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I. INTRODUCTION

A natural gas lessor is customarily paid a royalty by the lessee based upon a certain fraction of production as set forth in the royalty provision of the lease pertaining to the lessor's property. Because the physical nature of natural gas makes the payment of royalties in kind impracticable, royalty provisions typically found in gas leases contemplate that the lessee will pay to the lessor a royalty equal to some fraction of the "proceeds" the lessee receives from the sale of the gas or a fraction of the "market value" or "market price" of the gas. Most royalty provisions do not expressly address which costs or expenses, if any, the lessee may deduct from the royalty paid to the lessor. It may be argued that lessees should be able to deduct certain "post-production" expenses, including compression expenses, from royalties paid to lessors.[1] The courts of the natural gas producing states are divided as to whether lessees may deduct such expenses absent explicit language in the royalty provision allowing such deductions.

1. "Post-production" expenses are those expenses incurred by the lessee *after* the gas has been brought to the wellhead and are to be contrasted with "production" expenses which are incurred in bringing the gas to the wellhead. "Post-production" expenses include costs of dehydration, processing, gathering, compression and transportation.

Prior to the recent Oklahoma Supreme Court decision in *Fox Wood III v. TXO Prod. Co.*,[2] most commentators[3] and most producers in the Oklahoma oil and gas industry[4] placed Oklahoma among the states that permit compression expenses to be deducted from royalties absent contrary language in the governing lease. In *Wood*, however, the Oklahoma Supreme Court (the "Court") held, in a five-four decision, that the costs of compressing gas for delivery into a pipeline on the lease premises could not be deducted from royalties absent express language so providing in the lease. As a result of the *Wood* decision, Oklahoma was suddenly transformed into a state that, absent express authorization in the lease, does not allow post-production expenses to be deducted from royalties.

The *Wood* decision was based on suspect authority and is insupportable under prior Oklahoma case law. *Wood* should be overturned because it places an unreasonable and unforeseeable burden on lessees. To the extent that the *Wood* decision remains the law in Oklahoma, we argue that its holding should be applied only narrowly and prospectively and only to similar factual situations.

II. SUMMARY OF THE *WOOD* DECISION

A. *Facts*

The Plaintiffs in *Wood* executed two oil and gas leases in favor of TXO's predecessor lessee on December 12, 1978. The leases provided for the Plaintiffs to receive a royalty of "3/16 at the market price at the

2. 854 P.2d 880 (Okla. 1993) (modifying 63 Okla. B.J. 2023 (July 11,1992)). The original opinion was modified to delete references the Court had made to the effect that the *Wood* decision was in accordance with the "custom and practice" of the natural gas industry in Oklahoma.

3. *See* Richard B. Altman & Charles S. Lindberg, *Oil and Gas: Non-Operating Oil and Gas Interests' Liability for Post-Production Costs and Expenses*, 25 OKLA. L. REV. 363, 376 (1972); M. Keith Blythe, Note, Hanna Oil and Gas Co. v. Taylor: *Compression Costs in Oil and Gas Leases—Who Pays?*, 43 ARK. L. REV. 201, 207 (1990); RICHARD W. HEMINGWAY, LAW OF OIL & GAS, § 7.4(F) at 361 n.46 (2d ed. 1983); EUGENE KUNTZ, A TREATISE ON THE LAW OF OIL AND GAS, § 40.5 at 353 n.27 (1991); J. Clayton La Grone, *Calculating the Landowners' Royalty*, 28 ROCKY MTN. MIN. L. INST. 803, 817 (1982); T. Lynam, *Royalty and Overriding Royalty Payments and Deductible Expenses*, 6 E. MIN. L. INST. 14-1, 14-9 (1985); G. Alan Perkins, Note, *Oil and Gas—Deductions Under a Proceeds Royalty Lease—Arkansas Puts the Pressure on Lessee*, 12 U. ARK. LITTLE ROCK L.J. 395, 398 n. 23 (1989-90); Robert R. Reis, Comment, *Oil and Gas: Lessee's Duty to Compress Gas in Order to Make the Gas Marketable*, 18 OKLA. L. REV. 94, 97 (1965).

4. *See* Motion of Oklahoma Independent Petroleum Association for Leave to Intervene as *Amicus Curiae* in Support of a Petition for Rehearing, Including a Statement in Support of Rehearing at 4; Fox Wood III v. TXO Prod. Co., 854 P.2d 880, 881 (Okla. 1993) (No. 75,929) (stating that the custom and practice of the gas industry in Oklahoma has been that a lessor, absent a contrary provision in the governing lease, is charged a proportionate share of post-production compression charges).

well for the gas sold." After the leases were assigned to TXO, TXO sold the gas produced under purchase contracts which required TXO to deliver the gas at sufficient pressure for entry into the purchaser's pipeline on the leased premises. For some time, the wells produced at sufficient pressure to enter the purchaser's pipeline without compression. Later, the pressure from the wells dropped, and TXO built compressors on the lease premises in order to push the gas into the purchaser's pipeline as required by the purchase contracts. After the compressors were built, TXO began subtracting the lessors' proportionate share of the compression costs from their royalties. Plaintiffs filed suit in the United States District Court for the Eastern District of Oklahoma to recover the withheld compression charges. The District Court certified the following question to the Court:

> Is an oil and gas lessee/operator who is obligated to pay the lessor '3/16 at the market price at the well for gas sold,' entitled to deduct the cost of gas compression from the lessor's royalty interest?[5]

B. *Summary of the Majority Opinion*

The Court's majority recognized that a split of authority exists among the gas-producing states as to the deductibility of compression costs and other post-production expenses from royalties.[6] Generally, Arkansas and Kansas do not allow such costs to be deducted, while Texas and Louisiana do. The Court examined the distinction made by the Texas and Louisiana courts between production and post-production expenses and their holding that all post-production expenses are deductible from royalties. The Court then explicitly rejected the Texas and Louisiana position and, citing the Oklahoma case of *Johnson v. Jernigan*,[7] indicated that the Court had thus far held only that *transportation* costs,[8] and not any other post-production expenses, must be shared by lessors. The Court espoused the view that gas is "sold" when it enters the purchaser's pipeline, and where that pipeline is located on the lease premises, there is no "transportation" cost.

5. *Wood*, 854 P.2d at 880.
6. *Id.* at 881.
7. 475 P.2d 396 (Okla. 1970).
8. Transportation costs are costs incurred in transporting gas to the purchaser's pipeline. Such costs usually entail usage fees for using a third party's pipeline or gathering system or the costs of building a new pipeline or gathering system which connects with the purchaser's pipeline.

Apparently, compression costs incurred to "transport" gas to a purchaser's pipeline *off the leased premises* would be deductible transportation expense under *Wood.*

The Court indicated it was not prepared "to require the lessor to bear compression costs as a matter of law where there is no agreement between the lessor and lessee to share those costs," because "[t]he lessee is in a position to provide specifically in its leases that lessors will be required to share in compression costs."[9] The Court apparently did not view the "market price at the well" clause in the royalty provision as indicating the parties' agreement that the price of the gas for royalty purposes was to be fixed at the wellhead, i.e., before any processing or compression took place.

The Court cited the Kansas Supreme Court cases of *Gilmore v. Superior Oil Co.,*[10] *Schupbach v. Continental Oil Co.,*[11] and the Arkansas Supreme Court case of *Hanna Oil and Gas Co. v. Taylor*[12] as authority for its position, noting that the two Kansas cases turned upon an interpretation of the lessee's duty to diligently market the gas as entailing a duty to "mak[e] the gas marketable" by compressing the gas for delivery to the purchaser's pipeline at the lessee's sole expense, and that *Taylor* held that lessees are in a position to change lease language to specifically provide for the deduction of compression costs if they so desire.[13]

The majority then stated that, in Oklahoma, the gas purchase contract price is the "market price" for purposes of the royalty provision, implying that lessees are not entitled to make any deductions from the contract price when paying royalties under a "market price" or "market value" royalty provision.[14] The Court apparently failed to fathom or simply disregarded the inherent conflict between its position that "contract price equals market price" and its affirmation that transportation costs are deductible from royalties.[15]

9. Fox Wood III v. TXO Prod. Co., 854 P.2d 880, 881 (Okla. 1993).

10. 388 P.2d 602 (Kan. 1964).

11. 394 P.2d 1 (Kan. 1964).

12. 759 S.W.2d 563 (Ark. 1988).

13. *Wood,* 854 P.2d at 882.

