-eighth of $.87 for each thousand cubic feet of gas which it had sold. In arriving at the $.87 per thousand cubic feet base figure, it took the position that it had deducted certain expenses which it had paid from the $2.22 per thousand cubic feet of gas which it had actually received.

Id.

86. *Id.* at 263.

87. *Id.* at 265 ("Energy Resources, Inc., introduced no evidence whatsoever to show that the costs were actually incurred or that they were reasonable.").

88. *Id.* at 263.

89. *Id.* ("Energy Resources, Inc., does not dispute that it paid royalties on the basis of $0.87 rather than $2.22, but it contends that it was entitled to deduct certain expenses from the amounts received from Mountaineer Gas Company before calculating the Wellman['s] royalty.").

90. *Id.* at 258.

This probably prompted the court to make the following statement, casting the work-back issue[91] in a most pejorative light:

> [T]here has been an attempt on the part of oil and gas producers in recent years[92] to charge the landowner with a *pro rata* share of various expenses connected with the operation of an oil and gas lease such as the expense of transporting oil and gas to a point of sale, and the expense of treating or altering the oil and gas so as to put it in a marketable condition. *To escape the rule that the lessee must pay the costs of discovery and production*, these expenses have been referred to as "post-production expenses."[93]

Therefore, the court's first opportunity to evaluate royalty calculation is in the context of what appeared to be a totally unsupportable "short-changing" of the royalty owner. As the court's subsequent opinion in *Tawney* reveals, bad facts not only make bad law, but also interesting "art."

In *Tawney*, the producer was moving gas downstream away from the wellhead to a delivery point on an interstate pipeline operated by Columbia Gas Transmission.[94] The producer was selling the gas for a downstream price and then deducting the costs of moving the gas from the wellhead to the point of sale. The resulting net number was used to calculate royalty.[95] After a class action consisting of 8,000 plaintiffs "with 2,258 leases of varying forms and types" was certified, the producer sought summary judgment on the 1,382 leases that had language providing for calculation of royalty "'at the well,' 'at the wellhead,' 'net all costs beyond the wellhead,' or 'less all taxes, assessments, and adjustments.'"[96] The court was asked to address two certified questions, which the court reformulated into the following single certified question:

> In light of the fact that West Virginia recognizes that a lessee to an oil and gas lease must bear all costs incurred in marketing and transporting the product to the point of sale unless the oil and gas lease provides otherwise, is lease language that provides that the lessor's 1/8 royalty is to be calculated "at the well," "at the wellhead" or similar language, or that the royalty is "an amount equal to 1/8 of the price, net of all costs beyond the wellhead," or "less all taxes, assessments, and adjustments" sufficient to indicate that the lessee may deduct post-production expenses from the lessor's 1/8 royalty, presuming that such expenses are reasonable and ac-

91. Although the issue is commonly referred to as a "deduction of costs" issue, it is more accurately a "work-back" issue to adjust a downstream price to reflect an upstream value by subtracting (deducting) from the downstream price what it cost to put the wellhead gas in the position to fetch the downstream price.

92. As noted in *Tawney*, "recent years" probably refers to the period of time since the Federal Energy Regulatory Commission changed the function of the interstate pipeline in marketing gas from merchant to common carrier. *See* Tawney v. Columbia Nat. Res., Inc., 633 S.E.2d 22, 27 (W. Va. 2006); *see also infra* text accompanying notes 108-110.

93. *Wellman*, 557 S.E.2d at 264 (emphasis added) (internal footnote added).

94. *Tawney*, 633 S.E.2d at 25.

