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Chapter Five

An Afternoon With Professors Anderson & Pierce

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AN AFTERNOON WITH PROFESSORS ANDERSON & PIERCE*

by

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RECENT DEVELOPMENTS IN NON-ROYALTY OIL & GAS LAW

I. CONVEYANCING ISSUES

A. *Wilderness Cove, Ltd. v. Cold Spring Granite Co.*, 62 S.W.3d 844 (Tex. Ct. App.–Austin 2001).

1. 1890 deed from owners of undivided one-half fee interest in land conveyed "all our interest in and to the Granite on the . . . land together with the necessary right of way to the extent of our interest in the same for constructing Rail Road and for quarrying and handling said Granite." Cold Spring Granite now owns this undivided one-half interest in the Granite.

2. In 2000 Wilderness Cove purchased the balance of the rights in the land (covering 30 acres fronting Lake LBJ) for residential development.

Outlines prepared by David Pierce who assumes sole responsibility for any errors, omissions, or irritating statements.

3. Wilderness Cove sought a ruling that Cold Spring's rights are limited to a share of the profits from the sale of granite, when, and if, Wilderness Cove elects to mine the granite.

4. Court held in favor of Cold Spring:

   a. Cold Spring owned the granite *in situ* as a mineral estate, which is the dominant estate giving it the right "to make necessary and reasonable use of the surface to remove the minerals."

   b. Cold Spring's basic mineral ownership rights are not diminished because it owns an undivided interest n the granite as a cotenant with Wilderness Cove.

B. *Cornelius v. Moody Bible Institute of Chicago*, 18 P.3d 1081 (Okla. App. 2001).

1. Cornelius' mother granted an oil and gas lease in 1945 and received royalties from the lease until her death in 1966 at which time Cornelius began receiving royalties through inheritance. Cornelius continued to receive royalties for 29 years and paid production taxes on the royalties he received.

2. In fact, Cornelius' mother had conveyed the mineral estate shortly before she died to her brother, James Tarpley, who also died in 1966. The Moody Bible Institute claims title to the minerals through a conveyance from Tarpley's heirs. Cornelius claims title by adverse possession.

3. The court holds the receipt of royalties and payment of taxes on the royalties is not adverse possession of the mineral estate.

   a. Cornelius' actions did not put the record title owner on notice of an adverse claim.

   b. Typically this requires some sort of adverse activity on the land; activity on other lands pooled with the land at issue is not adequate notice.

C. ***Mack Oil Co. v. Garvin*, 39 P.3d 775 (Okla. 2001).**

1. Will the after-acquired title doctrine apply when the source of the after-acquired title is the previously shorted grantee?

2. Yes, "'no matter what conduit or circuity of conveyancing the title may pass through in returning to the grantor.'"

3. Grantor "A" owned one-half the minerals in a tract of land from which the following mineral conveyances took place:

   a. 1/3 from A to B (leaving A with 1/6)

   b. 1/4 from A to C (over-conveyance by 1/12)

   c. 1/8 from C to A (reconveyance to A)

   d. 3/8 from A and B to D (A's contribution intended to be 1/8)

4. Following conveyance c. 1/12 of the 1/8 A received from C immediately passed back to C as after-acquired title to make C whole under conveyance b. This left A with 1/24 which was A's maximum possible contribution under conveyance d.

D. ***Hazelwood Farm, Inc. v. Liberty Oil and Gas Corp.*, 790 So.2d 93 (La. Ct. App. 2001).**

1. Owner of surface estate sought to enforce covenant contained in oil and gas lease between mineral interest owner and lessee that provided: "The use of the surface of the land is granted only for purposes hereof. Grantee shall be responsible for all damages caused by his operations."

2. Court held surface owner was a third party beneficiary of the covenant. Under Louisiana law stipulations in a contract benefitting a third party "are favored."

3. NOTE: the primary focus of this lawsuit related to historic use of the surface for routine oil and gas operations "at various times since 1926 . . . ."

4. The latest litigation cottage industry is revealed by the court's description of the plaintiff's allegations and cause of action:

"[D]amages for environmental contamination and other damages that the Defendants' oil operations have caused to the surface and subsurface of the Property. The Defendants' operations included the construction of numerous earthen pits, including a twelve-acre evaporation pond in which Hazelwood alleges that the Defendants dumped oil, grease, salt water, and other hazardous and/or toxic oil production waste. As a result of such operations, Hazelwood asserts tht the surface, surface soils, and grounwater on and beneath the Property have become contaminated with hazardous and toxic wastes consisting of oil and grease, heavy metals, chlorides, and other by-products and constituents of oil and gas production. Hazelwood also shows evidence that the Property is contaminated with radioactive materials and asserts that the Defendants failed to properly plug and abandon wells there." 790 So.2d at 95-96.