14. *Id.* at 882 (citing Tara Petroleum Corp. v. Hughey, 630 P.2d 1269 (Okla. 1981)).

15. Once transportation costs are allowed to be deducted from the contract price, then the contract price is no longer equal to the "market price" upon which royalties are based. Once *any* deductions are allowed from the contract price received by the lessee, then the "contract price equals market price" precept is violated and fails to prevent other post-production expenses from being deducted.

The Court set forth its view that the lessee's implied duty to market gas included a duty to get the gas to the place of sale in marketable form. Therefore, the Court reasoned, lessees should properly bear the risk that gas will be unmarketable because its natural pressure is low.[16] Low pressure gas requires compression in order to transport it to a purchaser's pipeline.

Finally, the majority attempted to distinguish the Texas and Louisiana position which allows lessees to deduct compression and other post-production expenses. The Court pointed out that the Louisiana case of *Merritt v. Southwestern Electric Power Co.*,[17] used a "reconstruction" approach to determine the market value of the gas produced by subtracting the costs of moving gas from the wellhead to the pipeline from the gross proceeds received for the gas, as opposed to the Oklahoma approach set forth in *Hughey* that the contract price equals the market price.[18] The Court also pointed out that the royalty provision in the Texas case of *Martin v. Glass*[19] called for a royalty of "1/8 of the net proceeds at the well," which clearly suggested that some costs were to be deductible.[20]

The Court concluded its opinion by explicitly rejecting the Texas/Louisiana approach and choosing to follow the Kansas/Arkansas approach. The Court held that the lessee's duty to market the gas included the duty to prepare the gas for market. The Court indicated its unwillingness to require lessors to share in costs over which they have no control or input. It once again stated that if the lessee had wanted the lessors to share in compression costs, the lessee could have added specific language to that effect in its oil and gas leases.[21] The Court answered the certified question in the negative.

C. *Summary of the Dissenting Opinion*

The dissent rejected the majority position on the ground that it imposed an "undue burden" on the lessee by placing on it the sole responsibility for adding a cost-apportionment clause to the lease and the entire expense of gas compression—including all post-production

16. Fox Wood III v. TXO Prod. Co., 854 P.2d 880, 882-83 (Okla. 1993).

17. 499 So.2d 210 (La. Ct. App. 1986).

18. *Wood*, 854 P.2d at 882. Again, the Court ignored the ramifications of its admission that transportation costs are deductible on its "contract price equals market price" position.

19. 571 F. Supp. 1406 (N.D. Tex. 1983), *aff'd*, 736 F.2d 1524 (5th Cir. 1984).

20. *Id.*

21. *Wood*, 854 P.2d at 883.

compression costs.[22] The dissent would have adopted the Texas and Louisiana approach, supported by the majority of commentators,[23] which provides that, where a lease contains no cost-apportionment provision, the lessee is allowed to deduct compression expenses incurred to move the gas from the wellhead to the pipeline, as well as any other post-production expenses from the lessor's royalties.[24]

The dissent pointed out that since gas is measured at the wellhead and the lease required that the royalty be based upon the market price of the gas at the wellhead the lessee's implied duty to market the gas does not place upon the lessee the sole burden of expenses incurred after the gas passes through the wellhead, i.e., post-production costs.[25] Compression costs necessary to deliver gas from the wellhead into a purchaser's pipeline are post-production expenses which arguably should be borne proportionately by lessors, while compression costs which are required in order to bring the gas up to the wellhead are production costs which should be borne solely by lessees.

The dissent then briefly analyzed the cases supporting both the Kansas/Arkansas view and the Texas/Louisiana view, pointing out that the Kansas/Arkansas view, as espoused in *Gilmore*, *Schupbach* and *Taylor*, has been strongly criticized by many commentators, with some taking the view that the three cases are insupportable under prior case law in Kansas and Arkansas and should be given a restrictive application.[26] The dissent concluded that the Texas/Louisiana approach was preferable because it did not unfairly encumber lessees with the burden of including a cost-apportionment provision in their leases and because the dichotomy between production expenses and post-production expenses provided a clear division between costs which should be borne solely by lessees and those which should be shared by lessors.[27]

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22. *Id.*, at 883 (Opala J., dissenting).

23. Altman & Lindberg, *supra* note 3, at 365-66; Blythe, *supra* note 3, at 210; HEMINGWAY, *supra* note 3, § 7.4; KUNTZ, *supra* note 3, § 40.5(b) at 352; Frederick R. Parker, Jr., *Costs Deductible by the Lessee in Accounting to Royalty Owners for Production of Oil or Gas*, 46 LA. L. REV. 895, 906 (1986); Perkins, *supra* note 3, at 398; Donald W. Vasos, *Oil and Gas—Deduction of Compression Costs from Lessor's Royalty Payments,* 14 KAN. L. REV. 128, 131-32 (1965).

24. Fox Wood III v. TXO Prod. Co., 854 P.2d 880, 883 (Okla. 1993) (Opala, J., dissenting).

25. *Id.* at 884-85.

26. *See infra* note 38.

27. *Wood,* 854 P.2d 880, 887-888 n.29 (Okla. 1993) (Opala, J., dissenting) (citing Perkins, *supra* note 5, at 404).

III. Analysis of the *Wood* Decision

The dissenting opinion is the better reasoned approach. The majority opinion is supported solely by highly-criticized Kansas and Arkansas decisions (which arguably provide only minimal support for the *Wood* majority's decision), ignores or misapplies prior Oklahoma case law, unjustifiably expands the nature and scope of a lessee's implied duty to market gas into a duty to "make the gas marketable," and unfairly burdens Oklahoma gas producers with compression costs after they have entered into their leases with the reasonable expectation, based upon prior Oklahoma authority, that the royalty provisions of their leases allow them to deduct compression costs from gas royalties.

A. *The Kansas and Arkansas Cases Relied Upon by the* Fox Wood *Majority are Suspect*

1. *Gilmore* and *Schupbach*

The primary authority relied upon by the *Wood* majority to support their opinion are the *Gilmore* and *Schupbach* decisions. *Gilmore* and *Schupbach* are factually similar cases both of which deal with lease provisions which call for royalties to be paid on "1/8 of the proceeds of the sale of gas at the mouth of the well."[28] The *Gilmore* holding was based upon the rule that any ambiguous provisions in a lease should be construed against the lessee,[29] and upon a determination that lessees have a duty to "use reasonable diligence in finding a market for the product."[30] Significantly, after stating the rule that ambiguities in oil and gas leases should be construed against the lessee, the *Gilmore* court never indicated what, if any, ambiguity existed in the lease. In our view, leases which provide that royalties shall be determined "at the well" indicate in sufficient detail the place and manner in which royalties are to be determined so as not to be ambiguous.[31]

Regarding the expansion of the lessee's duty to diligently market gas into a duty to make the gas marketable, the *Gilmore* court cited the following passage from Dr. Merrill's treatise on implied covenants:

28. Gilmore v. Superior Oil Co., 388 P.2d 602, 603 (Kan. 1964); Schupbach v. Continental Oil Co., 394 P.2d 1 (Kan. 1964).
29. *Gilmore*, 388 P.2d at 605.
30. *Id.* at 606.
31. Where there is no finding that an oil and gas lease is ambiguous, the intention of the parties is to be determined from the language of the lease. *See* Carlisle v. United Producing Co., 278 F.2d 893, 895 (10th Cir. 1960).

> If it is the lessee's obligation to market the product, it seems necessarily to follow that his is the task also to prepare it for market, if it is unmerchantable in its natural form. No part of the costs of marketing or of preparation for sale is chargeable to the lessor. This is supported by the general current of authority.[32]

The *Gilmore* court also cited Dr. Merrill to support its notion that lessees should be solely responsible for any expenses incurred in preparing gas for market.[33] The *Schupbach* court merely indicated that the issue of the deduction of compression costs was settled by the *Gilmore* decision.[34]

Dr. Merrill's claim that a lessee's duty to prepare unmerchantable gas for market is supported by the "general current of authority" has been persuasively criticized.[35] It seems that a lessee's duty to market the product should not encompass a duty to transform the product produced from the well into a different, more valuable product and to market that new product all at the lessee's sole expense.

