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## 7. The *Tawney* Decision

### Meaningless Words and Post-Production Costs

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#### Overview

A wise man once said that only law professors qualify as trained commentators on the law, except that practitioners with forty (40) or more years of oil and gas practice are occasionally permitted to comment, but not to profess.<sup>1</sup> Having reached 41 years of that practice, I declare myself as qualified, but not trained, to comment on one aspect of the perennial battles over post-production costs. More particularly, I want to discuss “the marketable product” or “first marketable product rule,”<sup>2</sup> dealing with how post-production costs are treated in the calculation of royalties. My topic is further narrowed primarily to price, value or proceeds “at the well,” “at the wellhead” or “at the mouth of the well” and similar royalty provisions which do not contain detailed wording on how to handle post-production costs.

The primary vehicles for this commentary are two marketable product rule cases decided by the West Virginia Supreme Court. The first is *Wellman v. Energy Resources, Inc.*, decided in 2001.<sup>3</sup> The second is *The Estate of Tawney v. Columbia Natural Resources*, decided in 2006.<sup>4</sup> The *Tawney* case is currently on appeal to the West Virginia Supreme Court following an earlier remand. This paper also contains discussions of selected Kansas, Oklahoma and Colorado decisions that undoubtedly influenced the West Virginia Supreme Court’s adoption of a version of a marketable product rule.

Most of my career has been spent representing mineral lessees, including both litigation and counseling. However, I fully appreciate that over the long haul both lessors and lessees prosper most when the terms of their lease contracts are respected and enforced by the courts as written. Temporary advantages to lessors or lessees because of judicial excursions beyond the proper meaning of the terms of the lease bring some short term elation to the “winning” side. In the long term, however,

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<sup>1</sup> Patrick Martin, trained commentator, professor and practitioner.

<sup>2</sup> Although there is no single “marketable product rule,” “first marketable product rule” or “marketable condition rule,” for convenience hereinafter, reference is often made to the “marketable product rule.” Different versions of the “rule” are also discussed in this paper.

<sup>3</sup> 557 S.E.2d 254 (W. Va. 2001).

<sup>4</sup> 633 S.E.2d 22 (W.Va. 2006).

sanctity of contract is one of the most important features of this nation's economic success.

Having hoisted the flag, however, I am compelled to disclose now that I harbor at least an intellectual hostility to the marketable product or marketable condition rules of royalty law that have sprung up in the last 10 to 15, years primarily in Kansas, Oklahoma, Colorado and, most recently in West Virginia. Unlike the talking heads on TV covering the presidential primaries who profess complete neutrality with respect to the candidates, I do have "a dog in this hunt." In the main, I believe that in formulating the marketable product rule, some courts have frequently misused their jurisdiction's contract construction rules, have effectively read out of leases terms like "at the well" and "at the mouth of the well" and have declared unambiguous provisions to be ambiguous. These courts have then imported into the royalty provision of the lease some species of implied marketing covenant or duty by means of which the economic bargain between lessor and lessee is rewritten to provide what well intentioned courts believe is the best result for the parties.

This goal-oriented approach has required some nifty mental gymnastics by courts in order to deal with the meanings of terms like "production" and "post-production costs" "at the well" and "at the wellhead." In more than a few cases this approach has lead to an egregious disregard of long established meanings of oil and gas terms. "Production" has become an elastic term, stretched far beyond the well and beyond cessation of the extraction activities. These courts have used findings of **ambiguity** and **silence** as springboards to invoke various versions of implied marketing covenants to determine the rights of the parties. The impacts of these goal-oriented opinions have profoundly affected the royalty rights and obligations under tens of thousands of leases from which oil and/or gas have been produced and yielded royalties for many, many decades.

A few statements regarding what this paper and presentation are not about might be useful. This is not a "soup-to-nuts" history and/or analysis of the marketable product rule or of how post-production costs are dealt with in all states. Numerous excellent papers have already been published which provide extensive history and analysis. Possibly the most comprehensive is an article published in 2005 in the *St. Mary's Law Review*.<sup>5</sup> For the convenience of Institute participants, a fairly extensive bibliography is appended as a ready resource for further exploration of this topic.

Louisiana and Texas courts have not succumbed to the pressures from certain sources to adopt some version of a marketable product rule.

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<sup>5</sup> Brian C. Keeling & Karolyn King Gillespie, *The First Marketable Product Doctrine: Just What Is the "Product"?*, 37 ST. MARY'S L.J. 1 (2005).

Hopefully, they never will. I hope, however, you will find this paper and presentation useful in your practice because of what we can learn from how the courts in some other states are dealing with post-production cost issues. Also, I am sure that many of you have clients (royalty owners and lessees) who are doing business in both marketable product rule and non-marketable product rule jurisdictions.

### I. The Issues Presented to the West Virginia Supreme Court in *Tawney*

In *Tawney*, the circuit court certified (trial court) two (2) questions to the West Virginia Supreme Court.

(a) Where the royalty language is as set out in Exhibit A [see below], may a lessee of oil and gas in West Virginia deduct money and/or volume from the lessor's 1/8 royalty payments for post-production expenses, where the lease does not provide specifically that the lessee may take such deductions from the royalty?<sup>6</sup>

(b) Where in an oil and gas lease there is no specific provision allowing for deduction of post-production expenses[,] does language such as "wholesale market at the well," "amount realized at the well," "net revenue realized," "1/8 of price," "net of all costs beyond the wellhead," and other language as set forth in Exhibit A, grant to the lessee the right to deduct post-production expenses from the lessor's royalty (assuming for purposes of this question that such expenses were reasonable and actually incurred)?<sup>7</sup>

The West Virginia Supreme Court reformulated the two questions into one as follows.

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

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<sup>6</sup> *Tawney*, 633 S.E.2d at 25 n. 2 (emphasis added).

<sup>7</sup> *Id.* (emphasis added).

<sup>8</sup> *Id.* at 24-25 (emphasis added).

These questions from *Tawney* provide an excellent background and context for the discussions which follow, and which lead to the detailed analysis of the *Tawney* decision.

## II. Brief Summary of Selected Marketable Product Rule Cases in Oklahoma, Kansas and Colorado

An excellent source of information on the development of the first marketable product rule in Kansas is the 1995 Kansas Supreme Court decision in *Sternberger v. Marathon Oil Co.*<sup>9</sup> This was a class action gas royalty case involving both Kansas and non-Kansas plaintiffs, with royalty and overriding royalty interests in oil and gas leases located in Kansas, Oklahoma, Texas, Louisiana, Utah and Colorado. Only the Kansas, Texas and Oklahoma leases are involved in the appeal to the Kansas Supreme Court.

The issue of interest here is Marathon's predecessor's **deduction from the royalties** marketing costs or gathering line amortization expenses to recover a portion of its expenses in constructing and maintaining gas gathering pipeline systems to transport gas from the lease to market off the lease. The trial court declared Marathon's deductions improper and Marathon appealed.

There was no market for the gas at the wellhead and after gathering gas from the individual wells, the gas was transported downstream to the purchaser. The royalty provision of the class representative provided that:

"[t]o pay lessor for gas of whatsoever nature or kind produced and sold, or used off the premises, or used in the manufacture of any products therefrom, **one-eighth (1/8), at the market price at the well**, (but, as to gas sold by lessee, in no event more than one-eighth (1/8) of the proceeds received by lessee from such sales), for the gas sold, used off the premises, or in the manufacture of products therefrom, said payments to be made monthly."<sup>10</sup>

The Kansas Supreme Court interpreted this provision as being "silent as to deductions." In other words, the "at the well" wording meant absolutely nothing to the court in terms of post-production cost allocation.