E. *Senn v. Texaco, Inc.*, 55 S.W.3d 222 (Tex. Ct. App.–Eastland 2001).

1. Texaco and other oil and gas companies had obtained oil and gas leases covering the land in 1948, with interests being assigned through the years to other companies. Texaco assigned all its rights to Apache Corporation in 1995. The plaintiff obtained surface rights in the property in 1997 through a deed that excluded any warranty or representation concerning the enviornmental condition of the land.

2. The surface owner then brought suit against past and present oil and gas lessees for damages associated with oil and gas drilling and production activities, to include contamination of the aquifer underlying their land.

3. Court holds the plaintiffs lacked standing to pursue prior owners stating "a cause of action for injury to real property is a personal right which belongs to the person who owns the proprty at the time of the injury." 55 S.W.3d at 225.

F. Creason v. Unified Government of Wyandotte County, 33 P.3d 850 (Kan. 2001).

1. County condemned 31-acres with home and other improvements, including an operating natural gas well owned by the landowner.

2. The dispute concerns the trial court's refusal to permit evidence concerning the commercial value of the gas well. Under the "unit rule," used with the comparable sales method of valuation, improvements on land cannot be separately valued but are merely considered in determining the total value of the real estate.

3. However, in 1999 K.S.A. § 26-513 was amended to provide: "The fair market value shall be determined by use of the comparable sales, cost or capitalization of income appraisal methods or any combination of such methods."

   a. This placed these three valuation methods on equal footing with the "unit rule" a limit only on the comparable sales method.

   b. Creason argued "that to arrive at the fair market value of his property, the capitalization of income method of valuation must be utilized, and McCune's testimony regarding the potential income represented by the gas reserves was necessary to value the property using the capitalization of income method of valuation." 33 P.3d at 854.

4. Reversing the trial court, the court holds: "[T]o demonstrate how the value of the property as a whole is enhanced by a natural asset, evidence can be introduced of its separate value. . . . . Properly instructed, the jury could have found that the commercial value of the gas well on Creason's property would have an effect on the amount of money that a well-informed buyer would be justified in paying for Creason's property. The trial judge erred by failing to allow the jury to consider the testimony relative to the value of the gas well." 33 P.3d at 855.

II. CONTRACTING ISSUES

A. *Encina Partnershp v. COREnergy, L.L.C.*, 50 S.W.3d 66 (Tex. Ct. App.–Corpus Christi 2001).

1. Landman obtaining seismic permits for COREnergy negotiated a permit with Encina Partnershp under which COREnergy would pay Encina $197,240 under a conditional draft which stated: "On approval of seismic permit or lease described hereon and on approval of title to same by drawee not later than 3 days after the arrival of this draft at collecting bank."

2. COREnergy refused to pay the Encina permit draft one day after it was issued. Encina sued seeking to enforce the obligation to pay.

3. Court holds the language of the drafts makes COREnergy's approval of the seismic permit a condition precedent to the formation of a contract–and therefore no contract was formed.

4. Question: was Encina bound to anything during the 3-day approval period?

   a. More accurate to view it as a solicitation of an offer from Encina for home office approval by COREnergy? Therefore no contract, because no acceptance.

   b. What bargained-for exchange took place when the draft was delivered to Encina? Limits on COREnergy's ability to reject the draft? What about the obligation to act within 3 days?

B. *Redman Energy Corp. v. Koch Midstream Services Co.*, 45 S.W.3d 341 (Tex. Ct. App.–Texarkana 2001).

1. Gas Processing Agreement provided: "In the event Gas from the lease . . . is or becomes insufficient in volume or liquefiable hydrocarbon content, ***or becomes uneconomical for processing***, the processor reserves the right to submit to Producer an alternate processing proposal. . . . Should Producer reject such alternate proposal . . . this agreement shall be terminated . . . ." 45 S.W.3d at 343-44.

2. Koch gathered Redman's gas for processing under the Gas Processing Agreement. The gathering line was gradually eaten-up and Koch determined it would not be economic to rebuild the line at its sole cost. Therefore, Koch made an "alternate processing proposal" to share the cost of a new gathering line with Redman. Redman contended Koch had an obligation to build the line at its own expense.

3. The issue was whether the "gathering" line was "processing" encompassed by the economic-out clause. The court concludes: "the parties intended that the gathering of the gas from the well in order to process it at the processing plant would be an integral part of the processing, not a separate and distinct function." 45 S.W.3d at 346.

C. *MCEN 1996 Partnership v. Glassell*, 45 S.W.3d 262 (Tex. Ct. App.–Corpus Christi 2001).

1. When parties entered into a pooling agreement to conduct development it resulted in a cross-conveyance of the mineral interests and the parties became cotenants in the pooled minerals.