As mentioned above, the *Gilmore* and *Schupbach* decisions have been criticized by a number of commentators as being against the great weight of authority and as being insupportable under prior Kansas case law.[36] Altman and Lindberg, two commentators in particular, have argued persuasively that the *Gilmore* court confused the lessee's duty to exercise diligence in marketing with an obligation to pay all of the marketing expenses — a duty which they said has little, if any, support in case law.[37] The same commentators also argued that post-production expenses such as costs of compression, dehydration,

32. *Gilmore*, 388 P.2d at 607 (quoting Maurice H. Merrill, Merrill on Covenants Implied in Oil and Gas Leases, § 85, at 214-15 (2d ed. 1940)). Dr. Merrill later modified his initial assertion that the duty of a lessee to make gas marketable at his own expense was supported by the "general current of authority," and admitted that "actually the decisions vary." Altman & Lindberg, *supra* note 3, at 369-70 (citing Maurice H. Merrill, *Implied Covenants in Oil and Gas Leases*, 1959 U. Ill. L. F. 584, 591).

33. Gilmore v. Superior Oil Co., 388 P.2d 602, 607 (Kan. 1964).

34. Schupbach v. Continental Oil Co., 394 P.2d 1, 4 (Kan. 1964).

35. Altman & Lindberg, *supra* note 3, at 370-80.

36. *See* Piney Woods Country Life School v. Shell Oil Co., 539 F. Supp. 957, 973 (S.D. Miss. 1982) (finding that *Gilmore* and *Schupbach* are unconvincing and apparently in conflict with prior authority), *aff'd in part, rev'd in part on other grounds*, 726 F.2d 225 (5th Cir. 1984), *cert. denied*, 471 U.S. 1005 (1985); Altman & Lindberg, *supra* note 3, at 379 (arguing that *Gilmore* and *Schupbach* are insupportable under Kansas law and should be given a restrictive application); 3A W. L. Summers, The Law of Oil and Gas § 589, at 21, n.18 (Supp. 1991) ("Though this text was cited [by Gilmore], it is believed the case is contrary to the majority rule and lays upon the lessee a financial burden not necessarily a part of the duty to market."); A.B.A. Section of Mineral and Natural Resources Law, Committee Report, 69 (1964) ("This case [*Gilmore*] appears to be entirely contrary to the great weight of opinion, and in fact, cannot be reconciled with established precedent in the State of Kansas.").

37. *See* Altman & Lindberg, *supra* note 3, at 376-379.

processing, and transportation should be apportioned among lessors because royalties are to be determined under most leases "at the wellhead." In other words, a lessee's duty to market the product ceases at the wellhead. "Post-production" compression costs, in particular, are analogous to and should be treated like transportation costs since compression costs are incurred only to push or transport gas into the purchaser's pipeline.[38]

In fact, if any type of post-production expense should fall within the lessee's duty to market gas it is transportation expense, not the other post-production expenses. Transportation expense is incurred merely to transport gas in its natural state (i.e., the substance which was actually produced from the well) from the wellhead, at which no market for the gas exists, to a pipeline at which there is a market for the gas. Conversely, costs of compression, dehydration and processing are all attributable to the transformation of the gas from its natural state as produced at the well into a new, more valuable product.[39] It seems unreasonable to allow lessors to benefit from higher prices received for processed or compressed gas that result from the post-production activities after the gas passes the wellhead (where, according to most leases, the gas is to be measured for royalty purposes) without requiring the lessors to share in the costs of such activities. As Altman and Lindberg stated, "[i]t defies logic to argue that where gas cannot be sold at the wellhead because of its inferior quality the lessee's duty to market gas can be converted into a duty to *render the gas more valuable than it actually was, all at his own expense*."[40]

Other criticism of the *Gilmore* and *Schupbach* decisions results from their seeming disregard of prior Kansas case law.[41] At least one prior Kansas Supreme Court case seemed to prescribe a different result than that reached in *Gilmore* and *Schupbach*. In *Matzen*, the Kansas Supreme Court held that a lessee's royalty obligation was to be measured by a "proceeds-less-expenses" formula.[42] This "proceeds-less-expenses" formula, the court explained, provided that the

38. *Id.* at 378.

39. The new products resulting from such processes would include "dry" gas (resulting from dehydration) instead of "wet" gas, "sweet" gas (resulting from processing) instead of "sour" gas, and high pressure gas (resulting from compression) instead of low pressure gas.

40. *See* Altman & Lindberg, *supra* note 3, at 379.

41. *See* Piney Woods Country Life School v. Shell Oil Co., 539 F. Supp. 957, 972-73 (S.D. Miss. 1982). The *Piney Woods* court noted that the *Gilmore* and *Schupbach* holdings conflicted with *Matzen*. *See* Matzen v. Hugoton Production Co., 321 P.2d 576 (Kan. 1958) (holding that gathering, processing, and dehydrating expenses must be deducted to calculate that value of the gas at the wellhead).

42. *Matzen*, 321 P.2d at 582-83.

royalty to be paid to the lessor should be based upon the gross proceeds received on the sale of the gas less "reasonable expenses relating directly to the costs and charges of gathering, processing and marketing the gas."[43] The *Gilmore* court attempted to distinguish *Matzen* but did so unconvincingly.

The *Gilmore* court disregarded *Matzen* on the basis that the parties in that case had stipulated that the lessors were responsible for paying their proportionate share of the reasonable expenses of gathering, marketing and processing the gas produced and, therefore, the deductibility of such expenses was not at issue. A careful reading of *Matzen*, however, indicates that the parties were not in agreement as to how royalties were to be calculated and that the deductibility of post-production expenses was, in fact, at issue in that case. The lessors in *Matzen* claimed that since there was no market for the gas produced at the wellhead, they were entitled to prove the "fair value" of the gas at the wellhead by any competent evidence. The lessee claimed that the "proceeds-less-expenses" formula was the exclusive means of determining the royalty. The *Matzen* court agreed with the lessee.[44] Thus, the *Gilmore* court appears to have incorrectly distinguished *Matzen* and wrongly disregarded its authority.

2. *Taylor*

The Arkansas case of *Hanna Oil Co. v. Taylor*[45] has also been the subject of criticism.[46] The *Taylor* court relied primarily on two factors in holding that the lessee was not entitled to deduct compression costs from the lessor's royalties: (1) the language of the lease did not expressly provide for the deduction of these costs and (2) the construction placed upon the lease by both parties did not allow such deductions.

The royalty provision in *Taylor* provided, "[L]essee shall pay Lessor one-eighth of the proceeds received by Lessee at the well for all gas (including all substances contained in such gas) produced from the leased premises and sold by Lessee."[47]The court indicated that "proceeds" usually means "total proceeds," unless the context indicates

43. *Id.*
44. *Id.*
45. Hanna Oil and Gas Co. v. Taylor, 759 S.W.2d 563 (Ark. 1988).
46. *See* Blythe, *supra* note 3, at 215; Perkins, *supra* note 3, at 404.
47. *Taylor*, 759 S.W.2d at 564. Royalty clauses which contain "proceeds" or "market price" or "market value" provisions are distinguishable from one another only with respect to the *basis* of determining the royalty. *Id.* at 566 (Hays, J., dissenting); *but see* Blythe, *supra* note 3, at 205. In *Wood*, as well as in *Taylor* and *Gilmore*, the key issue was determining what deductions were

otherwise.[48] The court reasoned that if the parties had intended for compression costs to be deducted, they would have made reference to costs or "net proceeds."[49] Although the phrase seemed to indicate that the value of the gas was to be determined at the wellhead and not after post-production activities such as compression, the court's interpretation of the royalty provision totally ignored the phrase "at the well" and failed to impute any meaning to it.[50]

The key factor in the *Taylor* court's analysis appears to have been "the construction the parties themselves placed upon their agreement for more than two years."[51] For over two years after compression became necessary to move the gas into the purchaser's pipeline, the lessee in *Taylor* did not seek to deduct the costs of the compression. The court held that by not deducting the compression costs for those two years, the lessee had essentially acquiesced in the lessor's construction - that the compression costs were not deductible.[52] Since the determination of royalties owed is strictly a contractual matter, we agree that the construction that the parties to a lease give to their own agreement should weigh heavily, if not decisively, in how a court construes the lease. Parties who, before *Wood*, construed their lease as allowing deduction of compression costs should not, as a result of that case, have their agreement effectively reformed by the Court merely because the Court did not find such an agreement in *Wood*.[53]

B. *The* Wood *Majority Unduly Expanded a Lessee's Duty to Market Gas*

The *Wood* majority appears to have taken the lessee's "duty to make the gas marketable," as espoused in *Gilmore*, and extended it by

allowable from that basis. *See* Kuntz, *supra* note 3, at 351. Whether or not a provision calls for royalties to be determined "at the well" is much more important for purposes of determining deductions from royalties than whether a "proceeds" or "market value" or "market price" provision is present. Providing that a royalty is to be determined "at the well" implies that the expenses of any activities occurring past the wellhead should be shared. *Id.* However, a "net proceeds" royalty provision does indicate that certain deductions from royalties are contemplated, and cases involving a "net proceeds" provision are distinguishable from *Wood*, *Taylor* and *Gilmore* and would likely result in a different outcome. *See* Martin v. Glass, 571 F. Supp. 1406 (N.D. Tex. 1983) (holding a "net proceeds" provision suggested that certain costs were deductible).