95. *Id.*

96. *Id.*

tually incurred.[97]

The first sentence bears the mark of *Wellman*: "[A] lessee to an oil and gas lease must bear all costs incurred in *marketing and transporting* the product to the point of sale."[98] This sets the hurdle which the lessee must overcome by proving the lease "provides otherwise."[99]

The lessee argued that language such as "at the well" and "an amount equal to 1/8 of the price, net of all costs beyond the wellhead" clearly indicated the parties chose to "provide otherwise."[100] Therefore, the lessor's royalty, when calculated using downstream prices, reflects reasonable marketing and transporting costs incurred downstream of the wellhead to secure the enhanced downstream price.[101]

The apparent legal hurdle the court faced is the rule that "[a] valid written instrument which expresses the intent of the parties in plain and unambiguous language *is not subject to judicial construction or interpretation* but will be applied and enforced according to such intent."[102] This was only a momentary hindrance because the court observed: "However, when a contract is ambiguous, it is subject to construction."[103] The court then noted that whether a contract is ambiguous is a question of law for the court.[104] The court then proceeded to conclude that all of the "at the well"-type language is ambiguous and fails to convey any definitive guidance regarding costs associated with obtaining the enhanced downstream royalty revenues.[105]

In an effort to resolve the ambiguity, the court considered the parties' course of performance. The court began its analysis by stating: "traditionally in this State the landowner has received a royalty based

97. *Id.* at 24-25 (footnote omitted).

98. *Id.* at 24 (emphasis added). *Wellman* states: "[I]f an oil and gas lease provides for a royalty based on proceeds received by the lessee, unless the lease provides otherwise, the lessee must bear all costs incurred in exploring for, producing, *marketing, and transporting* the product to the point of sale." 557 S.E.2d at 265 (emphasis added). This statement was supposedly supported by the court's citation of *Davis v. Hardman*, 133 S.E.2d 77, 81 (W. Va. 1963), which is cited for the proposition that "[t]he distinguishing characteristics of a non-participating royalty interest are . . . that [it is] not chargeable with any of the costs of *discovery and production*." (emphasis added). The statement in *Davis* is universally accepted, but the expansion of the statement to include "marketing and transporting" costs is not even the approach taken by the Colorado Supreme Court when the gas is found to be a marketable product at the well. *Wellman*, 577 S.E.2d at 265. This expansion of *Davis* by the court in *Wellman* is quoted as one of the foundations for the court's analysis in *Tawney*. 633 S.W.2d at 28.

99. *Tawney*, 633 S.W.2d at 28.

100. *Id.* at 28, 30.

101. The court stated the issue as follows: "Accordingly, the present dispute boils down to whether the 'at the well'-type language at issue is sufficient to alter our generally recognized rule that the lessee must bear all costs of marketing and transporting the product to the point of sale. We conclude that it is not." *Id.* at 28.

102. *Id.* (citation omitted) (emphasis added).

103. *Id.* This is the critical point at which one must ask: What makes the court *want* to engage in construction as opposed to giving effect to the terms of the agreement? Is that language really ambiguous? Another way of posing the question is: What makes the Texas Supreme Court *not* want to engage in construction of the same language?

104. *Id.*

105. *Id.*

on the sale price of the gas received by the lessee."[106] To support this proposition, the court cited a 1951 treatise.[107] From 1938 through 1993, the operation of the Natural Gas Act of 1938 ensured that most gas sales would be wellhead sales with the federally-regulated interstate pipeline often providing transmission services from the point of production to the point of consumption.[108] Therefore, by necessity, most sales would have been wellhead sales. However, by 1993, the major regulatory changes implemented by the Federal Energy Regulatory Commission had been completed, and the interstate pipeline ceased being a purchaser of gas and would thereafter only provide transportation services to buyers and sellers of gas. This means that producers would often choose to, or have to, look beyond the wellhead to market their gas. It is most revealing that the court sought to use the pre-1993 regulated wellhead sales as a course of performance to interpret the "ambiguous" oil and gas leases against the lessee. The court stated: "Also of significance is the fact that although some of the leases below were executed several decades ago, apparently CNR did not begin deducting post-production costs from the lessors' royalty payments until about 1993."[109] The problem with this observation is that the lessee would not have incurred post-production costs prior to 1993 because the pipeline company would most likely have been purchasing gas at the wellhead for a price that reflected the gathering, dehydration, compression, treating, processing, line loss, and other investments associated with the gas as it moved from the wellhead to the point of sale.[110]

The court then proceeded to apply the rule that oil and gas leases will be liberally construed in favor of the lessor and strictly construed against the lessee—which usually means the lessee loses.[111] The lessee also argued that because the court held the language to be ambiguous, the meaning of the language should have been determined by the trier of fact.[112] The court had an answer for this as well. Apparently, the

106. *Id.* at 27.