2. Cotenants in Texas have a very broad right to partition.

3. MCEN acquired an interest in the pooled area and sought to partition the pooled interests by sale.

4. Court found the pooling agreements indicated partition would not be compatible with the pooled relationship and therefore the parties had waived their partition rights for as long as the pooled leases remained in effect.

D. *Duffy v. Casady*, 28 P.3d 1040 (Kan. Ct. App. 2001).

1. Judge Knudson: "As Casady would discover, the old adage, 'what goes around, comes around,' would be given special meaning when he inadvertently failed to make the payment for extension before July 1, 1998." 28 P.3d at 1041.

2. 1.8-acre surface lease for a tank farm to support area oil and gas operations was entered into in 1975 with a 5-year primary term, renewable annually by payment of $250 prior to July 1 of each year.

3. Landlord through the years sought an increase in rent; tenant instructed the landlord concerning the express terms of the lease which provided for a $250 annual rental.

4. Tenant accidentally missed the July 1 renewal date and the landlord instructed the tenant concerning the express terms of the lease which stated: "Lessee shall have the option to extend this lease for successive one-year terms upon payment to Lessors, in advance of each July 1 anniversary, the annual rental hereunder." 28 P.3d at 1041.

5. Trial court applied equitable principles and allowed the tenant to make the payment late. Tenant established it would cost over $90,000 to move its equipment.

6. Court of Appeals reverses stating: "Kansas law does not permit the application of equitable principles under the facts of this case, there being no showing of fraud, mutual mistake as to content of the lease, or undue influence." 28 P.3d at 1042.

7. "Under the facts of this case, equity could not be invoked to extend or renew a commercial lease that has already expired by its express terms." 28 P.3d 1042.

    a. Court noted this was not similar to other cases where the error was discovered and payment offered while the lease was still in effect.

    b. Court also relied upon oil and gas lease cases for the proposition this is not a forfeiture but merely enforcement of the contract the parties made.

III. OIL & GAS LEASE ISSUES

A. *Crawford v. Hrabe*, 44 P.3d 442 (Kan. 2002).

1. Lessee Crawford brought water produced from adjacent leases onto the lessor Hrabe's land and injected it to conduct secondary recovery operations. Although the injection was approved by the KCC, no statutory unitization of the area was involved and the KCC did not address Crawford's right to inject off-lease produced water into the authorized injection well.

2. Hrabe contended Crawford could only use water produced from the leased land for injection into the well.

. The granting clause in the lease from Hrabe authorized use of the leased land "for the sole and only purpose of mining and operating for oil and gas, and laying pipe lines, and building tanks, power stations and structures thereon to produce, save and take care of said products." 44 P.3d at 444.

   a. The lessee's express term argument is that water was being injected "for the sole and only purpose of mining and operating for oil and gas . . . ."

   b. The lessee's implied right to make reasonable use of the surface argument is that secondary recovery is a recognized and necessary process to maximize recovery of the granted oil and gas and is therefore encompassed by the leasing of the oil and gas rights.

   c. The court states: "[B]ecause Crawford's salt water injection is related to the primary purpose of obtaining additional oil production, it should be found permissible under the lease." 44 P.3d at 448.

   d. The court also notes: "Even when no contractual rights exist between a property owner and an oil and gas lease operator, courts have been reluctant to apply the general rules of trespass to subsurface intrusions or migrating sale water." 44 P.3d at 449.

4. Court carefully defines, and limits, the bases for its decision:

   a. "We, like the trial court, do not believe that our decision should be reached on the language, or lack thereof, in the oil and gas lease involved in this case." 44 P.3d at 453.

   b. "In the final analysis our decision must, as the trial court's was, be driven by the facts of this particular case. The secondary recovery operations have increased production. This increase is economically beneficial to all parties. Off-lease salt water is economically available. To drill a supply well on the Hrabe property would increase expenses of lease operations. The water from the Kansas city formation is more beneficial that water from the Dakota formation [if a water well were drilled]. This is a true injection of salt water necessary to increase production and not the disposal of water being attempted under the injection banner." 44 P.3d at 453.

B. *Bunnell Farms Co. v. Samuel Gary, Jr. & Assoc.*, 47 P.3d 804 (Kan. Ct. App. 2002).

1. Lease stated: "If the lessee shall ***commence to drill a well*** within the term of this lease . . . ." 47 P.3d at 805.

2. The end of the primary term of the lease was on July 14, 2000.

   a. July 11, 2000: lessee field a notice of intent to drill with KCC.

   b. July 12, 2000: lessee entered into a drilling contract to drill a 6,500-foot well; dirt contractor began work.

   c. July 14, 2000: lessee discovered could not drill at noticed location so field a second notice of intent to drill at the revised location; another drilling company, with a small rig, drilled a 51-foot hole to set conductor pipe (presumably at the revised location).