48. Hanna Oil and Gas Co. v. Taylor, 759 S.W.2d 563, 564-65 (Ark. 1988) (citing Warfield Natural Gas Co. v. Allen, 88 S.W.2d 989 (Ky. 1935)).
49. *Id.*
50. *Id.*
51. *Id.* at 565.
52. *Id.*
53. *See infra* notes 106-07 and accompanying text.

imposing three closely-related corollaries of such duty which require the lessee to "get the product to the place of sale in marketable form," "prepare the gas for market" and "obtain a marketable product."[54] While it is generally accepted that a lessee has an implied duty to market production,[55] authority is split with respect to the extension of this duty to include preparation of the product for market at the lessee's sole expense if the product is unmerchantable in its natural form.[56]

The *Wood* majority, relying primarily upon *Gilmore*, *Schupbach* and *Taylor*, held that the lessee must bear the cost of installing and operating a compressor where compression was required to market the gas because the lessee had the duty to make the gas marketable.[57] The gas was not marketable "at the well" because it had insufficient pressure to move into the purchaser's pipeline without artificial compression. Therefore, the compression and resulting expense were necessary to make the gas marketable, and the Court held the lessee was required to bear such expense. The Court argued that, in executing an oil and gas lease, the lessor retains a smaller interest, giving the lessee a much larger interest in exchange for bearing the risks of lease development and the associated costs.[58] Since lessors generally have no input with regard to post-production costs incurred, the Court reasoned that it is unfair to require them to share in them.

Keeping in mind, however, that under Oklahoma law, as well as under the law of most other states, a royalty interest is defined as an interest free of any of the lessee's costs of production,[59] it is implicit in the concept of a royalty that such interests may be subject to costs other than costs of production. Certainly under most, if not all oil and gas leases, a lessee must bear all of the costs of actual production.[60] "Production" has been judicially defined as the act of bringing forth gas from the earth.[61] Once the gas has been brought forth from the earth and reaches the wellhead, "production" ceases.[62] Once gas is at

54. Fox Wood III v. TXO Prod. Co., 854 P.2d 880, 882 (Okla. 1993).
55. Wolfe v. Texas Co., 83 F.2d 425, 432 (10th Cir. 1936), *aff'd*, 299 U.S. 553 (1936).
56. Compare MAURICE H. MERRILL, MERRILL ON COVENANTS IMPLIED IN OIL AND GAS LEASES, § 85, at 214 (2d ed. 1940) and Gilmore v. Superior Oil Co., 388 P.2d 602, 607 (Kan. 1964) *with* Piney Woods Country Life School v. Shell Oil Co., 539 F. Supp. 957, 973 (S.D. Miss. 1982) and G. Siefkin, *Rights of Lessor and Lessee with Respect to Sale of Gas as to Gas Royalty Provisions*, 4 OIL & GAS INST. 181, 199-201 (Sw. Legal Found. 1953).
57. *Wood*, 854 P.2d at 882.
58. *Id.* at 882-83.
59. Shinn v. Buxton, 154 F.2d 629, 632 (10th Cir. 1946).
60. Altman & Lindberg, *supra* note 3, at 365.
61. Martin v. Glass, 571 F. Supp. 1406, 1415 (N.D. Tex. 1983).
62. *Id.*

the wellhead, the lessee's sole financial obligation undertaken in exchange for the lessor's royalty interest ceases, and the costs of any subsequent activities undertaken by the lessee to improve the quality of the gas or to transport the gas to market should be shared proportionately by the lessor.[63] Absent a lease provision by which a lessee expressly assumes the burden of some or all post-production expenses, there is no justification for charging such costs solely to the lessee. A duty to market gas does not equate to a duty to pay all marketing costs arising after the gas has been produced.[64] This logic applies equally to all post-production expenses, including gross production and severance taxes, processing, compression, dehydration and transportation. This argument is strengthened by the fact that most leases, including the lease in *Wood*, call for the royalty to be determined "at the well."

While the lessee has a duty to diligently market the gas, it is "almost universally recognized that the lessee's marketing obligation is measured at the wellhead," absent a contrary lease provision.[65] If there is no market at the well, or if the gas is not marketable at the well, then the lessee's sole financial responsibility ceases. One commentator stated:

> If the gas cannot be sold there [at the wellhead] and must be transported to a market elsewhere, the lessor must contribute his portion of the transportation costs. Why is it any more or less a part of the lessee's obligation to 'market' gas to transport it to some distant market if no local outlet is available, than to pay for its dehydration if such processing is necessary in order to render it saleable? Here is a well and here is gas at the well head. At this time and place we evaluate that gas for purposes of computing royalty. It is worth what it will bring *at that point in its natural state*, no more, no less. Of course the lessee has an implied duty to market it. But it is a

63. Freeland v. Sun Oil Co., 277 F.2d 154, 159 (5th Cir. 1960), *cert. denied*, 364 U.S. 826 (1960); Piney Woods Country Life School v. Shell Oil Co., 539 F. Supp. 957, 971 (S.D. Miss. 1982).

64. *See* Kretni Dev. Co. v. Consol. Oil Corp., 74 F.2d 497, 500 (10th Cir. 1934), *cert. denied*, 295 U.S. 750, (1935); *Martin*, 571 F. Supp. at 1416; *Piney Woods*, 539 F. Supp at 972; Fox Wood III v. TXO Prod. Co., 854 P.2d 880, 884 (Okla. 1993) (Opala, J., dissenting); Hanna Oil and Gas Co. v. Taylor, 759 S.2d 563, 566 (Ark. 1988) (Hays, J., dissenting); Kuntz, *supra* note 5, § 40.5(b) at 350-51; J. Sneed, *Value of Lessor's Share of Production Where Gas Only is Produced*, 25 TEX. L. REV. 641, 644 (1947).

65. Siefkin, *supra* note 56, at 184; *see also* Sartor v. Arkansas Natural Gas Corp., 321 U.S. 620 (1944), *reh'g denied*, 322 U.S. 767 (1944); Phillips Petroleum Co. v. Ochsner, 146 F.2d 138 (5th Cir. 1944); Kretni Dev. Co. v. Consol. Oil Corp., 74 F.2d 497 (10th Cir. 1934), *cert. denied*, 295 U.S. 750, (1935); Clear Creek Oil & Gas Co. v. Bushmiaer, 264 S.W. 830 (Ark. 1924); Molter v. Lewis, 134 P.2d 404 (Kan. 1943); Warfield Natural Gas Co. v. Allen, 88 S.W.2d 989 (Ky. 1935); Katschor v. Eason Oil Co., 63 P.2d 977 (Okla. 1936).

> duty to market or dispose of it *at the well.* If it cannot be sold there for lack of a purchaser, it may be transported elsewhere. Fine. But for that transportation the lessor must pay proportionately. If it cannot be sold at the well because of its inferior quality, how can the lessee's duty to 'market' be transposed into a duty to render the gas more valuable than it actually is, all at his expense? . . . To my mind it is at least equally persuasive to insist that the duty to market is confined to the product *in the state in which it is produced at the well,* and does *not* include any duty, at the lessee's sole expense, to increase its value by processing, any more than it includes a duty to transport it free of charge to distant markets.[66]

Once the gas is made available for market, the lessee's duty to market ceases and any further expenses should be shared by the lessor.[67]

Since there is substantial agreement among the courts of gas-producing states and commentators that transportation expenses are deductible by the lessee, it is clear that the duty to market does not entail an absolute duty of the lessee to pay all costs of marketing. Transportation appears to be a marketing function — the process of moving the product to a purchaser where no market exists at the well.[68] Once it is established that the lessee does not have a duty to pay transportation expenses, then what principled basis exists for requiring the lessee to be solely responsible for other marketing expenses?[69] If anything, it is more logical to require lessees to pay the entire expense of building a pipeline to transport gas to a distant market than to require them to pay all compression and processing costs. At least a pipeline transports gas in its natural state, while compression and processing act to transform the gas into a new and more valuable product.[70] In fact, it is difficult to distinguish compression costs from other types of transportation costs. Compression merely acts to "push" the gas into a high pressure pipeline, and is not conceptually different from trucking the gas from the well to the purchaser's pipeline. Compression does not change the chemical nature of the gas in any way, it merely allows the gas to enter the purchaser's pipeline.