107. *Id.*

108. Pierce, *supra* note 2, at 82 (discussing the "traditional marketing scenario" in which there is a "[d]elivery and transfer of title to the gas from the lessee to the purchaser at or near the place where it is produced"). See pages 108-11 of the same article, in which the author, in the Appendix, provides "A Concise History of Federal Natural Gas Regulation" showing the adoption of the Natural Gas Act of 1938 and each of the major events leading up to 1993 when all federal gas prices and gas sales regulation were terminated under the Natural Gas Wellhead Decontrol Act of 1989, Pub. L. No. 101-60, 103 Stat. 157 (1989).

109. *Tawney*, 633 S.E.2d at 28.

110. It is also notable that often the post-1993 *physical* pipeline structure, including all facilities associated with moving, treating, processing, and delivering the gas, is identical or very similar to the pre-1993 structure. Frequently, the only real change is that instead of having the pipeline company control the gas from the wellhead to the city gate, the pipeline now functions merely as a long distance transporter of gas. Other entities now operate the other business functions that were once bundled into a pipeline's wellhead purchase and subsequent downstream sale.

111. *Id.* at 29.

112. *Id.* at 30.

court found that whatever parol evidence might be offered,[113] it would not be in conflict and, therefore, the contract would be construed by the court, not a jury.[114] The court concluded by instructing the oil and gas bar on how to write a royalty clause that would allow for a work-back to adjust downstream sales revenue to reflect upstream values.[115] This is, however, of little solace for lessees under the thousands of oil and gas leases executed during the past century using the language "at the well." The court effectively wrote the "at the well" language out of the lease—at least when a downstream sale is at issue.[116] The production pie is sliced anew to give the lessor a bigger piece and the lessee a smaller piece.

Why did the West Virginia Supreme Court of Appeals elect art over science and paint out the words "at the well" when gas is marketed downstream from the wellhead? The court began with the knowledge that a lessor once got short-changed when the lessee deducted costs to calculate royalty.[117] The court apparently believed West Virginia lessors needed protection against lessee adjustments to the proceeds received when calculating royalty. To provide that protection and to provide the lessor with a larger piece of the gas-production pie, it resorted to the powerful one-two punch of an ambiguity finding followed by the construe-against-the-lessee rule of construction to negate the troublesome "at the well" language.

Although the court's opinion is not as revealing regarding its motives as was the court in *Rogers*, the court's opinion suggests it wanted to make a protective equitable pronouncement of how royalty owners will be treated by lessees throughout West Virginia under the vast majority of the oil and gas leases in existence. In this regard, the *Tawney* approach is much broader than the *Rogers* approach. At least under

113. Note that the court concluded, based upon a certified question submitted out of a summary judgment proceeding involving 8,000 plaintiffs, that whatever extrinsic evidence that might have existed regarding the intent of these thousands of parties, the evidence would not have, in any event, been in conflict.

114. *Id.* at 30 n.5.

115. The court offered the following advice:

> Accordingly, this Court now holds that language in an oil and gas lease that is intended to allocate between the lessor and lessee the costs of marketing the product and transporting it to the point of sale must expressly provide that the lessor shall bear some part of the costs incurred between the wellhead and the point of sale, identify with particularity the specific deductions the lessee intends to take from the lessor's royalty (usually 1/8), and indicate the method of calculating the amount to be deducted from the royalty for such post-production costs.

Id. at 30.