   . July 16, 2000: big rig entered the property following

a delay caused by heavy rains; completed a producing gas well.

e. July 19, 2000: KCC approved revised notice of intent to drill.

f. November 8, 2000: mineral owner sues to establish that lease terminated on July 14, 2000 because:

(1) Lessee lacked KCC approval to drill at the location; and

(2) The drilling rig in use on July 14 was not capable of drilling the well.

3. Court notes it was "not uncommon" to being drilling with a smaller rig and, consistent with the plain terms of the lease, the lessee had commenced to drill a well on the critical date.

a. "The language of the lease required Dunne [lessee] to commence drilling, and, in the absence of evidence from Brunnell [lessor] that the small-rig drilling was not necessary to the completion of the well or in accordance with standard drilling practices, the district court properly granted summary judgment." 47 P.3d at 808.

b. Court finds that failure to have prior KCC approval was "interesting" but "not dispositive of this case." 47 P.3d at 808.

C. Ridenour v. Herrington, 47 S.W.3d 117 (Tex. Ct. App.–Waco 2001).

1. The secondary term of the lease habendum clause would run "as long thereafter as oil, gas or other mineral is produced from said land."

2. However, the lease also stated: "Cessation of paying production after the primary term for a period of sixty days shall cause the lease to terminate." 47 S.W.3d at 120.

3. Lease experienced a total cessation of production for 6 months. Court holds the lease expired following 60 days of cessation. Prudent operator and reasonable time concepts not applicable because there is an express provision: 60 days.

D. Krabbe v. Anadarko Petroleum Corp., 46 S.W.3d 308 (Tex. Ct. App.–Amarillo 2001).

1. The cessation of production litigation cottage industry. Trial in 1999 over cessations in 1985 and 1986. Lease would continue "so long as oil or natural gas is produced." No cessation clause so the cessation of production doctrine applies.

2. Cessation of production doctrine: "[T]he automatic termination rule is relaxed if the lessee can prove that the cessation of production was temporary and is due to sudden stoppage of the well, some mechanical breakdown of the equipment used in connection therewith 'or the like.' . . . The lessee is entitled to a reasonable time in which to remedy the cause of the temporary cessation and resume production. . . . What constitutes a reasonable time depends on the facts of each case. . . . The lessee must act with diligence in obtaining renewed production. . . . The burden is on the lessee to prove that the cessation of production fell within the temporary cessation doctrine." 46 S.W.3d 315-16.

3. The issue was whether cessations caused by gas contract disputes and gas plant maintenance were events that could trigger the cessation doctrine–or whether the cessation had to relate to some "sudden stoppage of the well" of "some mechanical breakdown of equipment."

4. Court refused to link prior cessations from some wells, due to gas marketing, with the gas plant interruptions. Instead, the court focused on the event that resulted in no current production from the property: shut-down of the gas plant for maintenance.

   a. The lessor argued the lessee should have built a pipeline to by-pass the gas processing plant to avoid the 92-day interruption in 1985 and the 61-day

interruption in 1986.

b. The lessor argued that the cessation must relate to equipment where the gas was sold–in this case at the wellhead.

c. The lessor argued the cessation event had to be unforeseeable.

5. Court rejects the lessor's arguments and holds the processing plant shut-down was the sort of events contemplated by the temporary cessation doctrine.

E. *Bryan v. Big Two Mile Gas Co.*, 2001 WL 1585653, Case no. 29641 (W. Va. Dec. 11, 2001).

1. Dispute over a 3-year cessation from 1987 through 1990 revealed a prior cessation from November 1979 through April 1980. Court upholds jury finding that the lease terminated in 1979 because the lessee failed to establish why the lease had not been producing.

2. The jury relied upon the lessee's meter records to establish the 1979 cessation; the lessee did not dispute the 1987 cessation.

3. Measure of damages: reject the "reasonable royalty" hold-over tenant measure applied by trial court and apply a value of the gas less reasonable costs of production measure from 1979 to the 1987 cessation.

a. However, for periods following the 1987 cessation the court found the lessee's actions to be "willful" and damages would be the value of production with not allowance for the cost of production.

b. "Willful" is similar to the "bad faith" terminology used by other courts. Good faith trespass, can receive credit for costs of production; bad faith trespass cannot obtain credit for any costs of production.

F. ***Natural Gas Pipeline Co. of America v. Law*, 65 S.W.3d 121 (Tex. Ct. App.–Amarillo 2001).**

1. Lessors sued asserting cessations of production in 1959, 1960, 1961, 1963, and 1964 caused the lease, which has been operated for over 40 years since some of the events, to terminate. The trial court concluded the lease had terminated and awarded damages.