66. Siefkin, *supra* note 56, at 200. Professor Kuntz is often cited as opposing authority, "It is submitted that the acts which constitute production have not ceased until a marketable product has been obtained." KUNTZ, *supra* note 3, § 40.5(b), at 351. However, later in the same treatise, Professor Kuntz stated specifically that "compression is more easily identified as an element of transport or as a marketing cost of a marketable product rather than as a production or refining process." *Id.* § 40.5(b), at 352.

67. Johnson v. Jernigan, 475 P.2d 396, 399 (Okla. 1970).

68. Altman & Lindberg, *supra* note 3, at 378.

69. *Id.* at 369.

70. *Id.* at 378.

In reaching its decision in *Wood*, the Court appears to have relied substantially upon the idea that in Oklahoma "we have equated the gas purchase contract price with the market value,"[71] which was initially set forth in *Tara Petroleum Corp. v. Hughey*.[72] It is not clear from *Wood* exactly what was the scope or significance of the Court's reliance upon *Hughey*, but the Court apparently used the "contract price equals market price" concept as justification for its rejection of the Texas/Louisiana or "reconstruction" approach to determining "market value." The Court apparently felt that since in Oklahoma under *Hughey*, the contract price for gas was the "market price" of the gas for purposes of a "market price" royalty provision, there was no need or justification to "reconstruct" a market value for royalty purposes using the Texas/Louisiana approach. However, the Court misapplied *Hughey*.

The *Hughey* case involved a "market price" royalty provision. The lessee entered into a two-year purchase contract for the gas produced and, subsequently, the price of gas increased markedly. The initial purchaser was able to resell the gas at a much higher price. The lessor brought suit against the lessee claiming that its royalty should be based upon the current "market price" — the higher price for which the initial purchaser was reselling the gas. The Court held that when a lessee enters into a purchase contract in good faith and at arm's length for the best price then available, the contract price is the "market price" specified in the lease.[73]

Hughey dealt with the basis upon which royalties were to be determined under the lease (i.e., what proceeds were to be used to calculate royalties) instead of with the deductions from that basis which were allowed under the lease (i.e., what expenses were to be deducted from the chosen set of proceeds).[74] There was no mention of post-production expenses in *Hughey*. The mere fact that the *Hughey* court held that the contract price was the "market price" for purposes of the royalty provision does not mean that the court would not have allowed any deductions from that "market price." The *Hughey* decision

71. Fox Wood III v. TXO Prod. Co., 854 P.2d 880, 882 (Okla. 1993).

72. 630 P.2d 1269, 1275 (Okla. 1981).

73. *Id.* at 1274-75.

74. To use a taxation analogy, *Hughey* dealt with a determination of gross income, whereas *Wood* dealt with deductions to gross income allowable to determine adjusted gross income. *Cf.* Matzen v. Hugoton Production Co., 321 P.2d 576, 582-83 (Kan. 1958). "The court [in *Kretni*] was not concerned with the distinction between ['proceeds', 'fair market value' and 'market value'] because their meanings were not pertinent to the controversy. *Id.* The issue there was the point at which the royalty was to be determined." *Id.*

cannot be taken to mean that the "contract price" equals the market price at the well. The *Wood* majority's affirmation of the deductibility of transportation costs under *Johnson* demonstrates that the "contract price equals market price" rule does not foreclose the possibility of allowing deductions from the "market price."[75] The *Hughey* court simply did not address the issue of deductions from royalties and should not be cited as authority on that issue.

In sum, we find no authority or justification for the *Wood* majority's extension of a lessee's duty to market gas into a duty to "make the gas marketable." As stated above, the duty to market is a duty to market "at the well." Once the gas has reached the wellhead and is available for market, the lessee has satisfied his duty to market and any expenses incurred in improving the product or in transporting the product to a purchaser should be borne proportionately by the lessor. The only authorities cited by the *Wood* majority for this rather drastic extension of a lessee's duty to market were two highly-criticized Kansas cases, which relied primarily upon a statement by Dr. Merrill which he later retracted, and an Oklahoma case which was arguably misapplied. The great weight of authority holds that lessees should not be solely responsible for paying all costs of processing, compressing, marketing and transporting gas.

C. Wood *Effectively Changed Oklahoma Law Upon Which Producers Have Relied*

As mentioned previously, prior to the *Wood* decision most observers placed Oklahoma among the states which allowed lessees to deduct post-production compression costs.[76] That conclusion was based primarily upon four Oklahoma cases: *Katschor v. Eason Oil Co.*,[77] *Cimmarron Util. Co. v. Safranko*,[78] *Harding v. Cameron*,[79] and *Johnson v. Jernigan*,[80] as well as upon decisions of the Oklahoma Corporation Commission. Many Oklahoma producers have relied upon this seemingly clear precedent in structuring their leases.[81]

75. *See* notes 13-14 and accompanying text.
76. *See* notes 2-3 *supra* and accompanying text.
77. 63 P.2d 977 (Okla. 1936).
78. 101 P.2d 258 (Okla. 1940).
79. 220 F. Supp. 466 (W.D. Okla. 1963).
80. 475 P.2d 396 (Okla. 1970).
81. *See* Defendants' Petition for Clarification and Brief in Support, Fox Wood III v. TXO Prod. Co., 854 P.2d 880 (Okla. 1993) (No. 75-929); Motion of Oklahoma Independent Petroleum Association at 4, Fox Wood III v. TXO Prod. Co., 854 P.2d 880 (Okla. 1993) (No. 75,929).

1. *Katschor* and *Safranko*

In *Katschor*, the Court construed a "market value" royalty provision and held that where there is no market for the gas at the well, royalties should be calculated "by showing the sale price of the gasoline and the residue gas and deducting from the sum thereof the cost of manufacture of the gas after production, plus depletion of the plant and cost of marketing the gasoline and residue gas."[82] This "sales price less marketing costs" approach appears to comport with the Texas/Louisiana approach to royalties which was rejected by the *Wood* majority.[83] In *Safranko*, the Court approved the "sales price less marketing costs" formula applied in *Katschor* for a "market price" royalty provision, but indicated that there are no rigid rules in determining value at the wellhead where there is no market and that every factor which properly bears on value should be considered.[84]

2. *Harding*

Harding involved a lessee who had built a compressor station on the lease premises to compress low pressure gas for delivery into the purchaser's pipeline which was also on the lease premises.[85] The District Court for the Western District of Oklahoma, citing *Katschor* and *Safranko*, held that "[t]he rule in Oklahoma fixing the 'value' or 'market price' of gas at the wellhead and processed by lessee through a compressor plant constructed by it is the gross price which the lessee receives from the purchaser less the actual cost of compression and reasonable depreciation on its compressor plant."[86]

It should be noted that *Harding* is factually very similar to *Wood*. In *Harding* as in *Wood*, the lessee built a compressor plant on the lease premises and the purchaser's pipeline was also located on the lease premises. There was no market at the wellhead for the low pressure gas in either *Harding* or *Wood*. The *Harding* court stated that the value of the gas for purposes of determining the royalty was the sale

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82. Katschor v. Eason Oil Co., 63 P.2d 977, 981 (Okla. 1936).

83. *See* Merritt v. Southwestern Elec. Power Co., 499 So.2d 210, 213 (La. Ct. App. 1986) (stating market value equals gross proceeds less any costs of taking the gas from the wellhead to the point of sale); LeCuno Oil Co. v. Smith, 306 S.W.2d 190, 193 (Tex. Civ. App., Texarkana 1957, *writ ref'd n.r.e.* (stating that where there was no market for gas at the well, the royalty was to be based upon the price received for the gas by the lessee less the cost of dehydration, gathering, transporting and processing), *cert. denied*, 356 U.S. 974 (1958).