116. Presumably, unlike the Colorado Supreme Court's approach in *Rogers*, a West Virginia oil and gas lessee can safely sell gas at the wellhead and pay royalty based upon the proceeds received. The court's holding in *Tawney* is not the product of an implied covenant analysis. The opinion does not suggest that the lessee must seek out downstream sales. In fact, the court's opinion created an incentive to never seek out a downstream sale if forcing the lessee to bear 100% of the costs makes it a marginal proposition.

117. The court was relying on its decision in *Wellman*. *See supra* text accompanying note 90.

Rogers the lessee has the opportunity to prove to the trier of fact the gas was marketable at the wellhead.[118] Because the court concluded that there were no factual issues regarding the ambiguity of the "at the well" language, in the context of a class action with 8,000 royalty owners and over 2,000 leases, the result of the *Tawney* opinion is to, in effect, declare that the "at the well" language in all leases in the state will dictate the same result as in *Rogers*. The court strained to keep its ambiguity finding in the category of "law" instead of "fact" so the opinion could have state-wide impact on all parties to oil and gas leases that fail to rise to the level of the court's new drafting standards.[119]

B. The North Dakota "Scientist"

The North Dakota Supreme Court in *Bice v. Petro-Hunt, L.L.C.*[120] interpreted a group of royalty clauses, which the court identified as requiring "gas royalty payments to be calculated based on the market value of the gas at the well."[121] The gas at issue is described as: (1) "casinghead gas";[122] (2) "sour gas which contains hydrogen sulfide and other liquid hydrocarbons";[123] (3) "sour gas with no discernible market value at the well before it is processed and the hydrogen sulfide and liquid hydrocarbons are removed";[124] and (4) gas for which "no comparable sales exist since the gas is not saleable at the wellhead."[125]

The royalty owners argued that the court should adopt a "first marketable product rule" which, under these facts and the version of the rule advocated by the royalty owners, would require the lessee to incur the processing costs necessary to make the gas "marketable."[126] Under the marketable product rule, the "market value" of the gas would be based upon its downstream value at the tailgate of the processing plant as opposed to the upstream "at the well" location. The court was apparently concerned that the "first marketable product rule" had the practical effect of negating the express "at the well" language.

To give effect to the "at the well" language, the court turned to the "science" of contract interpretation. First, the court limited the inquiry to the confines of the oil and gas lease by declaring that the phrase "market value at the well" was not ambiguous.[127] This was followed by a recitation of familiar contract interpretation rules: confine your in-

118. *See supra* text accompanying notes 64-66.
119. These drafting standards are stated at *supra* note 115.
120. 768 N.W.2d 496 (N.D. 2009).
121. *Id.* at 499.
122. *Id.* at 498.
123. *Id.* at 500.
124. *Id.* at 502.
125. *Id.*
126. *Id.* at 500.
127. *Id.* at 502.

quiry to the writing, construe the document as a whole, giving effect to each provision if possible, and give words their ordinary, popular meaning unless it is proven that they were used in a technical sense.[128] This framework made it difficult for the court to ignore the "at the well" language in the leases and also provided some congruency with its decision in *West v. Alpar Resources, Inc.*[129]

In *West*, the royalty clause required a royalty of "one-eighth of the proceeds from the sale of gas, as such."[130] Absent from the royalty clause was any sort of language that expressly tied the "proceeds" to a particular location; there was no "at the well" language. The court described the gas at issue by stating:

> The gas obtained from the well on the lease premises contains hydrogen sulfide which is known in the oil and gas industry as "dirty" or "sour" gas. In order to obtain "clean" or "sweet" gas which is a usable and marketable product it is necessary to extract the hydrogen sulfide from the sour gas.[131]

The gas was processed in an amine plant and then sold to Montana-Dakota Utilities Company at the tailgate of the processing plant.[132] This would have been the first instance of any discernable "proceeds" from the sale of gas.