2. Court of appeals held the lease had been "revived" when the parties entered into a 1979 family settlement agreement which recited the property was "***now*** subject to an oil and gas lease in favor of Natural Gas Pipeline Company of America . . . ."

G. ***Wellman v. Energy Resources, Inc.*, 557 S.E.2d 254 (W. Va. 2001).**

1. Court holds common form of judicial ascertainment clause is void because it violates public policy of "economy of judicial effort."

2. The clause provides: "This lease shall never be forfeited or terminated for failure of Lessee to perform in whole or in part any of its express or implied covenants, conditions or obligations until it shall have been first finally judicially determined that such failure exists, and Lessee shall have been given a reasonable time after such final determination within which to comply with any such covenants, conditions or obligations."

H. ***Niemeyer v. Tana Oil and Gas Corp.*, 39 S.W.3d 380 (Tex. Ct. App.–Austin 2001).**

1. Oil and gas lease provides:

"In the event lessor considers that lessee has not complied with all its obligations hereunder, both express and implied, lessor shall notify lessee in writing, setting our specifically in what respects lessee has breached this contract. Lessee shall then have sixty (60) days after receipt of said notice within which to meet or commence to meet all or any part of the breaches alleged by lessor. The service of said notice shall be precedent to the bringing of any action by lessor on said lease

for any cause, and no such action shall be brought until the lapse of sixty (60) days after service of such notice on Lessee."

2. Relying upon the Texas Supreme Court's analysis in *Texas Oil & Gas Corp. v. Vela*, 429 S.W.2d 866, 875 (Tex. 1968), the court holds the notice requirement only applies to actions seeking cancellation as opposed to damages. What in the express terms of the clause create such a limitation?

3. Note: in Vela the issue was whether the notice had to be given before damages associated with drainage would begin to accrue.

RECENT DEVELOPMENTS IN ROYALTY CALCULATION ISSUES

I. EXPRESS COVENANT ANALYSIS

A. *Yzaguirre v. KCS Resources, Inc.*, 53 S.W.3d 368 (Tex. 2001).

1. "Market value" means what a willing buyer will pay a willing seller at the time gas is produced, even though it may be less than what the lessee actually receives under a gas sales contract.

2. "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." 53 S.W.3d at 374.

3. Court rejects lessors' arguments that: "the implied covenant to reasonably market the oil and gas means that the producer must attempt to obtain the best price available for the benefit of the royalty owner" and that "'the entire body of implied covenant law has been aimed at . . . making sure the royalty owner gets the best deal.'" 53 S.W.3d at 373-74.

4. Evidence of prices paid under lessee's 1979 gas contract was properly excluded because it was not relevant to determining the current market value of gas. 53 S.W.3d at 374-75.

B. *Creson v. Amoco Production Co.*, 10 P.3d 853 (N.M. Ct. App. 2000).

1. "[N]et proceeds derived from the sale of Carbon Dioxide Gas at the well" is unambiguous and entitles the plaintiffs "to royalties based on the value of the carbon dioxide gas as it emerges at the wellhead." 10 P.3d at 857.

2. "It is undisputed that a small percentage of the carbon dioxide gas 'is sold in the form in which it emerges from the wellheads prior to processing or from the wellheads prior to processing or transportation' and that the carbon dioxide is marketable in its unprocessed state at the wellheads. It is also undisputed

that compression, dehydration, and gathering are processes to make the carbon dioxide suitable for delivery into the pipeine system and that these expenses, along with depreciation, are unit expenses under the Unit Agreement." 10 P.3d at 856.

3. "Even under cases from other jurisdictions, such as *Garman* and *Sternberger*, the costs of compression, gathering, and dehydration in this case would be deductible. Because the carbon dioxide was marketable at the wellhead, this would be considered post-production, value-enhancing costs that could be deducted from the value of the gas at its termination point as a means of establishing the value of the gas at the wellhead, before the gas was sold downstream at an enhanced value. We thus hold that the post-production values Defendants added was [were] properly deducted before calculation of royalties due." 10 P.3d at 859.

4. "In summary, because 'net proceeds . . . at the well' is an unambiguous phrase and evinces a clear intent that deductions will be made and the gas is to be valued at the wellhead, we affirm the trial court's determination that the computations of Plaintiffs' royalties for gas sold downstream were subject to deductions for post-production, value-enhancing costs." 10 P.3d at 862.

II. IMPLIED COVENANT ANALYSIS

A. *Smith v. Amoco Production Co.*, 31 P.3d 255 (Kan. 2001).

1. Lessors challenge Amoco's actions in responding to FERC Order 451 which gave Amoco the ability to trigger gas prices that reflected current gas values on the emerging free market.

2. Single gas sales contract between Amoco and Williams Natural Gas Company, Inc. dedicating gas from 1,439 leases within a 600,000-acre area.