84. Cimmarron Util. Co. v. Safranko, 101 P.2d 258, 260 (Okla. 1940).

85. Harding v. Cameron, 220 F. Supp. 466, 467-68 (W.D. Okla. 1963).

86. *Id.* at 471.

price of the gas less the compression costs.[87] The *Wood* Court's only reference to this directly on-point authority was in a footnote in which it attempted to distinguish *Harding* by stating "[t]he *Harding* case, however, involved casinghead gas, for which there was no market value at the well, and thus, the court was 'reconstructing' a market value using a work-back approach."[88] However, a close reading of *Harding* reveals that it involved both casinghead gas and low pressure gas.[89]

Both *Harding* and *Wood* dealt with low pressure gas for which there was no market value at the well and which the respective lessees compressed on the lease premises for delivery to purchaser pipelines on the lease premises. We see no basis upon which to distinguish the cases, at least with respect to the crucial issues of the point at which royalties are to be calculated and the deductions from royalties which will be allowed.[90]

3. *Johnson*

The *Johnson* case indicated the Court's view that transportation costs are deductible from royalties, even under a "gross proceeds" royalty provision that did not specify that royalties were to be determined at the well.[91] The *Wood* majority indicated that the *Johnson* holding only supported the limited notion that transportation expenses are deductible where the point of sale is off the lease premises.[92] As argued above,[93] the fact that certain post-production costs such as transportation costs are deductible in Oklahoma leaves no reasonable basis for denying deduction of other post-production costs from royalties. While the *Johnson* decision does not provide direct authority for this proposition, it does provide indirect authority and

87. *Id.*

88. Fox Wood III v. TXO Prod. Co., 854 P.2d 880, 882 n.1 (Okla. 1993).

89. Harding v. Cameron, 220 F. Supp. 466, 467 (W.D. Okla. 1963) ("The defendant began construction of a compressor plant in June 1958, to boost the pressure of the low pressure gas and casinghead gas so that it would enter the pipeline connection of Arkla.").

90. The Court also attempted to distinguish *Harding* by stating that "[t]he lessors also had agreed at pretrial to bear a part of the compression costs." *Wood*, 854 P.2d at 882 n.1. A close reading of *Harding* indicates in our view, however, that the stipulation referred to by the *Wood* majority was actually an agreement between the parties as to the *amount* of the compression charges and *not*, as the *Wood* majority stated, an agreement by the lessors to bear a portion of the compression charges. *See Harding*, 220 F. Supp. at 472.

91. Johnson v. Jernigan, 475 P.2d 396 (Okla. 1970). The royalty provision in *Johnson* provided for royalty payments upon "one eight [sic] (1/8) of the gross proceeds at the prevailing market rate for all gas sold off the premises." *Id.* at 397.

92. Fox Wood III v. TXO Prod. Co., 854 P.2d 880, 881 (Okla. 1993).

93. *Id.* at 882; *see* notes 13-14 and accompanying text.

certainly does not provide authority against that proposition, as the *Wood* majority seemed to indicate.

The *Wood* majority placed too much emphasis on the fact that the *Johnson* decision held only that transportation costs were deductible from royalties.[94] The *Wood* Court, citing *Johnson*, stated that "[w]e have said only that the lessor must bear its proportionate share of *transportation* costs where the point of sale was off the leased premises."[95] The *Johnson* court, however, only examined the treatment of transportation costs because those costs were the only costs at issue in that case.[96] The deduction of compression costs and other marketing costs was never raised. The *Johnson* court did, however, indicate that *Katschor* and *Safranko* were still good law by citing both cases approvingly.[97] The *Johnson* court stated that the *Katschor* and *Safranko* holdings that the "market price," where there is no market at the well, is the "actual price," i.e., the sales price less the costs of processing and marketing the gas or any other value evidenced by all of the factors bearing on the market value of the gas, generally comported with the view taken by a majority of other jurisdictions and authorities.[98] Thus, *Johnson* affirms generally the "sales price less expenses" formula for determining market price at the well when there is no market at the well. It does not provide authority for the notion that transportation costs are the only post-production expenses which are deductible from royalties, except with respect to a "gross proceeds" royalty provision.

94. In *Wood*, the majority appears to have taken particular notice of the fact that the gas was being compressed and delivered into the purchaser's pipeline *on the lease premises*. The majority indicated that as long as the gas was being delivered into the pipeline on the lease premises, that no "transportation" of the gas occurred for which the lessee could deduct transportation expenses under Johnson. The Court rejected the "production expenses" vs. "post-production expenses" distinction and was apparently of the view that the *only* expenses that a lessee may deduct are transportation expenses to transport gas off the lease premises. *Fox Wood*, 854 P.2d at 881.

95. *Id.* at 881.

96. "[T]he only evidence of market or actual value was the sale price of the gas less the pipe line costs at a distance of some ten miles." Johnson v. Jernigan, 475 P.2d 396, 398 (Okla. 1970). The *Johnson* court indicated that since the royalty provision at issue was a "gross proceeds" provision, the royalty was to be based upon "the value of the gas on the lease property without deducting any of the expenses involved [sic] in developing and marketing the dry gas to this point of delivery." *Id.* at 399. It is not clear that a different type of royalty provision would not have produced a different result.

97. *Id.* at 398.

98. *Id.*

4. Oklahoma Corporation Commission

In addition to the four Oklahoma cases discussed above which support a different result in *Wood*, hearings before the Oklahoma Corporation Commission also presupposed a different result. In *In re: Sanguine, Ltd.*,[99] the Appellate Hearing Officer for the Commission stated the following conclusions of law:

> It is generally understood that royalty interests are not burdened by costs of production. However, under lease law, there is often controversy over whether above ground costs or post production costs must be borne by the royalty interest. Where the [forced pooling] statute gives an owner the right to his just and fair share of the oil and gas or, in other words, the title to the production vests in the royalty owner as a severance; once the oil and gas has been produced any additional costs must be borne by the royalty interest. Therefore, any other expenses attributable to the oil after the owner has taken possession of his just and fair share, i.e., post production costs, must be borne by that owner. . . .[100]

On appeal, the Commission upheld the decision of the Hearing Officer, and stated the following:

> Upon production of the oil and gas from the well, each of the owners should bear the post production expenses attributable to their interest as a necessary expense. Therefore, while royalties should bear no expense attributable to the drilling, testing, completing, equipping, operating or producing the well; the costs attributable to the marketing and transportation, as well as, other post production costs of an owner's share of royalty which occurs after production should be borne by the royalty interests.[101]

The Oklahoma Corporation Commission views compression costs and other post-production expenses as deductible from royalties. Moreover, the Commission's interpretation of Oklahoma oil and gas law is entitled to considerable deference by the courts.[102]

D. Wood *Should Have Been Applied Only Prospectively*

Because the *Wood* decision has substantially changed Oklahoma jurisprudence with respect to the determination of oil and gas royalties, the Court should have applied *Wood* only prospectively even

99. Appellate Report of the Hearing Officer, *In re* Sanguine, Ltd., Cause CD No. 137575 (Okla. Corp. Comm'n, June 24, 1987).
100. *Id.* at 8.
101. Order of the Commission, In re: Sanguine, Ltd., Cause CD No. 137575, Order No. 316018 at 3, (Okla. Corp. Comm'n, August 21, 1987).
102. *See* Jones v. FDIC, 748 F.2d 1400, 1405 (10th Cir. 1984).

though the Court declined to do so. The combined weight of the *Katschor*, *Safranko*, *Harding* and *Johnson* decisions, in light of the Commission's decisions as well as an abundance of authority from other jurisdictions, has reasonably led Oklahoma producers to conclude that Oklahoma law provides for the deduction of compression costs and other post-production costs from royalties.[103] As a result, producers have entered into leases which they believed adequately protected their perceived right to deduct post-production expenses from royalties. *Wood* appears to invalidate that assumption. The producers reasonably relied on the prior Oklahoma precedents which have been effectively emasculated by *Wood*; therefore, Oklahoma law would seem to require that *Wood* should only be applied prospectively.[104]

E. *Summary*

As argued above, the *Wood* decision rests solely upon the much-criticized Kansas and Arkansas cases of *Gilmore*, *Schupbach* and *Taylor*. These cases are widely viewed as departures from established authority and from the resulting custom and practice in the industry. The *Wood* decision unnecessarily and unjustifiably expands the scope of a lessee's duty to market into a duty to "get the product to the place of sale in marketable form"[105] or to transform an unmarketable product into a marketable product at its sole expense. This view, that a lessee must get the gas to the place of sale in marketable form, is irreconcilable with the Court's previous affirmation of the deductibility of transportation costs. The Court's reliance upon *Hughey* that, in Oklahoma, the "contract price is the market price" is a misapplication of the *Hughey* decision. Finally, the *Wood* decision effectively ignores prior Oklahoma precedent as to the deductibility of compression and other post-production costs. Because the Court departed from Oklahoma precedent upon which the the gas industry relied, the *Wood* holding should be applied only prospectively.