After surveying the literature on the issue and noting that commentators and courts have gone many different directions in addressing the issue, the court in *West*, as in *Bice*, sought guidance in the basic rules of contract interpretation.[133] However, in *West* the court declared the lease language ambiguous, stating:

> We are of the opinion that the royalty clause involved herein is ambiguous. The royalty clause simply provides that the lessor is entitled to receive "one-eighth of the proceeds from the sale of the gas" without further explanation. Rational arguments can be made in support of the view that the term "proceeds" means gross proceeds without deduction for expenses as well as in support of the view that the term "proceeds" means net proceeds derived by deducting production and processing expenses from the price received for the gas. Rational arguments can also be made to support the view that the royalty obligation is to be determined at the wellhead as well as to support the view that the royalty obligation is to be

128. *Id.* at 500. Although North Dakota's contract interpretation rules are statutory and derived from the Field Code, they nevertheless are a restatement of the common law rules other courts would apply.

129. 298 N.W.2d 484 (N.D. 1980).

130. *Id.* at 486.

131. *Id.* at 487. Justice Pederson's concurring opinion indicated that "sour" gas can be sold at the wellhead like any other product. He stated that if Alpar had sold the gas to Montana-Dakota Utilities Company at the wellhead, and then Montana-Dakota incurred the processing costs, Alpar's "proceeds" would reflect the reduced value of the sour gas at the wellhead point of sale. *Id.* at 492-93 (Pederson, J., concurring). However, Justice Pederson concurred that "'sour' gas has no market value at the 'wellhead'" because the parties had stipulated to that fact. *Id.*

132. *Id.* at 487 ("The sweet gas was then sold by Alpar to Montana-Dakota Utilities Company.").

133. *Id.* at 490.

> determined at the location of the sale of the gas.[134]

The court made specific note that it was "requested to construe the written lease by the language used therein without the benefit of extrinsic evidence of the parties' intentions or of evidence showing custom and usage in the oil and gas industry relating to the interpretation of such leases."[135]

Once the court declares the lease ambiguous, unless there is extrinsic evidence to consider, it will move from interpretation to construction. The court in *West* applied one of the crudest rules of construction: Hold against the party who drafted the ambiguous language.[136] As is often the case when the *contra proferentem* rule of construction is applied, it simply resolves the interpretive dispute against the party deemed to have tendered the language. This was the result in *West*, in which the court held:

> Consistent with our view that the lease must be construed most strongly against Alpar, we conclude that the Wests are entitled to royalty payments based upon a percentage of the total proceeds received by Alpar from the sale of the gas without deduction for the cost of extracting hydrogen sulfide and without deduction for any other cost incurred by Alpar.[137]

This means that for lessors and lessees alike, the critical turning point for their case may be the initial finding that the royalty language is ambiguous. Absent extrinsic evidence that can assist the court in resolving the ambiguity, the outcome will often hinge on which party supplied the ambiguous language.

The congruency between the court's approach in *Bice* and *West* is the court's search for guidance within the lease as to the critical *location* where "market value" or "proceeds" must be determined. In *Bice*, the "at the well" language answered the question; in *West*, the lack of similar language left it ambiguous whether the proceeds received by the lessee could be reduced to account for the downstream point of sale. In *Bice*, the plain language of the lease controlled; in *West*, the lack of plain language and extrinsic evidence caused the court to resolve the ambiguity with a rule of construction.

The court in *Bice* also found persuasive the analysis in *Hurinenko v. Chevron, USA, Inc.*[138] in which the United States Court of Appeals

134. *Id.* The author has offered an analysis that can be used when the lease lacks explicit language stating the location where "proceeds" or "value" are to be determined. *See* David E. Pierce, *The Missing Link in Royalty Analysis: An Essay on Resolving Value-Based Royalty Disputes*, 5 TEX. WESLEYAN L. REV. 185, 185-86 (1999).

135. *West*, 298 N.W.2d at 487.

136. *Id.* at 491. As noted previously, Professor Farnsworth has observed that this rule of construction is often used as a rule of "last resort" because it is designed to arrive at a conclusion instead of ascertaining the intent of the parties. FARNSWORTH, *supra* note 75, at 460 (footnote omitted).