After detailed discussion of previous Kansas cases relating to post-production costs issue, the court addressed the marketable product concept, citing with approval a 1994 Colorado case, *Garman v. Conoco, Inc.*,<sup>11</sup> the court stated that:

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<sup>9</sup> 894 P.2d 788 (Kan. 1995).

<sup>10</sup> *Id.* at 792 (emphasis added).

<sup>11</sup> 886 P.2d 652 (Colo. 1994).

That case involved a certified federal question. In it, the Colorado Supreme Court held as we believe the law in Kansas to be: Once a marketable product is obtained, reasonable costs incurred to transport or enhance the value of the marketable gas may be charged against nonworking interest owners. The lessee has the burden of proving the reasonableness of the costs. Absent a contract providing to the contrary, a nonworking interest owner is not obligated to bear any share of production expense, such as compressing, transporting, and processing, undertaken to transform gas into a marketable product. In the case before us, the gas is marketable at the well. The problem is there is no market at the well, and in that instance we hold the lessor must bear a proportionate share of the reasonable cost of transporting the marketable gas to its point of sale.<sup>12</sup>

The requirement that the gas must first be in marketable condition before any post-production costs can be deducted trumps the “at the well” lease language.

Colorado is a very “friendly” marketable product rule jurisdiction. The leading Colorado case is *Rogers v. Westerman Farm Company*.<sup>13</sup> In the opinion conclusion the Colorado Supreme Court “laid down the law” with particularity as follows.

First, the court focused on the “at the well” and “at the mouth of the well” wording which the lessee insisted clearly demonstrated the intention of the parties to allocate post-production costs. The court responded:

**After assessing the “at the well” and “at the mouth of the well” language in this case, we conclude that the leases at issue here are silent with respect to the allocation of costs. Moreover, we decline to adopt the rule that the “at the well” language in the leases allocates transportation costs, while being silent as to other costs. Because we have determined that the leases are silent with respect to allocation of costs, we look to the implied covenant to market to determine the proper allocation of costs.**<sup>14</sup>

Having rejected the “at the well” and “at the mouth of the well” wording as SILENT with respect to the allocation of post-production costs, the court resorted to that contract construction tool all too often the cause of mischief – the implied covenant to market – to forge the Colorado first-marketable product rule.

Under the implied covenant to market, the lessees have a duty to make the gas marketable. In analyzing that duty, we look to the

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<sup>12</sup> *Id.* at 800.

<sup>13</sup> 29 P.3d 887 (Colo. 2001).

<sup>14</sup> *Id.* at 912 (emphasis added).

first-marketable product rule as guidance and adopt a definition of marketability to include both a physical condition such that the gas would be acceptable for sale in a commercial market, and a location-based assessment, such that it would be saleable in a commercial marketplace. The determination as to when gas is marketable is a question of fact. Once a determination is made that gas is marketable, costs can be allocated accordingly. Costs incurred to make the gas marketable are to be borne solely by the lessees. Alternatively, costs incurred subsequent to the gas being marketable are to be shared proportionately between the lessee and the lessors. Finally, we decline to adopt the court of appeals' view that the gas was marketable as a matter of law, and that the costs were properly deductible by the lessees as a result of such a conclusion.<sup>15</sup>

A 2007 decision by a Colorado appellate court applied the *Rogers* decision to a dispute which included, *inter alia*, the royalty owner's claim that the producer underpaid gas royalties by "improperly deducting the cost of gathering, processing, and transporting the gas to the commercial marketplace from the royalty payment."<sup>16</sup>

After reviewing the major pronouncements of the Colorado Supreme Court in *Rogers*, the *Clough* court repeated the definition of marketability.

Once gas is marketable, the supreme court concluded, the allocation of costs between the working interest owner and the royalty interest owner can be determined. The working interest owner must bear the costs of getting the gas to a marketable condition and marketable location, but once the gas is marketable, additional costs to improve or transport the gas must be shared proportionately between the working interest owner and the royalty interest owner. *Rogers v. Westerman Farm Co.*, *supra*.<sup>17</sup>

One appeal point in this case was whether the plaintiff royalty owner was entitled to **an instruction that the "at the well" royalty provision was silent about the allocation of costs.** The trial court refused to give the requested instruction. This court held that since *Rogers* resolved that issue as a matter of law, there was no need for the instruction. The appellate court further stated:

Here, the jury was given all the necessary instructions, including an explanation of the implied duty to market gas; the working interest owner's obligations under this implied duty; the definition of a market; the test for marketability; and the working interest owner's

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<sup>15</sup> *Id.* There is more discussion of *Rogers* in Section VI hereinafter.

<sup>16</sup> *Clough v. Williams Production Company*, 2007 WL 416119, p. 5 (Colo. App.).

<sup>17</sup> *Id.* at 7.

entitlement to take deductions from royalties for costs incurred after the gas has become marketable.<sup>18</sup>

Under the Colorado cases, whether, when and where gas becomes marketable are questions of fact.<sup>19</sup>

The Oklahoma Supreme Court has adopted and modified over time a marketable condition or marketable product rule which is thoroughly discussed in the court's 1998 decision *Mittelstaedt v. Santa Fe Minerals, Inc.*<sup>20</sup> The *Mittelstaedt* opinion followed two earlier opinions of the court that were criticized by many as overly harsh to the interests of lessees, *Wood v. TXO Production Corporation*,<sup>21</sup> and *TXO Production Corp. v. State of Oklahoma, ex rel, Commissioners of the Land Office, et al.*<sup>22</sup>

The primary facts involved in the case made the subject of this opinion are that the lessee made **deductions "from the royalty interest paid to the lessors"** for transportation, compression, dehydration, and blending costs. The United States Court of Appeals for the Tenth Circuit certified to the Oklahoma Supreme Court the question whether such deductions were proper under a "gross proceeds" lease. The certified question was framed as follows:

In light of the facts as detailed below, is an oil and gas lessee who is obligated to pay "3/16 of the gross proceeds received for the gas sold" entitled to **deduct** a proportional share of transportation, compression, dehydration, and blending costs **from the royalty interest paid to the lessor?**<sup>23</sup>

The court recounted the development of the marketable condition rule in Oklahoma, specifically referencing *Wood*, *TXO Production Corp.* and *Johnson v. Jernigan*.<sup>24</sup> These three decisions provide considerable insight regarding as to how Oklahoma became a marketable condition jurisdiction, including use of an implied marketing obligation as a primary basis of the rule. Further, a careful reading of the opinions of the Supreme Court in *Wood* and *TXO Production Corp.* helps to explain the deeply divided *Mittelstaedt* court.<sup>25</sup>

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<sup>18</sup> *Id.* at 11.

<sup>19</sup> *Savage v. Williams Prod. RMT Co.*, 140 P.3d 67, 69-72 (Colo. App. 2005); *Rogers v. Westerman Farm Company*, 29 P.3d 887 (Colo. 2001).

<sup>20</sup> 954 P.2d 1203 (Okla. 1998).

<sup>21</sup> 854 P.2d 880 (Okla. 1992).