IV. Implications of *Wood*

As an initial matter, since *Wood* was a 5-4 decision, it is possible that it may be overturned, modified or limited to its facts if a similar

103. Fox Wood III v. TXO Prod. Co., 854 P.2d 880, 881 (Okla. 1993); *see also* note 4 and accompanying text.

104. *See* Carlile Trust v. Cotton Petroleum Co., 732 P.2d 438 (Okla. 1986), *cert. denied*, 483 U.S. 1007 (1987), *cert. denied*, 483 U.S. 1021 (1987).

105. *Wood*, 854 P.2d at 882.

but distinguishable case is brought before the Court. Until such time, *Wood* will undoubtedly have a great impact on Oklahoma producers.

In light of the *Wood* decision, Oklahoma producers whose leases do not expressly provide for deduction of post-production costs will not only have to stop deducting compression and other post-production costs from future royalties but will likely face claims by many of their lessors for charges which have previously been deducted. The increased financial burdens on lessees resulting from the *Wood* decision will likely shorten the economic life of low pressure gas wells and result in earlier termination of numerous leases. Neither of these outcomes benefits the lessors or the lessees.

If a lessee continues deducting compression costs from royalties despite *Wood*, it will almost certainly be liable in damages to its lessor for the amount of the deductions.[106] However, the lease apparently would not be subject to forfeiture if the lessee had a good faith argument that its circumstances were distinguishable from *Wood*. In Oklahoma, mere underpayment or even nonpayment of royalties is not grounds for cancellation of a lease unless the lease so provides.[107] Despite the *Wood* Court's intimation to the contrary,[108] a lessee would unlikely forfeit its lease for continuing to deduct compression costs as long as it had a good faith argument that *Wood* should not apply to it and the lease did not provide for forfeiture for nonpayment of royalties.

The retroactive application of the *Wood* decision will also result in lessees being bound to leases in which there was never a "meeting of the minds." Lessors and lessees both enter into oil and gas leases with certain expectations and undertake certain burdens in exchange

106. Breaches of contract are ordinarily not subject to punitive damages unless the conduct amounts to an "independent, willful tort." Zenith Drilling Corp. v. Internorth, Inc., 869 F.2d 560, 565 (10th Cir. 1989); *see* Storck v. Cities Service Gas Co., 634 P.2d 1319, 1323 (Okla. Ct. App. 1981) (denying punitive damages because breach did not result from "distorted or fanciful contract term interpretation").

107. *See* Craig v. Champlin Petroleum Co., 421 F.2d 236, 240 (10th Cir. 1970) (Oklahoma law does not permit cancellation of a lease for nonpayment of royalties absent an express provision in the lease allowing such cancellation); Cannon v. Cassidy, 542 P.2d 514, 516-17 (Okla. 1975) (holding despite the lessor's contention that nonpayment of royalties was a breach of the lessee's implied duty to market the gas, a lessee's failure to pay royalties in violation of the terms of a lease was not grounds for forfeiture of the lease where the lease did not expressly authorize cancellation for nonpayment of royalties); *cf.* El Rio Oils, Canada, Ltd., 212 P.2d 927, 931-32 (Cal. Ct. App. 1949) (denying forfeiture claim where lessee erroneously, but honestly and in good faith, took the position that the costs of making injections of distillate into oil wells were deductible from royalties).

108. Fox Wood III v. TXO Prod. Co., 854 P.2d 880, 882 (Okla. 1993) ("Cessation of marketing can mean the termination of the lease.") (citing Townsend v. Creekmore-Rooney Co., 332 P.2d 35 (Okla. 1958)).

for perceived benefits or potential benefits. Many leases regarding low pressure wells have been in existence for years with both parties in agreement as to their respective rights and obligations, including the deductibility of compression costs. By retroactively changing the terms of these leases entered in to possibly years ago, the *Wood* majority would effectively bind the lessees to contracts to which they have never agreed. Such a result is unjust. It is inevitable that *Wood* will spawn numerous attempts by lessees to avoid the effects of the decision.

V. Possible Strategies to Avoid the Effects of *Wood*

A. *Construe* Wood *Narrowly*

The *Wood* decision did not expressly overturn any previous Oklahoma cases and, therefore, should be construed so as to be consistent with prior case law where possible. Although *Wood* only explicitly addressed the treatment of compression costs, it appears to us that its holding would also apply to all post-production expenses other than transportation expenses. Although its logic escapes us, the Court apparently viewed transportation expenses differently from other post-production expenses and either did not view such expenses as "marketing expenses" or it excepted transportation from the lessee's duty to "get the gas to the place of sale in marketable form" set forth in *Wood*. For purposes of our analysis, then, we assume that transportation costs are the only post-production expenses which would be deductible under *Wood*, and they would only be deductible if the point of sale is off the lease premises.

1. *Wood* Should Apply Only if the Point of Sale is On the Lease Premises

Fox Wood specifically held only that compression costs incurred to deliver gas into a pipeline located on the leased premises were not deductible from royalties. It appears then that the Court might allow the deduction of compression costs incurred to transport gas into a pipeline located off the leased premises. It might be argued that the *Wood* majority implicitly accepted the lessee's argument that compression costs are analogous to transportation costs,[109] but nevertheless held that where the purchaser's pipeline was located on the lease

109. After it restated the lessee's argument that compression is analogous to transporting the gas because it merely "pushes" the gas into the pipeline, the Court responded that, "[w]e have

premises no "transportation" occurred for which expenses may be deducted. As stated previously, the Court took the position that in order to incur deductible "transportation" expenses, the point of sale must be off the lease premises.[110] That position appears to stem from a belief that the lessee's duty to market the gas at its sole expense extends to the boundary of the lease. Therefore, as long as gas is being delivered into a pipeline located off the lease premises, the costs of "transporting" that gas, arguably including compression costs, should be deductible from royalties. A lessee desiring to avoid the impact of *Wood* might attempt to arrange its leases and purchase contracts to ensure that all of its sales of gas are to pipelines located off the lease on which the gas was produced. By selling the gas off the lease premises, compression costs arguably should be treated as deductible "transportation" costs.[111]

2. *Wood* Should Apply Only Where the Lessor Timely Objects to the Deduction of Compression Costs

In *Wood*, the gas was initially of sufficient pressure that no compression was required to move it into the purchaser's pipeline. Once the pressure dropped and compression was required, the lessee built the compressor plant and began deducting the lessor's proportionate share of the costs from its royalties. The lessor apparently brought suit for the withheld compression charges within a reasonable time after the lessee began deducting the charges. Although the *Wood* majority makes no mention of that fact, several authorities, including some on which the *Wood* majority relies, indicate that where the terms of a lease are ambiguous the courts should place great weight upon the parties' own construction of the terms of their lease.[112] If,

not yet held that the lessor is required to bear *any* costs of transportation where the point of sale is on the leased premises." *Id.* at 881 (emphasis in original). It is difficult to determine whether the Court, in making that statement, was acknowledging the merit of the argument but found it not to be determinative, or whether the Court was indicating merely that *even if* the argument were true, the lessee still would not prevail.

110. *See id.* ("We have said only that the lessor must bear its proportionate share of *transportation* costs where the point of sale was off the leased premises.") (emphasis in original).

111. Since a lessee has a duty to market the gas at the highest price obtainable, Johnson v. Jernigan, 475 P.2d 396, 399 (Okla. 1970), a lessee cannot sell the gas to a distant pipeline if one is present on the lease. One by-product of the *Wood* decision may be the decrease of the market value of leases upon which pipelines are located.

112. *See* Hopkins v. Texas Co., 62 F.2d 691, 692 (10th Cir. 1933) (stating mutual interpretation of lease contracts should be considered as evidence of meaning of lease), *cert. denied*, 290 U.S. 629 (1933); Skaggs v. Heard, 172 F.Supp. 813, 816-17 (S.D. Tex. 1959) (stating "the construction placed thereon by the parties becomes important, entitled to great weight and, to my mind is decisive" where meaning of royalty provision is doubtful); Hanna Oil and Gas Co. v.

however, the lease is not ambiguous, then the express language of the lease should be determinative.[113]

Royalty provisions which provide for royalties to be determined "at the well" are not ambiguous and clearly indicate that any expenses incurred after the gas reaches the wellhead, i.e., post-production expenses, are not the sole responsibility of the lessee but must be shared by the lessor. Where a court finds that ambiguity does exist in a royalty provision, then construction placed upon that provision by the parties should be controlling.