3. Federal regulation resulted in widely varying contract prices for gas produced from individual wells within the 600,000-acre area. Some of the wells were entitled to regulated prices that exceeded current market values; some were entitled to prices that were far below current market values.

4. Order 451 linked the lessee's ability to raise the below-market gas prices with the gas purchaser's ability to lower the above-market gas prices–thereby promoting a federal policy of making existing gas contracts reflect current market realities.

5. The Order 451 process became available to Amoco on January 23, 1987 and it ultimately triggered the process on June 8, 1989. Between 1987 and 1989 Amoco attempted to renegotiate its contract with Williams outside of the Order 451 process.

   a. Major problem for Amoco: the contract with Williams only contained a ratable take obligation which meant Williams could not be forced to take a minimum volume of gas from Amoco–regardless of the price.

   b. Even if Williams agreed to pay the higher prices to keep the gas subject to the contract, it could not be forced to take any of the gas.

6. Amoco was sued by two classes of royalty owners:

   a. The Youngren class (representing lessors in wells authorized to receive below-market prices) for not triggering Order 451 sooner. This case settled.

   b. The Smith class (representing lessors in well authorized to receive above-market prices) for triggering Order 451 at all.

7. The lessors relied upon the implied covenant to market as the basis for their claim that Amoco breached its duty to obtain the "best price" for their gas, which meant Amoco should not have triggered the Order 451 process that could result in a lower contact price.

8. The court rejects the "best price" argument noting: "*Robbins* requires Amoco to use due diligence to market the gas it produced within a reasonable time and at a reasonable price." 31 P.3d at 272.

9. The "reasonableness" of Amoco's actions will be evaluated using the prudent operator standard which must account for several things:

a. "When negotiating with Williams Natural Gas under good-faith negotiating provisions [the Order 451 process] Amoco has a marketing duty to each of its lessors." 31 P.3d at 272. The court describes this as the "independent duty principle" which means Amoco's "obligations as lessee apply independently to each lease. . . . [T]o prevent Amoco from making the management of a given lease dependent upon the management of another lease." 31 P.3d at 272.

b. "The purpose of FERC Order 451 was to bring some rationality to natural gas pricing." 31 P.3d at 273.

c. "We do not feel that renegotiating under FERC's deregulation policy should expose Amoco as a common lessee to automatic liability under its implied covenant to market as a reasonably prudent producer. We believe that the better analysis involves a fact-specific approach for evaluating the Smith Class' claim that Amoco's actions under Order 451 breached the implied covenant to market. We reason that the implied covenant to market is to be enforced with a consideration given to the purpose of Order 451." 31 P.3d at 273.

d. Applying the *Robbins* guidelines:

(1) "[W]hat an experienced operator of ordinary prudence would do under the same or similar circumstances, having due regard for the interests of both [lessor and lessee."

(2) "Evaluation of Amoco's conduct under the prudent operator standard is a question of fact."

(3) "The district court must apply the prudent operator standard to the facts as they existed

at the time Amoco took the action complained of."

(4) "The lessors have the burden of proof."

(5) "The facts are not contested, and Amoco's actions are not patently imprudent; thus, expert testimony will be required to establish a breach of the covenants alleged." 31 P.3d at 273-74.

10. The court also addressed whether the implied covenant to market is "implied in fact" or "implied in law."

a. The court described the distinction as follows:

> "A contract implied in fact is one 'inferred from the facts and circumstances of the case' but which is 'not formally or explicitly stated in words.' . . . It is the product of agreement, although it is not expressed in words. . . . A contract implied in law does not rest on actual agreement. It is a legal fiction created by the courts to ensure justice or to prevent unjust enrichment."
>
> 31 P.3d at 265.

b. The issue arose in the context of the appropriate statute of limitations: K.S.A. § 60-511(1) as "An action upon any agreement, contract or promise in writing." (5 years) or K.S.A. § 60-512(1) as "All actions upon contracts, obligations or liabilities expressed or implied but not in writing." (3 years). 31 P.3d at 264.

c. Court holds: "We choose to join Oklahoma, Texas, and Montana in holding that the covenants are implied in fact."

d. The source of the implied obligation arises from the express oil and gas lease terms; it is part of the written contract and therefore a "contract . . . in writing."

B. *Rogers v. Westerman Farm Co.*, 29 P.3d 887 (Colo. 2001).

1. Various oil and gas leases providing for payment of royalty based upon either proceeds or market value "at the well" or "at the mouth of the well."

2. Lessee sold some gas at the well and downstream of the well after the gas had been gathered, compressed, dehydrated, and delivered to an interstate pipeline.

