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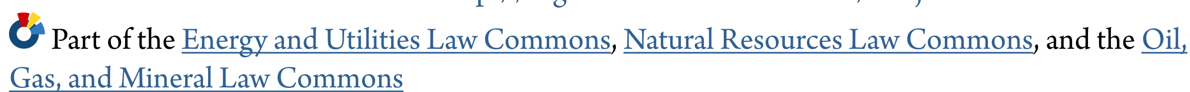
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Oil and Gas, Natural Resources, and Energy Journal

VOLUME 2 NUMBER 3

KANSAS

Sarah Trainer & Steven A. Rhodes[*]

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I. Introduction

The following is an update on Kansas legislative activity and case law relating to oil, gas and mineral law from August 1, 2015 to July 1, 2016.

II. Legislative And Regulatory Developments

On October 23, 2015, Kansas Administrative Regulation § 82-3-304, Tests of Gas Wells, was amended to no longer require an annual shut-in pressure test for gas wells, in addition to other changes detailed below.[1]

The amendment made three main changes to the statute. First, it lengthened the amount of time operators have to submit initial 24-hour shut-in pressure tests on new gas wells from 30 days to 120 days. Second, it increased the amount of gas a well must be capable of producing before requiring certain annual testing requirements to 500 mcf per day. Finally, it eliminated the need for operators to file annual exemptions for gas wells incapable of producing enough gas to trigger the annual testing requirements, which eliminated the need for an annual shut-in pressure test.[2]

These amendments were made for several reasons. Production at most gas wells is low enough that the tests typically had no effect on the minimum production allowable provided for by regulation at each well. Also, shut-in pressures are low enough that the data gathered no longer had much value. Another reason for the amendments was because low field pressures coupled with the nature of the tests can cause negative effects on production. The principal economic impact of these amendments will be the savings to operators from no longer needing to file annual exemption forms with the State Corporation Commission and no longer needing to conduct annual shut-in pressure tests to obtain the exemptions.[3]

Although outside of the applicable time frame of this article, it is worth noting that effective July 1, 2015, SB 124 was enacted to regulate land-spreading of solid waste generated by drilling oil and gas wells. The bill requires the sellers of any property where land spreading has occurred within the previous three years to disclose the land-spreading to any potential purchaser of the property prior to closing.[4]

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1. KAN. ADMIN. REGS. § 82-3-304 (2015).
2. KANSAS CITIZENS UTILITY RATEPAYER BOARD, Kansas Corporation Commission—K.A.R. § 82-3-304 (2015), http://www.crrb.ks.gov/regulation-detail/2015/06/02/kansas-corporation-commission---k.a.r.-82-3-304.
3. *Id.*
4. S.B. 124, 2015 Leg., 1st Sess. (KS. 2015).

III. Judicial Developments

A. Supreme Court Cases

Fawcett v. Oil Producers, Inc. of Kansas

In *Fawcett v. Oil Producers, Inc. of Kansas*, the Supreme Court of Kansas ("the Court") addressed (1) whether an operator's duty to bear the expense of making gas marketable is satisfied when the operator delivers raw natural gas to purchasers at the well in good faith transactions; and (2) whether the operator may take into account the deductions and adjustments identified in third-party purchase agreements when calculating royalties owed to the lessors.[5]

This was a class action for underpayment of royalties claimed under twenty-five oil and gas leases entered into between 1944 and 1991, of which Oil Producers, Inc. ("the Operator") is the lessee-operator.[6] The royalty provisions in the leases called for the royalty calculations to be made based on a sale of gas at the well, or on the market value at the well.[7] Natural gas coming from the ground in its raw condition must be processed before it is suitable for interstate pipelines.[8] The Operator lacked the means to independently process the raw natural gas and make it suitable for transport, so it entered into third-party purchase agreements where the purchaser did the processing of the raw natural gas.[9] The expense of processing the raw natural gas was deducted from the purchase price the third-party purchaser paid to the Operator, and the Operator had been deducting a proportionate share of that expense from the royalties paid to the class of lessors ("the Class").[10]

At the lower court, the Class argued (1) the royalty payments should be free of such deductions because the "marketable condition rule" places the burden of making gas marketable solely on the operator;[11] (2) raw natural gas is not marketable at the well since it was unsuitable for delivery into interstate pipelines;[12] and (3) the deductions in the purchase contracts simply represented expenses to make the gas marketable, which was the

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5. 352 P.3d 1032, 1038 (Kan. 2015).
6. *Id.* at 1034.
7. *Id.*
8. *Id.* at 1035.
9. *Id.*
10. *Id.*
11. *Id.* at 1036-37.
12. *Id.*

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Operator's obligation alone.[13] The Operator argued its royalty payments were proper because they were calculated on 100% of its actual proceeds from its sale of the gas at the wellhead.[14]

The lower court concluded the Operator's obligation prohibits deductions from royalties except as might be expressly authorized in the lease, noting no such language appears. The Operator petitioned the Supreme Court of Kansas for review, which was granted.[15]