<sup>22</sup> 903 P.2d 259 (Okla. 1994).

<sup>23</sup> *Mittelstaedt* at 1204.

<sup>24</sup> 475 P.2d 356 (Okla. 1970).

<sup>25</sup> Three justices concurred in part and dissented in part and three justices dissented in part.



The *Mittelstaedt* court summarized its answer to the certified question as follows:

In sum, a royalty interest may bear post-production costs of transporting, blending, compression, and dehydration, when the costs are reasonable, when actual royalty revenues increase in proportion to the costs assessed against the royalty interest, when the costs are associated with transforming an already marketable product into an enhanced product, and when the lessee meets its burden of showing these facts.<sup>26</sup>

The court further described its version of the marketable product rule.

We conclude that this clause, when considered by itself, prohibits a lessee from deducting a proportionate share of transportation, compression, dehydration, and blending costs when such costs are associated with creating a marketable product. However, we conclude that the lessor must bear a proportionate share of such costs if the lessee can show (1) that the costs enhanced the value of an already marketable product, (2) that such costs are reasonable, and (3) that actual royalty revenues increased in proportion with the costs assessment against the nonworking interest. Thus, in some cases a royalty interest may be burdened with post-production costs, and in other cases it may not.<sup>27</sup>

The *Mittelstaedt* court generally places on the lessee the burden of proving that it has met the three qualifying conditions.

### III. Some Important Terminology

By way of further background, it is instructive to consider the meanings ascribed to certain oil and gas terms by the marketable product rule courts. These terms include “marketable condition,” “marketable product,” “production,” “deduction from what,” “allocation” of post-production costs, “at the well” and “at the wellhead.” All of these terms are implicated in the commonly litigated fact situation: (i) the gas royalty clause provides for royalties based upon values or prices “at the well” or “at the wellhead;” (ii) there is no market for the gas at the well or wellhead; (iii) downstream of the well or wellhead costs for gathering, compressing, treating, sometimes processing and transportation are incurred before the gas is delivered to the pipeline company at the location where the gas is sold; the distances of the points of the sale from the wellhead vary greatly; and (iv) sometimes these costs represent a substantial portion of the sales price to the pipeline.

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<sup>26</sup> *Id.* at 1204.

<sup>27</sup> *Id.* at 1205.

For purposes of exploring the importance of the above-referenced terminology, assume that the operative wording in the lease royalty provision is as follows:

The royalty on gas shall be an amount equal to 1/6 of the price, net of all costs beyond the wellhead.

Assume further that there are no other lease provisions which discuss post-production costs and how, if at all, those costs are to be dealt with in calculation of the royalties payable to the royalty owner.

Finally, assume that the marketable product rule to be applied is stated as follows:

The only post-production costs deductible for gas royalty calculation purposes are those incurred after the lessee has achieved a marketable product.

While this articulation is quite basic, it is adequate to explore the meanings attributed to the terminology.

#### A. When Does Production End?

If the subject is “post-production costs,” it is logical that the threshold determinations are what is meant by the term “production” and when does the production process end. Until marketable product doctrines began to take hold, in most jurisdictions the oil and gas engineers and the courts answered these two questions in essentially the same ways.

As participants in the oil and gas industry, you are probably confident that you know what is meant by the term “production” as that term has been used for royalty determination purposes in Louisiana, Texas, Colorado, Kansas, Oklahoma and many other jurisdictions far back into the last century. It has long been widely understood in the industry that for royalty determination purposes, production ends at the wellhead.<sup>28</sup> One of the frequently used definitions of “production” in industry circles is that production ends when the oil and/or gas are reduced to possession of the operator at the surface.<sup>29</sup> One commentator explains that “[l]ittle dispute has arisen under the oil royalty clause as to when oil or gas is produced . . . for purposes of the oil royalty clause, production normally means the act of severing the hydrocarbons from the ground.”<sup>30</sup> Accepting these commonly used industry definitions, most

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<sup>28</sup> See, e.g., *Riley v. Merriwether*, 780 S.W.2d 919, 923 (Tex. App.—El Paso 1989, writ denied) (stating that production of a well involves actually taking oil or gas from the well in a captive state for either storing or marketing the product for sale) citing 3 HOWARD R. WILLIAMS & CHARLES J. MEYERS, OIL AND GAS LAW §631 at 395 (1989); Bruce K. Kramer, *Interpreting the Royalty Obligation By Looking at the Express Language: What a Novel Idea*, 35 TEX. TECH L. REV. 223, 234 (2004).

<sup>29</sup> *Riley*, 780 S.W.2d at 923.

<sup>30</sup> *Kramer, supra*, note 19 at 234.

folks in the oil and gas industry have had no difficulty in deciding when production activities end and post-production activities begin for royalty determination purposes. The “well,” “wellhead” and “mouth of the well” terms provide a clear and unambiguous location of the end of “production.”

That confidence in understanding of the meaning of the term “production” for royalty determination purposes is confirmed by many court decisions and state statutory laws and regulations. For example, the Fifth Circuit Court of Appeals has stated that “[i]n the interests of consistency, logic, and economics, [the] court adopts as the legal definition of the word ‘production,’ as used in the context of calculating royalty payments, the actual physical severance of minerals from the formation.”<sup>31</sup> The court then cited numerous cases from various courts, including the Supreme Court of the United States, which had given consistent or even identical definitions of the term “production.”<sup>32</sup>

It is generally accepted in the oil and gas industry and in most judicial jurisdictions that “production” ends upon severance of the mineral from the ground, not at some uncertain point downstream of the well.<sup>33</sup> This generally accepted definition of “production” is not conditioned on whether or not a marketable product exists or how a “marketable product” is created or defined. This definition does not rely upon any implied covenant to market gas, nor is there any reason for any such reliance. This generally accepted definition means what it says—“production” ends upon severance of the gas at the well by the lessee.

Now, enter the first marketable rule and marketable product rule jurists, and suddenly the term “production” as it has been defined and used in the oil and gas industry for over a century takes on some new meaning for royalty determination purposes. The new meaning is not the result of any change in the physical activities associated with severance of the gas from the reservoir or of activities occurring downstream of the wellhead separators. Rather, it has become one of the contract interpretation tools used to eliminate the longstanding understanding that

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<sup>31</sup> *Diamond Shamrock Exploration Co. v. Hodel*, 853 F.2d 1159, 1168 (5th Cir. 1988).

<sup>32</sup> *Id.* citing *Interstate Natural Gas v. FPC*, 331 U.S. 682, 690, 67 S.Ct. 1482, 1487, 91 L.Ed. 1742, 1748 (1947) (production involves a physical act); *Energy Oils v. Montana Power Co.*, 626 F.2d 731, 738 (9th Cir. 1980); *Saturn Oil & Gas Co. v. FPC*, 250 F.2d 61, 64 (10th Cir. 1957), *cert. denied*, 355 U.S. 956, 78 S.Ct. 542, 2 L.Ed.2d 532 (1958) (act of bringing forth gas from the earth); *Wyoming v. Pennzoil Co.*, 752 P.2d 975, 979 (Wyo. 1988) (production requires severance of mineral from ground); *Exxon Corp. v. Middleton*, 613 S.W.2d 240, 244 (Tex. 1981) (requires extraction of gas); *Monsanto Co. v. Tyrrell*, 537 S.W.2d 135, 137 (Tex.Civ.App. 1976) (actual physical severance); *Christian v. A.A.Oil Corp.*, 161 Mont. 420, 428, 506 P.2d 1369, 1373 (1973) (withdrawn from land and reduced to possession); *Continental Oil Co. v. Landry*, 215 La. 518, 41 So.2d 73, 75 (1949) (requires extraction).