3. The gas at issue is "sweet and dry as it emerges from the well." 29 P.3d at 892.

4. Lessors argued:

   a. Gas was not "marketable" at the well and therefore "should not have been sold at the well" but instead must be taken to an interstate pipeline at the lessee's sole expense.

   b. For lessees selling gas at the interstate pipeline, the lessee should not have deducted any costs associated with moving gas from the wellhead to the interstate pipeline.

5. The court finds the "at the well," "market value," "proceeds" and similar express lease language, offer no guidance on the calculation of royalty stating: "Instead, we conclude that because the leases are silent, we must look to the implied covenant to market, and our previous decision in *Garman v. Conoco*, to determine the proper allocation of costs."

6. "In defining whether gas is marketable, there are two factors to consider, condition and location. First, we must look to whether the gas is in a marketable condition, that is, in the physical condition where it is acceptable to be bought and sold in a commercial marketplace. Second, we must look to location, that is, the commercial marketplace, to determine whether the gas is commercially saleable in the oil and gas marketplace." 29 P.3d at 905.

7. "Gas is marketable when it is in the physical condition such that it is acceptable to be bought and sold in a commercial marketplace, and in the location of a commercial marketplace, such that it is commercially saleable in the oil and gas marketplace. The determination of whether gas is marketable is a question of fact, to be resolved by a fact finder." 29 P.3d at 906.

8. "Absent express lease provisions addressing allocation of costs, the lessee's duty to market requires that the lessee bear the expenses incurred in obtaining a marketable product. Thus, the expense of getting the product to a marketable condition and location are borne by the lessee. Once a product is marketable, however, additional costs incurred to either improve the product, or transport the product, are to be shared proportionately by the lessor and lessee." 29 P.3d at 906.

9. "The commercial market and the condition of the gas dictates the marketability of the gas, not the independent actions of a particular lessee." 29 P.3d at 909.

10. "While we agree that a single purchaser, in a good faith purchase of gas, is evidence that there is a market for the gas, we do not agree that such a purchase conclusively establishes a market." 29 P.3d at 910.

C. *Wellman v. Energy Resources, Inc.*, 557 S.E.2d 254 (W. Va. 2001).

1. Energy Resources sold gas to Mountaineer Gas Company for $2.22/Mcf and paid royalty on $0.87/Mcf. When challenged, Energy Resources presented no evidence concerning the nature or existence of any deductions, but merely contended it was entitled to deduct costs.

2. Royalty clause: "1/8th of the proceeds from the sale of gas as such at the mouth of the well . . . ."

3. The court viewed the Colorado (*Garman* version), Kansas, and Oklahoma approaches to the deduction of costs as persuasive, and adopted the following rule: "[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.

4. The court noted the "at the mouth of the well" language "might be language indicating that the parties intended that the Wellmans, as lessors, would bear part of the costs of transporting the gas from the wellhead to the point of sale . . . ." 557 S.E.2d at 265. However, in this case the issue was moot "because Energy Resources, Inc., introduced no evidence whatsoever to show that the costs were actually incurred or that they were reasonable." *Id.*

5. The court also noted that a different rule might apply for leases that provide for a market value measure. 557 S.E.2d at 264, n.3.

PROFESSORIAL MUSING ON THE ROYALTY OBLIGATION

I. HOW SHOULD WE ASCERTAIN THE PROPER SCOPE OF THE OIL & GAS LEASE RELATIONSHIP?

A. Owen L. Anderson, *Royalty Valuation: Should Royalty Obligations Be Determined Intrinsically, Theoretically, or Realistically? Part 1*, 37 NATURAL RESOURCES J. 347 (1997).

B. David E. Pierce, *The Missing Link in Royalty Analysis: An Essay on Resolving Value-Based Royalty Disputes*, 5 TEXAS WESLEYAN L. REV. 185 (1999).

II. IS THE OIL & GAS LEASE A COOPERATIVE RELATIONSHIP?

A. John S. Lowe, *Defining the Royalty Obligation*, 49 SMU LAW J. 223, 251 (1996).

B. David E. Pierce, *Rethinking the Oil and Gas Lease*, 22 TULSA L. J. 445 (1987).

C. David E. Pierce, *Exploring the Jurisprudential Underpinnings of the Implied Covenant to Market*, 48 ROCKY MOUNTAIN MINERAL L. INST. (2002).

D. David E. Pierce, *What's Behind the Valuation Controversy Anyway?*, SPECIAL INSTITUTE ON FEDERAL & INDIAN OIL AND GAS ROYALTY VALUATION AND MANAGEMENT (Rocky Mountain Mineral Law Foundation and Minerals Management Service April 17, 2000).

E. David E. Pierce, *The Royalty Value Theorem and the Legal Calculus of Post-Extraction Costs*, 23 ENERGY & MINERAL L. INST. (2002).