As the Court framed it, the primary issue in this case was whether an operator is "solely responsible under the common-law marketable condition rule for the costs and adjustments taken by third-party purchasers."[16]

Under Kansas law, a lease imposes on an operator an implied duty to market the minerals produced. To satisfy this duty, an operator has to market its production at reasonable terms within a reasonable time following production.[17]

In this case, the Operator claimed its duty was fulfilled when it entered into the purchase agreements for sale of the gas at the wellhead and that the pricing formulas in the purchase agreements gave both itself and the royalty owners the opportunity to share in higher prices received for the gas as it got closer to the consumer.[18]

The Class argued "the 'marketable condition rule,' which is an offshoot of the implied duty to market, imposes on the operators the obligation to make gas marketable at the operators' own expense."[19] The Class further claimed that "raw natural gas sold at the well is not marketable as a matter of law or fact until it is processed and enters an interstate pipeline, so its royalties cannot be reduced by the processing costs that are set out as deductions in the purchase agreements."[20]

The Court turned to prior Kansas cases for guidance on this issue. In *Gilmore v. Superior Oil Co.*, the lease required the operator to pay for gas sold, "as royalty 1/8 of the proceeds of the sale thereof at the mouth of the well." [21] The operator had built a compressor station on the leased premises to collect and compress the gas, which allowed the operator to sell the gas

13. *Id.*
14. *Id.* at 1036.
15. *Id.* at 1038.
16. *Id.*
17. *Id.* at 1039-40 (citing Smith v. Amoco Production Co., 31 P.3d 255 (Kan. 2001)).
18. *Id.* at 1039.
19. *Id*.
20. *Id.*
21. 388 P.2d 602, 605 (Kan. 1964).

and sought contribution from the royalty owners for the compression costs.[22] In holding that the deductions of the expense of the compressor station from the royalty payments were improper, the court in *Gilmore* reasoned that the compression simply "made the gas marketable and was in satisfaction of the duties of the lease [operator] to do so."[23]

In *Schupbach v. Continental Oil Co.*, the facts were nearly identical to those in *Gilmore*, and the Court similarly held that the operator could not deduct the compression cost from the gross proceeds in calculating the royalties. [24]

In *Sternbe*rger v. Marathon Oil Co.*, [25] the lease language also required the operator to pay royalties based on "the market price at the well for gas sold or used."[26] As in the prior cases, the operator built a compressor and deducted a proportionate share of that expense from the royalties paid to the lessors. However, in this case the third-party purchasers were unwilling to build a gathering pipeline system to access the well, so the operator built one at his own expense. The operator then deducted a proportionate share of said expense from the royalties paid to the lessors.[27] The court in *Sternberger* held that the operator could not deduct the compression cost from its gross proceeds in computing royalties, but could deduct a proportionate share of the expense of building the gathering pipeline system from the royalty payments because the royalties were based on the market value of the gas at the well, and the operators had done nothing to prepare the wellhead gas for sale other than move it from the place where its value was to be determined (the well) to the purchaser.[28]

Taking these three cases into consideration, the Court in *Fawcett* reasoned that (1) when gas is sold at the well it has been marketed; and (2) when the operator is required to pay royalty on its proceeds from such sales, the operator may not deduct any pre-sale expenses required to make the gas acceptable to the third-party purchaser.[29]

The Court reversed the decisions of the lower courts and remanded the case to the district court, holding that "when a lease provides for royalties

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22. *Id.* at 604.
23. *Id.* at 606.
24. Schupbach v. Continental Oil Co., 394 P.2d 1 (1964).
25. Sternberger v. Marathon Oil Co., 894 P.2d 788 (1995).
26. Fawcett v. Oil Producers, Inc. of Kansas, 352 P.3d 1032, 1040-41 (Kan. 2015) (quoting *Sternberger*, 894 P.2d at 793).
27. *Id.*
28. *Id.* at 1041.
29. *Id.*

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based on a share of proceeds from the sale of gas at the well, and the gas is sold at the well, the operator's duty to bear the expense of making the gas marketable does not, as a matter of law, extend beyond that geographical point to post-sale expenses."[30]

B. Appellate Activity

Oxy USA, Inc. v. Red Wing Oil, LLC

In *Oxy USA, Inc. v. Red Wing Oil, LLC*, the Court of Appeals of Kansas addressed, *inter alia*: (1) whether production within a unit, but outside of the subject property, constitutes "production" as the term is used in a deed reservation that fails to define "production"; and (2) whether failing to take legal action to have the holder of an expired term ousted from the property constitutes acquiescence and estops the reversionary interest holder from claiming their reversionary interest.[31]

In April 1945, Frank Luther conveyed a tract of land containing 160 acres, subject to an existing oil and gas lease ("the Luther lease"), unto E.W. Rahenkamp, reserving a one-half interest in the mineral rights for a period of twenty years "or as long thereafter as oil, gas or other minerals is produced therefrom."[32]