<sup>33</sup> See *supra* notes 28 and 29 and accompanying text.

“production” ends at the outlet of the well, and to justify ignoring the plain meaning of the terms “at the well” and “at the wellhead” in the context of post-production cost royalty considerations.

Professor Owen Anderson, one of the commentators who has addressed the marketable product type rules and post-production costs in several articles, states that production of oil and gas does not end until a marketable product is “produced” by the lessee.<sup>34</sup> Professor Anderson concludes that because royalty is a “share of production,” royalty should be calculated at the point that production ends—*i.e.*, in his view, at the point where there is a marketable product.<sup>35</sup>

With all due respect to Professor Anderson, royalty paid in money is not actually a “share of production.” Royalty in-kind is a share of production. Under the “at the well” type royalty provisions being considered here, the royalty owner does not own or receive any production as his/her “royalty share.” Upon severance, all of the gas is owned by the lessee. The royalty owner is entitled to the amount of money yielded by the proper application of the terms of the royalty provision.

While describing the royalty as a “share of production” sounds supportive of Professor Anderson’s elastic concept of production, it is, at best, a misnomer. However, Professor Anderson’s “reasoning” can be used by some to justify elimination of some or all of the post-production costs as those costs have long been understood in the oil and gas industry.

Some marketable product rule courts and commentators have relied upon an expanded definition of “production” to justify adoption of such rule. Such revisionist courts and commentators should pursue their goal without changing the meaning of such a fundamental lease and industry term as “production” just to facilitate altering the bargain long struck between royalty owners and lessees in terms of the payment of royalties. If a marketable product rule is appropriate under given leases, it should be so because of credible evidence of the intention of the parties, not because of redefining and/or extending the meaning of oil and gas terms that already have well established meanings.

## **B. “Deductions From What”**

Already this paper contains numerous references to “deduction” of post-production costs “from the royalty” or from the “lessor’s royalty.”

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<sup>34</sup> Owen L. Anderson, *Royalty Valuation: Should Royalty Obligations Be Determined Intrinsically, Theoretically, or Realistically? Part 2*, 37 NAT. RESOURCES J. 611, 684 (1997). Professor Anderson has written extensively on the marketable product rule. See also Owen L. Anderson, *Royalty Valuation: Should Royalty Obligations Be Determined Intrinsically, Theoretically, or Realistically? Part 1*, 37 NAT. RESOURCES J. 547 (1997).

<sup>35</sup> See generally Anderson *supra* note 34.

Some of those references have been highlighted for emphasis. In the two questions certified to the *Tawney* court and the court's reformulation into a single question, there are three (3) references to deduction of post-production costs "**from the royalty**" or "**from the lessor's royalty.**" Unfortunately, loose and imprecise use of this terminology by many of us in the oil and gas industry, and by many courts, adds to the misperception of the true nature of the monetary royalty interest provided for in the "at the wellhead" or "at the well" royalty provisions. Those of us who have litigated post-production cost royalty cases have deposed royalty owners who almost always (in my experience) have the same explanation of **what is deducted from what.**

The royalty owner's explanation frequently goes something like this. Step one – my royalty is 1/6 of the downstream sales price of the gas – e.g., \$1.00 per MMBtu where the gas is sold downstream for \$6.00 per MMBtu. That is **MY ROYALTY.** Step two – the lessee deducts 1/6 of the \$2.00 in post-production costs (i.e., 33 cents) **FROM MY ROYALTY.** That **REDUCES MY ROYALTY** to \$2.00 minus \$0.33 or \$1.67 per MMBtu. Therefore, **I GET LESS THAN MY FULL 1/6 ROYALTY.**

It is not only the royalty owners who give this explanation of what is deducted from what. In representing producers it is common to find communications to the royalty owners from the producer's royalty department similar to the following (without the emphasis):

Dear Ms. Jones:

This will confirm that the \$1,006 **DEDUCTIONS FROM YOUR DECEMBER 2003 ROYALTY** was for various post-production costs . . .

Sincerely,  
Ms. Royalty Specialist

Dear Mr. Smith:

The reason we **DEDUCTED \$776.00 FROM YOUR ROYALTY FOR MARCH 2000** is because your lease provides that you are to be paid the price of the gas at the well.

Sincerely,  
Mr. Royalty Manager

In preparing Mr. Royalty Manager and Ms. Royalty Specialist for their depositions, they are often shocked when told that the royalty owner contends the producer is taking back part of the royalty owed to the royalty owner. Both Ms. Royalty Specialist and Mr. Royalty Manager insist that the royalty fraction is not applied until the netback at the well is calculated. Thus, none of the costs were ever included in the "royalty."

They are absolutely right. However, it is a fair reading of their letters as saying exactly what the royalty owner said in her/his deposition testimony, and will certainly say at trial.

When a lease provides for a royalty of “1/8 of the market price of the gas at the well,” the dollar amount of the 1/8 royalty does not come into existence until after deduction of the post-production costs from the downstream sales price. For example, if the downstream sales price is \$4.25 per MMBtu and the total amount of permitted deductions for post-production costs is \$1.00 per MMBtu, the price at the well is [ $\$4.25 \text{ per MMBtu}$ ] – [ $\$1.00 \text{ per MMBtu}$ ] or \$3.25 per MMBtu. When the \$3.25 per MMBtu<sup>36</sup> figure has been multiplied by the royalty fraction, it yields the dollar and cents amount of royalties per MMBtu. There has been no deduction from the lessor’s royalty. The lessor’s royalty amount did not come into existence until **after** the price at the well was established.

In my experience, royalty owners are totally unimpressed during litigation when they are told that the lessee’s royalty department personnel simply used “loose wording” and/or that they didn’t mean what they said. Such documents create doubt on the part of the royalty owners and sometimes the courts about the accuracy and/or truthfulness of the lessee’s explanation of its understanding of its royalty obligation and, more particularly, of how post-production costs should be dealt with in making royalty determinations. That doubt is also often readily created in the minds of jurors, who expect the lessee’s personnel to communicate accurately with full understanding of the information contained in such documents. Many jurors simply do not accept an employee’s: “I really didn’t mean what I wrote” explanation, even when it is a completely truthful statement.

Throughout this presentation, references to deductions of post-production costs mean deductions from the downstream sales price. References to the wellhead price mean the price after deduction of the post-production costs from the downstream sales price. It is that price to which the royalty fraction should be applied to calculate the royalty payments. A short-hand term for this royalty calculation component is “Royalty Value” or “Royalty Price.” The royalty fraction is multiplied by the Royalty Value or Royalty Price to get the amount of the royalty payment.

### **C. “At The Well” and “At The Wellhead”**

I really dislike automobiles that talk to the driver. I especially dislike those navigation systems which not only tell you how to proceed, but also rebuke you when you don’t follow instructions. Yet, I do

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<sup>36</sup> All numeric references to gas prices and amounts of post-production costs are expressed per MMBtu. For purposes of simplicity, the MMBtu unit is frequently omitted in this presentation.

understand that some remote locations can be very difficult to find without some extra-ordinary assistance. Some of the marketable product rule opinions leave me with the impression that the courts need a super-sophisticated “navigation system” to locate the “well” and the “wellhead” in gas royalty provisions providing for royalty to be calculated “at the well” or “at the wellhead.”