F. Owen L. Anderson, *Calculating Royalty: "Costs" Subsequent to Production–"Figures don't lie, but. . . ."* 33 WASHBURN L. J. 591 (1994).

III. SHOULD COURTS PURSUE AN INTERPRETIVE AGENDA TO "PROTECT" LESSORS BY PROMOTING THEIR INTERESTS?

A. Owen L. Anderson, *Royalty Valuation: Calculating Freight in a Marketable-Product Jurisdiction*, 20 ENERGY & MINERAL L. INST. 331 (2000).

B. Owen L. Anderson, *Calculating Royalty: "Costs" Subsequent to Production–"Figures don't lie, but. . . ."* 33 WASHBURN L. J. 591 (1994).

C. Owen L. Anderson, *Royalty Valuation: Should Royalty Obligations Be Determined Intrinsically, Theoretically, or Realistically? Part 2*, 37 NATURAL RESOURCES J. 611 (1997).

D. David E. Pierce, *The Royalty Value Theorem and the Legal Calculus of Post-Extraction Costs*, 23 ENERGY & MINERAL L. INST. (2002).

IV. WHAT IS THE PROPER ROLE FOR IMPLIED COVENANTS?

A. Owen L. Anderson, *2001: A Royalty Odyssey*, 53 INSTITUTE ON OIL & GAS LAW AND TAX'N (2002).

B. David E. Pierce, *Exploring the Jurisprudential Underpinnings of the Implied Covenant to Market*, 48 ROCKY MOUNTAIN MINERAL L. INST. (2002).

V. POST-EXTRACTION COST ISSUES: ROLE OF EXPRESS LEASE LANGUAGE "MARKET VALUE," "PROCEEDS," "AT THE WELL"

A. Owen L. Anderson, *Royalty Valuation: Should Royalty Obligations Be Determined Intrinsically, Theoretically, or Realistically? Part 2*, 37 NATURAL RESOURCES J. 611 (1997).

B. David E. Pierce, *Royalty Calculation in a Restructured Gas Market*, 13 EASTERN MINERAL L. INST. 13-1 (1993).

VI. POST-EXTRACTION COST ISSUES: PRODUCTION AND POST-PRODUCTION COSTS vs. MARKETABLE PRODUCT ANALYSIS

A. Owen L. Anderson, *Royalty Valuation: Should Royalty Obligations Be Determined Intrinsically, Theoretically, or Realistically? Part 2*, 37 NATURAL RESOURCES J. 611 (1997).

B. David E. Pierce, *Developments in Nonregulatory Oil & Gas Law: The Continuing Search for Analytical Foundations*, 47 INSTITUTE ON OIL & GAS LAW AND TAX'N 1-1 (1996).

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VII. POST EXTRACTION COST ISSUES: THE PROPER SCOPE OF A MARKETABLE PRODUCT ANALYSIS

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B. David E. Pierce, *The Royalty Value Theorem and the Legal Calculus of Post-Extraction Costs*, 23 ENERGY & MINERAL L. INST. (2002).

VIII. POST EXTRACTION COST ISSUES: MEASURING COSTS FOUND TO BE DEDUCTIBLE

A. Owen L. Anderson, *Calculating Royalty: "Costs" Subsequent to Production–"Figures don't lie, but. . . ."* 33 WASHBURN L. J. 591 (1994).

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B. David E. Pierce, *Exploring the Jurisprudential Underpinnings of the Implied Covenant to Market*, 48 ROCKY MOUNTAIN MINERAL L. INST. (2002).

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A. 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 Standard as Lease Royalty?* 35 LAND AND WATER L. REV. 1 (2000).

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A. Owen L. Anderson, *David v. Goliath: Negotiating the "Lessor's 88' and Representing Lessors and Surface Owners in Oil and Gas Lease Plays*, 27B ROCKY MOUNTAIN MINERAL L. INST. 1029 (1982).

B. David E. Pierce, *Incorporating a Century of Oil & Gas Jurisprudence into the 'Modern' Oil & Gas Lease*, 33 WASHBURN L. J. 786 (1994).

C. David E. Pierce, *Drafting Royalty Clauses*, 18TH ANNUAL ADVANCED OIL, GAS AND MINERAL L. COURSE 12-1 (State Bar of Texas 2000).

D. David E. Pierce, *Royalty Calculation in a Restructured Gas Market*, 13 EASTERN MINERAL L. INST. 13-1 (1993).

E. David E. Pierce, *The Royalty Value Theorem and the Legal Calculus of Post-Extraction Costs*, 23 ENERGY & MINERAL L. INST. (2002).

XIII. USE OF CLASS ACTION TO LITIGATE ROYALTY DISPUTES?

A. Owen L. Anderson, *2001: A Royalty Odyssey*, 53 INSTITUTE ON OIL & GAS LAW AND TAX'N (2002).

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