The Luther lease was unitized and consolidated with neighboring leaseholds and oil and gas was thereafter continuously produced on those neighboring leaseholds.[33] However, no oil and gas was produced directly on the Luther lease lands from March 27, 1945 until 2009, when Oxy USA, Inc. began producing oil and/or gas from the Tice Cattle #3 well.[34]

Through a series of conveyances: (i) Alice LaVelle King ("King") is the current owner of the interest conveyed unto E.W. Rahenkap in April 1945; (ii) the one-half mineral interest reserved unto Frank Luther became vested in multiple parties, *inter alia*, those parties identified herein as "the Luther mineral interest holders"; and (iii) Oxy USA, Inc. became the successor lessee under the Luther lease.[35]

Oxy USA, Inc. was unable to determine who it should be making royalty payments to under the Luther lease so it filed an interpleader and quiet title action to determine who currently holds the mineral rights to the property.[36]

30. *Id.*
31. 360 P.3d 457 (Kan. Ct. App. 2015).
32. *Id.* at 459.
33. *Id.*
34. *Id.* at 460.
35. *Id.*
36. *Id.*

The district court granted summary judgment in favor of the Luther mineral interest holders, holding that King's reversionary interest was triggered in 1972, but that her claim was untimely and, as a result, she acquiesced in the continuation of the Luther mineral interest.[37] King appealed, and the Luther mineral interest holders cross-appealed the decision of the district court.[38]

The first issue the Kansas Court of Appeals ("the Court") examined was whether production within a unit, but outside of the subject property, qualifies as "production" in the context of a term reservation for a stated term of years "or as long thereafter as oil, gas or other minerals is produced therefrom."[39]

The Court first addressed this issue in *Smith v. Home Royalty Association, Inc.*,[40] reasoning that the terms of a lease could not control the interpretation given to the terms of a deed, and therefore, if a deed does not define production to include a unitized or consolidated lease agreement, then the term "production" in the deed must only refer to production occurring on the subject property.[41]

The Court revisited the issue eight years later in *Classen v. Federal Land Bank of Wichita*[42], overturning *Smith* and holding that "production within the meaning of a defeasible term mineral interest included production occurring on unitized or consolidated lease property."[43]

Ten years after *Classen*, the Court once more revisited the issue in *Kneller v. Federal Land Bank of Wichita.*[44] This time the question before the Court was whether the rule stated in *Classen* should be applied retroactively to situations where the term of a defeasible mineral interest had expired prior to the *Classen* decision.[45] The Court held that *Classen* should not be applied retroactively, thus leaving *Smith* to control in situations where the term of the reservation had expired prior to the *Classen* decision.[46]

Because the term reservation in *Oxy USA, Inc.* expired prior to *Classen*, and there was no production on the subject property during the twenty-year

37. *Id.*
38. *Id.* at 460.
39. *Id.* at 457, 461.
40. 498 P.2d 98, 101-02 (Kan. 1972).
41. *Oxy USA, Inc.*, 360 P.3d at 461.
42. 617 P.2d 1255, 1257-59 (Kan. 1980).
43. *Oxy USA, Inc.*, 360 P.3d at 461-62 (citing *Classen*, 617 P.2d at 1252-64).
44. 799 P.2d 485, 489-90 (Kan. 1990).
45. *Oxy USA, Inc.*, 360 P.3d at 461-62 (citing *Kneller*, 799 P.2d 485, 489-90).
46. *Id.*

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term, the Court held that *Smith* should control. Therefore, the Court held that the reversionary interest was triggered and reverted to King.[47]

The Court also examined whether failing to take legal action to have the holder of an expired term ousted from the property constitutes acquiescence and estops the reversionary interest holder from claiming their reversionary interest.[48]

Acquiescence is defined as "an assertion of rights inconsistent with past conduct, silence by those who ought to speak, or situations wherein it would be unconscionable to permit a person to maintain a position inconsistent with one in which [the person] has acquiesced."[49]

The Luther mineral interest holders argue that King's failure to take legal action since 1972 to claim her reversionary interest constitutes acquiescence and precludes her from now claiming ownership of the reversionary interest.[50]

The Court focused on the facts in the present case to determine this issue. Because there was no production on the subject property until 2009, King lacked any specific incentive to quiet title against the Luther mineral interest holders unless she planned to sell the property.[51] The Court found King's lack of action to not be inconsistent with her present claim of ownership.[52] Therefore, the Court held that a claim of acquiescence does not apply to the reversionary interest of King.[53]

The Court of Appeals of Kansas reversed and remanded the decision of the district court with instructions to enter judgment for King.

C. Trial Activity

None reported.

47. *Id.*
48. *Id.* at 462.
49. *Id.* at 464 (quoting Harrin v. Brown Realty Co., 602 P.2d 79, 84 (Kan. 1979)).
50. *Id.* at 462.
51. *Id.* at 464.
52. *Id.* at 465.
53. *Id.*