To be sure, many things have changed in the oil and gas industry since that oil boom in Titusville long ago. One has never needed a satellite spying eye locator to find the “well” or the “wellhead” in any onshore gas field, however. If one wishes to visit the Bubba Boudreaux No. 1 well in a given field, one drives or walks out to the hunk of iron with the sign saying “Bubba Boudreaux No. 1 Well.” That is a fixed location. It doesn’t move.

When calculating royalty for Bubba Boudreaux for production from the Bubba Boudreaux No. 1 Well under a lease providing that royalty on gas shall be calculated “at the well” or “at the wellhead,” the point for calculating the dollar amount of royalty is no mystery. Or is it? As will soon be discussed, there appears to be considerable mystery regarding the “location of the well” or the meaning of the “at the well” wording. Of course, what appears to be a mystery is nothing more than judicial “logic” used to justify ignoring the plain meaning of the terms in determining the intention of the parties to the lease.

#### **D. Marketable Condition**

Concepts of marketable condition of gas existed long before the advent of the various species of marketable condition rules. Companies which transport natural gas have always established qualitative specifications for natural gas as a condition to taking the gas into their pipelines for transportation to the first or further markets. Excessive contaminants in the gas can cause great harm to the pipeline and associated facilities. Purchasers of gas do not want to buy gas unfit for resale or other use by them. The price paid for gas normally depends upon the various components of the gas stream. All of these considerations in a real sense are factored in the context of whether the gas is marketable.

In marketable product rule jurisdictions “marketable condition” frequently means something more than whether the gas is in a physical condition such that there are persons and/or entities which are willing to purchase the gas. One of the factors which distinguishes some marketable product rules from others is how the courts define “marketable condition.”

Kansas is a marketable rule jurisdiction. Under Kansas law, gas can be in “marketable condition” at the well even if there is no commercial market at the well. The Kansas Supreme Court in its 1995 decision in *Sternberger v. Marathon Oil Co.* held that where the gas is in marketable

condition at the well and transportation is required to a commercial market, the lessor must bear a portion of those transportation costs.<sup>37</sup> In *Sternberger*, the emphasis appears to be on the composition of the gas stream.

Colorado is another marketable product rule jurisdiction. The flagship Colorado case is *Rogers v. Westerman Farm Co.*<sup>38</sup> The producers in *Rogers* sought to make deductions through use of “netback” or “workback” methods to establish a Royalty Price or Royalty Value “at the well.”

The *Rogers* Court defined marketable condition as follows:

**In defining whether gas is marketable, there are two factors to consider, condition and location. First, we must look to whether the gas is in a marketable condition, that is, in the physical condition whether it is acceptable to be bought and sold in a commercial marketplace. Second, we must look to location, that is, the commercial marketplace, to determine whether the gas is commercially saleable in the oil and gas marketplace.**<sup>39</sup>

The *Rogers* court treats the issues of marketable condition and marketable location as fact issues.

In the *Mittelstaedt* decision the Oklahoma Supreme Court defines marketable condition as gas in terms of the physical condition of the gas.<sup>40</sup> It does not impose the location requirement in *Rogers*.

#### IV. West Virginia Contract Construction Rules

Any fair assessment of the West Virginia Supreme Court’s adoption of a marketable product rule is aided by consideration of the rules of contract construction by which the court was to be guided. The following contract construction rules were most relevant to the *Wellman* and *Tawney* decisions.

- a. A covenant will be implied in a contract only where the contract contains no express provisions with regard to the subject matter of the implied covenant.<sup>41</sup>
- b. Where contract terms are clear and unambiguous, they must be applied by the court and not construed.<sup>42</sup>

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<sup>37</sup> *Sternberger v. Marathon Oil Co.*, 894 P.2d 788, 800 (Kan. 1995).

<sup>38</sup> *Rogers v. Westerman Farm Co.*, 29 P.3d 887 (Colo. 2001) (*en banc*).

<sup>39</sup> *Id.* at 905 (emphasis added).

<sup>40</sup> *Mittelstaedt v. Santa Fe Minerals, Inc.*, 954 P.2d 1203, 1208 (Okla. 1998).

<sup>41</sup> *Croston v. Ema: Oil Co.*, 464 S.E.2d 728 (W. Va. 1995); *Thompson Dev., Inc. v. Kroger Co.*, 413 S.E.2d 137 (W. Va. 1991); *DeStubner v. Microid Process*, 21 S.E.2d 154 (W. Va. 1942); *Berry v. Humphreys*, 86 S.E. 569 (W. Va. 1915).

<sup>42</sup> Syl. pt. 3, *Waddy v. Riggelman*, 606 S.E. 2d 222 (W. Va. 2004); Syl. pt. 2, *Orteza v. Monongalio County General Hosp.*, 318 S.E.2d 40 (W. Va. 1984); Syl. Pt. 2,



- c. "An oil and gas lease which [sic] is clear in its provisions and free from ambiguity, either latent or patent, should be considered on the basis of its express provisions and it is not subject to a practical construction by the parties."<sup>43</sup>
- d. "It is not the right or province of the court to alter, pervert or destroy the clear meaning and intent of parties as plainly expressed in their written contract or to make a new and different contract for them."<sup>44</sup>
- e. It is a basic tenet of contract construction that each and every word is to be given meaning, and that the court cannot create or impose an implied covenant or construction that is inconsistent with the express terms of the contract.<sup>45</sup>
- f. Individual terms in a contract provision are not to be interpreted separately, but are to be read together with all other words in that contract provision so that all words are given meaning.<sup>46</sup>
- g. "The term 'ambiguity' is defined as language 'reasonably susceptible of two different meanings' or 'language of such doubtful meaning that reasonable minds might be uncertain or disagree as to its meaning'."<sup>47</sup>
- h. "If it is found to be ambiguous, the rules applicable to that type of instrument are used to ascertain the meaning of the parties and if the instrument contains irreconcilable provisions the rules are equally well established for determining the dominant intent in the circumstances."<sup>48</sup>
- i. "The question as to whether a contract is ambiguous is a question of law to be determined by the court."<sup>49</sup>

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*Bethlehem Mines Corp. v. Haden*, 172 S.E.2d 126 (W. Va. 1969).

<sup>43</sup> *Cotiga Dev. Co. v. United Fuel Gas Co.*, 128 S.E.2d 626, 634 (W. Va. 1962) (quoting Syl. pt. 3, *Little Coal Land Co. v. Owens-Illinois Glass Co.*, 63 S.E.2d 528 (W.Va. 1951)).

<sup>44</sup> *Id.* at 633 (emphasis added) (citing *Bischoff v. Francesca*, 56 S.E.2d 865, 870 (W. Va. 1949); *Lange & Crist Box & Lumber Co. v. Haught*, 52 S.E.2d 695, 699 (W. Va. 1949); *Kanawha Banking & Trust Co. v. Gilbert*, 46 S.E.2d 225, 236 (W. Va. 1947)).

<sup>45</sup> *Barn-Chestnut, Inc. v. CFM Dev. Corp.*, 457 S.E.2d 502, 509 (W. Va. 1995).