Where the parties to a lease have construed the royalty provision as permitting the deduction of compression or other post-production costs, then the courts should defer to that construction. In cases where a lessor has accepted royalties from which compression costs have been deducted for a considerable length of time without objection, the courts should bind the lessor to that construction of the lease and not use the *Wood* decision to reform the lease in contravention of the actual agreement reached by the parties as expressed by their conduct.[114]

B. *Add Express Deductibility Provisions to New Leases*

Since the language currently being used in most Oklahoma oil and gas leases does not explicitly provide that lessors must share in post-production costs,[115] as a result of the *Wood* decision, most Oklahoma producers should and will revise the language of the royalty provisions in their oil and gas lease forms to expressly provide that lessors are to share in all post-production expenses.[116] Of course,

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Taylor, 759 S.W.2d 563, 565 (Ark. 1988) ("[P]erhaps the most compelling support for our conclusion that the compression costs are not deductible lies in the construction the parties themselves placed upon their agreement for more than two years."); Earp v. Mid-Continent Petroleum Corp., 27 P.2d 855, 864-66 (Okla. 1933) (stating parties' construction of ambiguous oil and gas lease will be given great weight and should ordinarily control court's interpretation).

113. One court stated:

> If the landowners under the terms of the lease contract were entitled to payment on the basis of the actual value of the gas at the mouth of the well, it cannot be said that they have assented to a lesser value by unwittingly accepting payment not founded upon that value expressed in their written contract.

Katschor v. Eason Oil Co., 63 P.2d 977, 981 (Okla. 1936).

114. *See id.*

115. Although, as argued above, we believe that an "at the well" or similar royalty provision clearly indicates that post-production expenses should be deductible since they are incurred past the wellhead.

116. An example of such language is found in a proposed form:

> Lessee shall pay . . . to Lessor one-eighth of the net proceeds realized by Lessee for all gas (including all substances contained in such gas) produced from the leased premises and sold by Lessee, less Lessor's proportionate share of taxes and all costs incurred by

adding such provisions to all new leases does not provide relief from the effects of *Wood* on outstanding leases. Consequently, producers that fail to so revise their royalty provisions will likely be challenged by their lessors if they continue to deduct their post-production costs. Furthermore, such a challenge is likely to succeed unless the producer can distinguish its circumstances from those in *Wood.*

C. *Arrange for Purchasers to Bear Compression Expenses*

Since the *Wood* majority equated the "contract price" with the "market price" upon which royalties are to be paid, it seems that one way to avoid the impetus of *Wood* would be to cause the contract price of the gas at the well to reflect the true value of the gas when compression is required. The lessee would, thus, sell the gas at the well and allow the purchaser to assume the responsibility for and bear the expense of compressing and transporting the gas to its pipeline. The purchase price for the gas under this type of arrangement and the price upon which the royalties would be based would reflect only the actual value of the low pressure gas at the well.

For a simplistic example, imagine that an Mcf of gas is worth $2 at the pipeline of a gas purchaser and that it costs $.20 to compress the gas to deliver it to the purchaser's pipeline. If the lessee compresses the gas, the contract price would be $2, and the lessor's 1/8 royalty per Mcf would be $.25 ($2 × 1/8). The lessee in that instance would have net income per Mcf of $1.55 (2 – .25 – .20).[117] Now suppose that the lessee sells the gas to the purchaser *at the well* for $1.80 per Mcf and the purchaser compresses the gas itself (it should make no difference to the purchaser whether it or the lessee compresses the gas because it will pay $2 per Mcf for the gas either way). The contract price would be $1.80 per Mcf and the royalty paid to the lessor would be $.225 per Mcf ($1.80 × 1/8). The lessee in this instance would have net income per Mcf of $1.575. As long as the purchaser can gather and compress the gas at the same cost as the lessee, this arrangement offers a superior result for the lessee. Although a purchaser is unlikely to agree to

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> Lessee in delivering, processing, compressing or otherwise making such gas or other substances merchantable or enhancing the marketing thereof.

American Assoc. of Petroleum Landmen Form 235 (Rev. 12-88) (proposed paragraph 4). The *Wood* decision appears to indicate that current leases which contain a "net proceeds" royalty provision would be allowed to deduct compression and other post-production costs from royalties. *See* Fox Wood III v. TXO Prod. Co., 854 P.2d 880, 882 (Okla. 1993) ("[I]f the lessee's intention had been to [deduct compression costs], they would have made some reference to costs or 'net' proceeds.").

117. This calculation does not take into account production expenses payable by the lessee.

assume the compression and processing of gas for one producer, such arrangements could become the new custom and practice in the Oklahoma industry as a result of *Wood*.

A problem in utilizing this approach may arise when the lessee and the gas purchaser are affiliated entities because of concerns about collusive arrangements. The *Hughey* Court held that "[w]henever a lessee or assignee is paying royalty on one price, but on resale a related entity is obtaining a higher price, the lessors are entitled to their royalty share of the higher price."[118] Although the parties to such a transaction may be able to demonstrate that such transaction was conducted at arm's length, it appears that a heavy presumption of collusion exists with respect to affiliated party transactions.

D. *Execute New Division Orders Which Allow Deduction of Compression Costs*

Another possible strategy for avoiding the impact of the *Wood* decision would be to execute new division orders which allow the deduction of compression and other post-production expenses. The effectiveness of this approach, however, is limited by statute in Oklahoma. Under Oklahoma law, any portion of a division order which varies the terms of an oil and gas lease is invalid unless the changes have been previously agreed to by the parties.[119] Even if a royalty provision is ambiguous, a court is unlikely to allow a lessee to prevail as to the deduction of compression costs on account of division orders allowing such deductions unless the lessor knowingly agreed to share such costs. Therefore, executing new division orders appears to be effective in avoiding the impact of *Wood* only if the lessor agrees to allow compression costs to be deducted. While this approach may be useful for lessees whose lessors are sympathetic to the additional burdens placed on lessees by *Wood*, the execution of new division orders most likely cannot be used to impose responsibility as to post-production costs with respect to unwilling or unknowing lessors.

E. *Argue that the Lessor is Estopped from Objecting to Deductions of Compression Costs By Its Course of Conduct*

One might argue that because of a lessor's continued acceptance of royalties from which compression costs have been deducted, the

118. Tara Petroleum Corp. v. Hughey, 630 P.2d 1269, 1275 (Okla. 1981).
119. OKLA. STAT. ANN. tit. 52, § 570.11 (West Supp. 1994).

lessor is estopped from objecting to such deductions on grounds of equitable estoppel or laches. Both of these doctrines are based upon the concept that a party whose action or inaction causes another party to change its position in reliance on such action or inaction may not later assert rights which it otherwise would have possessed to the other party's detriment. However, it appears doubtful to us that a court would apply the doctrines of equitable estoppel or laches against a lessor to prevent him from challenging the deduction of compression costs on account of his continued acceptance of royalties from which such costs have been deducted.

As stated above, an essential element of estoppel is that the asserting party must have changed its position in reliance upon the other party's actions or failure to act. It would seem difficult to argue that a lessee has changed its position on account of the lessor's continued acceptance of reduced royalties when the lessee has merely continued to deduct compression costs. Also, a lessor can only be estopped if it knowingly fails to assert its rights. Where a lessor was unaware that the lessee may not have been entitled to deduct compression costs, a court is unlikely to estop the lessor from asserting a claim for such costs.

VI. Conclusion

The *Wood* decision represents a major departure from prior Oklahoma case law and from the general current of authority. It rests upon poorly-reasoned and highly-criticized Kansas and Arkansas cases that arguably were not supportable under the law of their respective jurisdictions. *Wood* unfairly places a new financial burden upon lessees that was unforeseeable at the time they entered into their leases. The likely economic impact of the *Wood* decision is that it will widely be circumvented through some of the above-described or other machinations, it will result in premature "shutting in" of low pressure wells, or that the decision either will be overturned or applied so narrowly as to have no practical effect.

The possibility of circumvention of *Wood* by any of the above or other strategies significantly undermines its value. The decision has transformed what was a widely-accepted custom and practice into a muddled, confused legal standard which is subject to several circumvention strategies and which has merely created uncertainty where little or none existed before. The production/post-production expense dichotomy adopted in Texas and Louisiana and supported by most commentators offers a much more clear and predictable legal standard upon which both lessors and lessees could ascertain their respective financial rights and obligations. The *Wood* decision should be reconsidered and overturned and the Oklahoma Courts should adopt the Texas/Louisiana rule that post-production costs are deductible to the lessee.