137. 298 N.W.2d at 491.

138. 69 F.3d 283, 285 (8th Cir. 1995) (applying North Dakota law and distinguishing *West v. Alpar Resources, Inc.*).

for the Eighth Circuit interpreted a royalty clause requiring payment of "market value at the well for gas produced from any oil well and used off the premises."[139] The court, rather summarily, noted: "Thus, the lease requires the oil companies to pay the Hurinenkos royalties based on the gas's 'market value at the well.'"[140] The Eighth Circuit approved of the "work-back" method to adjust downstream values to reflect the wellhead value, noting: "The gas had no readily discernible market value at the well before the incursion of processing costs to separate the compounds."[141] Apparently, the court felt the meaning of "market value at the well" was so plain it did not need to go through much of an interpretive process to give effect to the language.[142]

The final basis for the court's holding in *Bice* was its "safety in numbers" observation that it was following the "majority rule."[143] Although the court mentioned the majority/minority status of the rules four times,[144] it did not attempt to explain what it was about the analysis

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139. *Id.*

140. *Id.*

141. *Id.* This was another instance in which the casinghead gas required treatment and processing before it could be transported in major natural gas transmission lines. *Id.* at 284.

142. The court was also influenced by the North Dakota Supreme Court's use of the work-back formula to value gas for assessment of oil and gas taxes by the North Dakota Tax Commission. *Id.* at 285; *see*, *e.g.*, Koch Oil Co. v. Hanson, 536 N.W.2d 702 (N.D. 1995); Amerada Hess Corp. v. Conrad, 410 N.W.2d 124 (N.D. 1987). These cases were also mentioned by the court in *Bice*. Bice v. Petro-Hunt, L.L.C., 768 N.W.2d 496, 502 (N.D. 2009).

143. The court noted: "Currently, the majority of states interpret the term 'market value at the well' to mean royalty is calculated based on the value of the gas at the wellhead." *Bice*, 768 N.W.2d at 500. "As previously stated, the 'at the well' rule, allowing a lessee to deduct post-production costs prior to calculating royalty, is the majority rule." *Id.* at 501. "A minority of states have expressly rejected the 'at the well' rule and have adopted the first marketable product doctrine." *Id.* at 501. "We join the majority of states adopting the 'at the well' rule and rejecting the first marketable product doctrine." *Id.* at 502.

144. *See supra* note 143. Arguably, it is not possible to place all the cases, and, therefore, the states, into two distinct categories. For example, the Kansas Supreme Court gave controlling effect to the "at the well" language in *Sternberger v. Marathon Oil Co.*, 894 P.2d 788, 794 (Kan. 1995) ("The lease's silence on the issue of post-production deductions does not make the lease ambiguous. The lease clearly specifies that royalties are to be paid based on 'market price at the well.'"). Commentators quoted by the court in *Bice* placed Kansas into the category of states that have "adopted the first marketable product doctrine." 768 N.W.2d at 501. However, the lessee prevailed in *Sternberger* because the court gave effect to the plain meaning of "at the well." 894 P.2d at 796. As the author has written previously, the main reason the court discusses the "marketable product" rule is to try and justify applying Kansas law to leases covering lands in Oklahoma as well as Texas. Pierce, *supra* note 67, at 928-30. Note: The author was co-counsel to the American Petroleum Institute in the *Sternberger* case and filed an amicus brief arguing that the court should have resolved the issue by simply ascertaining the market value of gas "at the well." The author has also participated in many cases, as a consultant or expert witness, called primarily on behalf of oil and gas lessees, regarding various royalty issues. The court also relied upon the analysis of commentators to place Arkansas into the minority marketable product category. *Bice*, 768 N.W.2d at 501. To date, Arkansas has not had to determine which analysis it might apply when presented with facts similar to those in *Bice*. Therefore, of the states referred to in the court's opinion, it appears only Colorado and West Virginia have adopted a form of marketable product rule that would completely negate the "at the well" language. Although Oklahoma is also listed as a "marketable product" state, the analysis employed by the Oklahoma Supreme Court is fundamentally different from that used in Colorado and West Virginia because the "at the well" language is still quite relevant under Oklahoma's version of the marketable product rule. In *Howell v. Texaco Inc.*, 112 P.3d 1154 (Okla. 2004) the court observed:

> When the gas is marketable at the wellhead, the reasonable post-production costs may be charged against the royalty payments. . . . This is so because the referenced starting point in the calculations is the value of the gas after processing and the royalty owners are enti-

in the majority rule that it found convincing.[145] The court commented on what it found unappealing about the marketable product rule: It is not clear when a marketable product has been created.[146]

The ultimate foundation for the court's holding seems pretty simple: The justices felt they knew what the parties intended when they provided for a royalty based upon the "market value at the well." There was no compelling reason for the court to consider any sort of new rule or analysis when the express terms of the lease provided the necessary guidance. Although not restated by the court in *Bice*, it would have been appropriate to borrow a concluding sentence from *West*. After refusing to allow the lessee in *West* to deduct its processing costs to calculate "one-eighth of the proceeds from the sale of the gas," the court concluded: "The question of whether or not the result of this interpretation is the most equitable or just is not dispositive of the issue in this case."[147] The court was seeking to interpret and, if necessary, construe the parties' contract as opposed to remaking it to be more "equitable or just."

VII. THE ART CRITIC: WHO IS RESPONSIBLE FOR BAD GEOLOGY?

Any critique of the art and science of royalty jurisprudence depends, in part, on whether one really believes the language "at the well" is ambiguous or whether it should be treated as meaningless in determining a location for royalty calculations. If one believes the language has a role to play in defining the lessee's rights and obligations under the oil and gas lease, then the artful approaches of the Colorado and West Virginia courts are nothing more than a re-writing of the parties' contract to take money from the lessee and give it to the lessor. This judicial negating of the terms of an otherwise enforceable contract should only take place when the court determines the offending contract terms are unconscionable. It is highly unlikely, however, that either the Colorado Supreme Court, or the West Virginia Supreme Court of Appeals, would feel compelled to exercise directly their equitable authority to declare the "at the well" lease language unconscionable.

The presence of the "at the well" language is not a risk to public health, safety, or morals; it does not in any way violate, or even implicate, public policy.[148] The Colorado and West Virginia courts make it

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tled only to the value of the gas that is marketable at the wellhead.

Id. at 1159-60 (citation omitted).

145. Perhaps it is too obvious for comment by the court: It must give effect to all the language within the document in an effort to ascertain the intent of the parties, even "at the well" language.

146. *Bice*, 768 N.W.2d at 502 ("The problem that has emerged with the first marketable product doctrine is the difficulty in determining when the gas has become a marketable product.").

147. West v. Alpar Res., Inc., 298 N.W.2d 484, 491 (N.D. 1980).

148. The public has no interest in whether a lessor's royalty is calculated before or after gathering and compression costs are subtracted from downstream revenues.

clear that it is lawful, and perfectly permissible, to allow for the deduction of costs downstream from the wellhead—one just has to use the right language.[149] So, why do these courts turn to artful interpretation to negate the terms of the parties' contracts? It appears the justices have formed the opinion that lessors are entitled to a better deal, and counsel for the lessors, aided by Professor Merrill, have provided them with the conceptual tools to provide the better deal. Even though it may be difficult to reconcile the outcome with the express terms of the lease contract, that difficulty really does not matter when courts are the supreme reconcilers.

There is still the question of why this royalty calculation issue, as opposed to the thousands of other contract issues that these courts address, should catch the courts' eye and their penchant for art. It could be the sheer magnitude of the amounts of money often involved, the number of plaintiffs before a court in a single action, the individual versus oil-company context of the dispute, or that lessors' counsel seem so outraged. Of course, none of these facts should alter the underlying contractual rights of the parties. This raises the ultimate question: For lessors who share in revenues generated downstream from the wellhead, is there something inherently unfair about allowing their royalty to be calculated after deducting costs directly related to obtaining the enhanced downstream revenues?