<sup>46</sup> See, e.g., *Moore v. Johnson Serv. Co.*, 219 S.E.2d 315, 320 (W. Va. 1975); *Chambers v. Simmons*, 85 S.E. 182, 184 (W. Va. 1915).

<sup>47</sup> *Payne v. Weston*, 466 S.E.2d 161, 166 (W. Va. 1995) quoting Syl. Pt. 1, in part, *Shamblin v. Nationwide Mut. Ins. Co.*, 332 S.E.2d 639 (W. Va. 1985).

<sup>48</sup> *Lewis v. Dils Motor Co.*, 135 S.E.2d 597, 601-02 (W. Va. 1964).

<sup>49</sup> Syl. Pt. 1, in part, *Berkeley County Pub. Serv. Dist. V. Vitro Corp. of Am.*, 162 S.E.2d 189 (W. Va. 1968).

j. “[T]he general rule as to oil and gas leases is that such contracts will generally be liberally construed in favor of the lessor, and strictly as against the lessee.”<sup>50</sup>

k. “Where the meaning of a writing is uncertain and ambiguous, parol evidence is admissible to show the situation of the parties, surrounding circumstances when the writing was made, and the practical construction given to the contract by the parties themselves either contemporaneously or subsequently.”<sup>51</sup>

We know that courts have considerable discretion in selecting and applying the rules of contract construction they employ in resolving contract disputes. The West Virginia Supreme Court is no exception. This single reality has over time helped put droves of children of lawyers through college, including my daughter and son, one of whom is a lawyer. In the *Wellman* and *Tawney* decisions, the West Virginia Supreme Court demonstrated its discretionary skills, and provided wonderful opportunities for the children of many lawyers needing college tuition funding as the West Virginia courts are likely to be called upon repeatedly in the future to further explain and possibly develop further its marketable product rule.

#### V. *Wellman*, on the way to *Tawney*

*Tawney* is the proverbial “second shoe” after the West Virginia Supreme Court’s 2001 decision in *Wellman*. While there are other issues addressed in *Wellman*, comments here are limited to the Court’s construction of the following gas royalty provision:

... one-eighth (1/8) of the market value of such gas at the mouth of the well; is [if] such gas is sold by the Lessee, then as royalty one-eighth (1/8) of the proceeds from the sale of gas as such at the mouth of the well where gas, condensate, distillate or other gaseous substance is found.<sup>52</sup>

Stripped to their essentials, the critical facts included the above-quoted royalty provision, a downstream sales price of \$2.22, the amount of post-production costs which the Defendant sought to deduct from the downstream sales price was \$1.35, the amount of the proceeds at “the mouth of the well” was \$0.87.<sup>53</sup> Applying the 1/8 royalty fraction to the \$0.87 yields a royalty of \$0.10875, or rounded to 10.9 cents per MMBtu.

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<sup>50</sup> Syl. Pt. 1, *Martin v. Consolidated Coal & Oil Corp.*, 133 S.E. 626 (W. Va. 1926).

<sup>51</sup> Syl. Pt. 4, *Watson v. Buckhannon River Coal Co.*, 120 S.E. 390 (W. Va. 1923).

<sup>52</sup> *Wellman v. Energy Resources, Inc.*, 557 S.E.2d 254, 257-58 (W. Va. 2001) (emphasis added).

<sup>53</sup> *Id.* at 263.

The plaintiff royalty owner argued that no post-production costs should be deducted from the downstream sales price.<sup>54</sup> Thus, the royalty per MMBtu should be determined by multiplying \$2.22 by 1/8, which yields a royalty of \$0.2775, rounded to 28 cents per MMBtu. Using the royalty owner's approach, she/he will receive 16.9 cents more per MMBtu than by using the dollar amounts of the proceeds at the mouth of the well as urged by the Defendant producer.

Could the *Wellman* Court have held that application of the royalty provision as written requires making the royalty calculation by multiplying the \$2.22 MMBtu downstream sales price by the 1/8 royalty fraction? Of course, the Court could hold anything. Such a holding, however, would have been in irreconcilable conflict with the plain meaning of the provision as written and with several of the rules of contract construction already described.<sup>55</sup> For example, the West Virginia Supreme Court stated in its 1963 *Davis v. Hardman* opinion, upon which the *Wellman* Court relies, in part, that:

In the construction of a deed or other legal instrument, the function of the court is to **ascertain the intent of the parties as expressed in the language used by them.**<sup>56</sup>

The words "proceeds from the sale of such gas **at the mouth of the well**" where the "**gas, condensate, distillate or other gaseous substance is found**" must be ignored to base the royalty owner's 1/8 royalty on the value at any location other than "**at the mouth of the well.**" It is extremely difficult to imagine how the *Wellman* Court could be said to have complied with this rule set out in *Davis* and quoted immediately above.

The *Davis* Court also discussed another rule of contract construction:

All rules of construction must yield to be [the] expressed intention of the parties if that can be ascertained.<sup>57</sup>

It is equally difficult to conceive how the *Wellman* Court complied with this rule. It is not only the point of royalty valuation that is readily ascertainable—"at the mouth of the well." The proceeds at the mouth of the well are undeniably less (lower dollar amounts) than the downstream sales price. These indisputable facts, coupled with the plain meaning of the wording of the *Wellman* royalty provision, should have caused the *Wellman* court to reject the plea to adopt a form of a marketable product rule in lieu of enforcing the royalty provision as written.

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<sup>54</sup> *Id.* at 258.

<sup>55</sup> pp. 12 – 14, *supra*.

<sup>56</sup> *Davis v. Hardman*, 133 S.E.2d 77, 81 (W. Va. 1963) (emphasis added).

<sup>57</sup> *Id.*

A critical factor relied upon by the *Wellman* Court draws in part upon another part of the *Davis* opinion. The *Wellman* Court stated that:

The one-eighth received is commonly referred to as the landowners royalty. In *Davis v. Hardman* . . . this Court stated that a “a distinguishing characteristic of such a royalty interest is that it is not chargeable with any of the costs of discovery and production. The Court believes that such a view has been widely adopted in the United States.”<sup>58</sup>

This statement tells the reader that for royalty determination purposes the *Wellman* Court recognizes “discovery” and “production” as different activities. The statement also recognizes that the referenced view which “has been widely adopted in the United States” is specific to “discovery” and “production” activities. For example, transportation of gas from the well to a pipeline is neither a discovery nor a production activity or cost. It is a post-production activity and cost. While the quoted excerpt from *Davis* makes clear that the “royalty interest” is not chargeable with any costs of “discovery” or “production,” it makes no such declaration with respect to transportation or any other post-production costs.

The *Wellman* Court reasserts the belief “that such a view has been widely adopted in the United States.” “Such a view” is clearly a reference to the view that “a royalty interest is not chargeable with any of the costs of discovery and production.” If one defines production as ending at the well or upon severance of the oil and/or gas at the surface, the Court is indeed stating “a view which has been widely adopted in the United States.” Since *Wellman* is a case involving, among other things, the issue of deductibility of post-production costs from a downstream sales price for the gas, this portion of the opinion should have encouraged the Defendant to expect that post-production costs would be deductible if actually incurred and reasonable in amounts.

At this point in *Wellman* it appears that the court will not use some expanded, artificial concept of production to justify denial of deduction of post-production costs. The thought process by which the Court is building its opinion is better understood from another opinion excerpt regarding the assumed (not established by evidence) motivation of the defendants:

In spite of this, there has been an attempt on the part of oil and gas producers in recent years to charge the landowner with a *pro rata* share of various expenses connected with the operation of an oil and gas lease such as the **expense of transporting oil and gas to a point of sale, and the expense of treating or altering the oil and gas so as to put it in a marketable condition. To escape the rule**

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<sup>58</sup> *Wellman*, 557 S.E. 2d at 263-64 (emphasis added).

**that the lessee must pay the costs of discovery and production, these expenses have been referred to as ‘post-production expenses.’<sup>59</sup>**

The question here is from what rule is the Defendant seeking to “escape.” There is no “escape” from the rule “that the lessee must pay the costs of discovery and production” when the Defendant deducts “post-production costs,” as opposed to costs of discovery and production, from the downstream sales price. Neither *Wellman, Davis* nor any prior West Virginia court opinions characterized the costs the *Wellman* Defendant sought to deduct as “discovery” or “production” costs. From what, if any, established rule of West Virginia law has the defendant escaped by making the subject deductions from the sales price? Pre-*Wellman*, there was no West Virginia rule of law defining “production” to include the post-production costs at issue in *Wellman*.

It appears that the court’s erroneous “escape” wording betrays an underlying pre-disposition on the part of the Court to the view that it is somehow unfair or wrong for the royalty owner to receive royalty based upon the price at the mouth of the well rather than on the higher downstream sales price. It is further likely that that the amount of the post-production costs involved here struck an equity nerve of the court. The downstream costs totaled almost 60% of the \$2.22 price paid by the pipeline purchaser to the lessee. The total amount of deductions was 155% of the proceeds at the well used to calculate the royalty. This data does not necessarily mean that the amounts of post-production costs deducted from the downstream sales price are unreasonable based upon any proper evidentiary or other legal standard. However, the *Wellman* Court made a not too subtle shift in its analysis to find a justification for denying some or all of the deductions.

Is the Court actually concluding that it recognizes a different definition of “production” for interpretation and application of the royalty provisions than previously adopted by West Virginia courts? Is the Court actually concluding that the costs the defendant characterizes as “post-production costs” are instead “production costs?” Is the court suggesting, without being specific, that costs beyond the well remain production costs until a marketable product is achieved? None of the statements cited in *Davis* or any other pre-*Wellman* West Virginia cases provide any basis for a definition of production “widely adopted in the United States” which would include as part of “production” the activities occurring downstream of the mouth of the well.

After discussing with praise several marketable product rule court opinions,<sup>60</sup> the *Wellman* Court apparently abandoned the distinction

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<sup>59</sup> *Id.* at 264 (emphasis added).

<sup>60</sup> *Id.* at 264-65 citing among others, *Garman v. Conoco*, 886 P.2d 652 (Colo. 1994);

between production and post-production costs as a basis for resolving the deductibility issue, and, without characterizing it as such, the Court appeared to endorse a poorly articulated broad version of a marketable product rule. No longer is the key factor what the court describes as the attempt by defendants to “escape” their royalty obligations by mischaracterizing as post-production costs, costs which should be characterized as production costs. Rather, the court concludes that:

In view of all this, this Court concludes that if an oil and gas lease provides for a royalty based on proceeds received by the lessee, **unless the lease provides otherwise, the lessee must bear all costs incurred in exploring for, producing, marketing, and transporting the product to the point of sale.**<sup>61</sup>

The court’s emphasis on the requirement that the lessee must bear all costs of “discovery” and “production” has disappeared. Now marketing and transportation costs are added to the mix. Also, the court did not state whether the rule it enunciated applied regardless of the point at which the gas was placed in marketable condition—e.g., at the wellhead or somewhere downstream of the wellhead.

A fair reading of the somewhat rambling *Wellman* opinion is that the court recognized that re-defining “production” to encompass post-production activities lacked merit. This epiphany led the court to seize upon the implied marketing covenant as the means of excluding “marketing” and “transportation” costs from a netback calculation where one might be permitted.

Prior to the last paragraph in the portion of its opinion dealing with the post-production cost issues, the court: (i) had appeared to have concluded that the “proceeds at the mouth of the well” royalty provision does not provide for the allocation of costs between the lessor and lessee; (ii) had not found the wording of the royalty provision to be ambiguous; and (iii) appeared still to be applying a covenant to market concept essentially the same as the concept adopted by the previously discussed marketable product rule courts to be used when, in the court’s judgment the wording of the lease does not adequately provide for “allocation” of costs.

But then, the court ended this portion of the opinion with the following pronouncement:

Although this Court believes that the language of the leases in the present case indicating that the “proceeds” shall be from the “sale of gas as such at the mouth of the well where gas . . . is found” might

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*Wood v. TXO Production Corp.*, 854 P.2d 880, 882 (Okla. 1992); *Gilmore v. Superior Oil Co.*, 388 P.2d 602, 606 (Kan. 1964); *Hanna Oil & Gas Co. v. Taylor*, 759 S.W.2d 563, 565 (Ark. 1988).

<sup>61</sup> *Wellman*, 557 S.E.2d. at 265 (emphasis added).

be language indicating that the parties intended that the Wellmans, as lessors, would bear part of the costs of transporting the gas from the wellhead to the point of sale, whether that was actually the intent and the effect of the language of the lease is moot because Energy Resources, Inc., introduced no evidence whatsoever to show that the costs were actually incurred or that they were reasonable. In the absence of such evidence, this Court believes that the trial court properly granted the Wellmans summary judgment on the cost issue and that Energy Resources, Inc.'s, claims relating to the court's actions on this point are without merit.<sup>62</sup>

This statement strongly suggests (I believe clearly says) that if the defendant had offered proper proof of the post-production costs, the Circuit Court's denial of the defendant's motion for summary judgment would have been error.

In summary, the *Wellman* opinion appears to stand for three principles. The first is that:

. . . this Court concludes that if an oil and gas lease provides for a royalty based on proceeds by the lessee, **unless the lease provides otherwise**, the lessee must bear all costs incurred in exploring for, producing, marketing, and transporting the product to the point of sale.<sup>63</sup>

The second is that the "at the mouth of the well" wording in the lease might indicate that the parties to the lease intended that the lessors would bear part of the costs of transporting the gas from the wellhead to the point of the sale. And the third is that the failure of the producer Defendant to introduce evidence to show that the costs were actually incurred or that they were reasonable renders moot "whether that was actually the intent and the effect of the language of the lease."<sup>64</sup>

Because of the equivocation of the Supreme Court in *Wellman*, I refer to the decision as the "*Wellman* judicial stutter."

## VI. The *Tawney* Decision

### A. The "Second Shoe Falls"

The gestation period for a bad legal doctrine varies greatly depending upon the circumstances. The gestation period for the more clearly defined current rule of law in West Virginia on allocation of post-production costs under proceeds "at the well" and "at the mouth of the well" leases where the gas is sold by the defendant downstream of the well was almost exactly five (5) years. *Wellman* was decided on July 6, 2001. *Tawney* was decided on June 15, 2006. Whether *Tawney* is the

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<sup>62</sup> *Id.* at 265 (emphasis added).

<sup>63</sup> *Id.* (emphasis added).

<sup>64</sup> *Id.* at 265.

final word on post-production costs in West Virginia is uncertain at this time. Indeed, the *Tawney* case is currently on appeal to the West Virginia Supreme Court following remand in the 2006 decision.