One way to pose this question is by asking which party is responsible for the fortuity of bad geology? Is it the lessee's fault the leased land is located miles from the nearest interstate pipeline? Is it the lessee's fault that the gas that is discovered is of low pressure, of low British thermal units (Btu), or low-volume gas with contaminants such as water, hydrogen sulphide, and carbon dioxide? In each case, the parties must deal with the geological facts associated with the leased land. Nobody is at fault; nobody is responsible for the situation.[150]

However, when one applies the Colorado and West Virginia royalty analyses to this situation, the poorer the inherent qualities of the gas, the more the lessee has the potential to be penalized by having to spend money to bring it up to a condition in which it becomes eligible for enhanced downstream prices. In many of these situations, the lessee may be paying more royalty on post-production "services" than on the "gas" that is the object of the royalty obligation.[151] Colorado and West Virginia do not distinguish between paying 1/8th on *gas* worth $1.00 and

149. The courts even tell the oil and gas bar the language the bar should use to accomplish the task. *See supra* note 115.

150. The lessee would not be liable if it drilled a dry hole and there was no oil or gas to be found within the leased land.

151. The royalty clause provides for a royalty on "gas," not on gathering, compression, treatment, processing, or marketing services.

1/8th on compression *services* worth $1.00. The lessee's position in all these cases is that lessors at no time will be obligated to reach into their pockets to pay for anything. Instead, the lessee assumes all the risk, makes all the expenditures, but seeks in return the ability to deduct from the resulting enhanced downstream revenues those costs necessary to obtain the downstream revenues.

Whether one characterizes the post-wellhead activities as a separate business[152] or as beyond the scope of the lessor/lessee relationship,[153] any time the lessor is permitted to share in downstream revenues, the lessee will seek to deduct the related downstream costs before applying the lessor's royalty. Tens of thousands of oil and gas leases have been executed through the years using the "at the well" language to identify the point at which the lessor's cost-free share of production benefits ends. Many of the leases that are in effect today were entered into over fifty years ago. The longevity of the contracts at issue make judicial drafting tips to second-guess traditional lease language a hollow, meaningless gesture designed to try and reduce the magnitude of the courts' re-ordering of the parties' rights. The approaches taken by the Colorado and West Virginia courts appear to be carefully designed to have maximum re-ordering impact on existing lease contracts. When viewed in the context of traditional contract law, it is not a pretty picture.

VIII. CONCLUSION

Courts across the nation will be looking to the art and science of royalty jurisprudence to determine which judicial philosophy they will follow as they address the meaning to be given to "at the well" contract language. They truly have a choice. The same "at the well" language, used in similar contexts, presenting identical issues, has been held by courts to be: (1) clear and unambiguous; (2) unclear and silent; and (3) ambiguous. Correspondingly, interpretation of the same "at the well" language has resulted in: (1) application of the plain meaning rule and rejection of any sort of implied covenant; (2) rejection of the plain meaning rule and the use of an implied covenant to define the obligation; and (3) application of a rule of construction to redefine the obligation. Some courts have found the language meaningful and determinative; others have found it meaningless and of no effect. These vastly different approaches can only be explained by identifying and then

152. The author first offered a "separate business" analysis in 1994. *See* David E. Pierce, *Incorporating a Century of Oil and Gas Jurisprudence into the "Modern" Oil and Gas Lease*, 33 WASHBURN L. J. 786, 819-27 (1994).

153. The author first offered a "scope of the lease relationship" analysis in 1999. *See* Pierce, *supra* note 134, at 185-86.

evaluating what motivates courts to depart from the express terms of the oil and gas lease and employ interpretive devices in an effort to create a more aesthetically pleasing bargain for the parties. Depending on who one represents, the approach taken by a court will result in either "the best of times" or "the worst of times" for the client. Such is the tale of two states.