## **B. Certified Question as Reformulated by the *Tawney* Court**

*Tawney* is a class action, with over 8,000 Plaintiffs and with 2,258 leases containing various lease forms.<sup>65</sup> At least 1,382 of the leases have language indicating that the royalties are to be calculated “at the well,” “at the wellhead,” “net of all costs beyond the wellhead,” or “less all taxes, assessments, and adjustments.”<sup>66</sup> The Defendant moved for summary judgment only with respect to the royalty clauses which are identified in the Court’s reformulated certified question.<sup>67</sup> The Circuit Court denied the Defendant’s motion for summary judgment.

As stated earlier, the Supreme Court’s opinion is based upon the following single question:

In light of the fact that West Virginia recognizes that a lessee to an oil and gas lease must bear all costs incurred in marketing and transporting the product to the point of sale unless the oil and gas lease provides otherwise, is lease language that provides that the lessor’s 1/8 royalty is to be calculated “at the well,” “at the wellhead” or similar language, or that the royalty is “an amount equal to 1/8 of the price, net all costs beyond the “wellhead,” or “less all taxes, assessments, and adjustments” sufficient to indicate that the lessee may deduct post-production expenses from the lessor’s 1/8 royalty, presuming that such expenses are reasonable and actually incurred?<sup>68</sup>

## **C. Summary of Parties’ Positions**

### **1. Plaintiffs’ Positions**

The *Tawney* plaintiffs’ primary complaint is that following *Wellman*, the Colorado Supreme Court’s 2001 decision in *Rogers* and other marketable product rules decisions,<sup>69</sup> the court should reject all post-production cost deductions incurred prior to placing the gas in a “marketable condition.”<sup>70</sup> Plaintiffs contend that the gas was not in marketable condition until it was sold to the downstream purchasers.<sup>71</sup>

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<sup>65</sup> *Tawney v. Columbia Natural Resources, L.L.C.*, 633 S.E.2d 22, 25 (W.Va. 2006).

<sup>66</sup> *Id.*

<sup>67</sup> *Id.* at n. 2.

<sup>68</sup> *Id.*

<sup>69</sup> See *supra* cases cited at note 60.

<sup>70</sup> *Tawney*, 633 S.E.2d at 26 citing Syl. pt. 4 of *Wellman*, 557 S.E.2d 254 (W. Va. 2001); see also Plaintiffs’ Brief in Support of Affirming Trial Court’s Rulings on Certified Questions at 10-30 (filed Jan. 27, 2006). (“Plaintiffs’ Brief”).

<sup>71</sup> Plaintiffs’ Brief at 30.



Plaintiffs further contend that the wording in the leases is ambiguous, that the court should apply an implied covenant to market the gas, that the court should follow the reasoning in the *Rogers* case and that all ambiguous terms should be strictly construed against the defendant.<sup>72</sup> Alternatively, plaintiffs challenge many or most of the costs deducted by the defendant as inappropriate types to be deducted, and/or that the amounts of the deductions as excessive.<sup>73</sup>

In their briefing, plaintiffs list twenty-three (23) types of charges which they say the defendant includes in what defendant characterizes as an “across-the-board postage stamp” rate, and which are deducted on a unit basis from all royalty payments.<sup>74</sup> These charges include, among others, operating costs, return on investment, cost of royalty payments to owners, operating and maintenance expenses for gathering facilities and line losses usually attributable to line leaks.<sup>75</sup> According to plaintiffs, the defendant admitted that it pays all royalties from the pool of gas from multiple sources on the same basis regardless of the wording of the royalty provisions.<sup>76</sup> It appears that this fact was a major factor in the court’s decision to certify the class, despite the large number of leases (with many different royalty provisions) at issue. Plaintiffs assert that such a practice shows that the defendant was not actually relying upon or applying the specific lease provisions.<sup>77</sup>

According to plaintiffs, prior to 1993 the defendant did not make any of these deductions.<sup>78</sup> Plaintiffs point to evidence that the decision to begin the deductions in 1993 was made after serious debate within the company regarding its right to make the deductions.<sup>79</sup> If the wording in the leases so clearly permits the deductions, why, ask the plaintiffs, did the defendant not begin making the deductions earlier?<sup>80</sup> Why the need for internal debate over the decision whether to commence the deductions in 1993 if the terms of the royalty provision unambiguously give the defendant the right to make the deductions?<sup>81</sup> The obvious answers to all of these questions, according to the plaintiffs, is that the

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<sup>72</sup> *Id.* at 10-30.

<sup>73</sup> *See* Petitioner/Plaintiffs’ Reply Brief Regarding Certified Questions at 42-43 (Filed Mar. 31, 2006) (“Plaintiffs’ Reply Brief”).

<sup>74</sup> *See* Plaintiffs’ Brief at 1-3.

<sup>75</sup> *Id.*

<sup>76</sup> *Id.* at 3.

<sup>77</sup> *Id.* at 3-4.

<sup>78</sup> Plaintiffs’ Reply Brief at 9.

<sup>79</sup> *Id.* at 11.

<sup>80</sup> *See id.*

<sup>81</sup> *See id.*

deductions were not permitted under the leases and the defendant knew that they were not permitted.

Plaintiffs also complained that the defendant made “intra-sales” to sister companies, failed to pay for constituents extracted from the gas, made forward sales to offshore companies, experienced excessive line loss and sent monthly statements to the plaintiffs stating affirmatively that there were “0” deductions from their royalty and represented that defendants received an amount certain for their gas.<sup>82</sup> The plaintiffs’ argued that “[t]his figure was false.”<sup>83</sup>

While the Supreme Court did not analyze or decide any of the issues mentioned in the prior paragraph, it is quite possible that concerns on the part of the court regarding these issues, might have contributed to the court’s decision on the wording required in a lease to provide adequate instruction to permit the lessee to make deductions from the sales price for post-production costs.

The plaintiffs insisted that if the defendant wished to make the post-production costs deductions it would have been very easy to specify that right with a properly worded royalty provision.<sup>84</sup> The provision could have identified the specific types of costs to be deducted, and how the amounts of the costs were to be determined, along with the specific location at which the royalty payments were to be calculated.<sup>85</sup> Plaintiffs complained that wording like “at the well,” “at the wellhead” and/or “net proceeds at the well” failed to provide enough details on royalty calculations to permit the deductions.<sup>86</sup>

## 2. Defendant’s Positions

The defendant expressed its plea for relief from the Supreme Court, in part, as follows:

CNR now asks this Court to reverse the trial court on the basis that the “deductibility” language in the leases is clear and unambiguous and, as a matter of law, those leases which contain express deductibility language allow the lessee to deduct the royalty owners’ proportionate share of post-production expenses, **provided CNR can prove as if in an action for an accounting that such expenses are actual and reasonable.**<sup>87</sup>

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<sup>82</sup> See Plaintiffs’ Reply Brief at 43.

<sup>83</sup> *Id.*

<sup>84</sup> See *id.* at 13-14.

<sup>85</sup> See *id.* at 11.

<sup>86</sup> See *id.* at 13-18.

<sup>87</sup> Brief of Defendant Columbia Natural Resources, L.L.C. On Certified Questions at 4 (Filed Mar. 17, 2006) (“Defendant’s Brief”) citing *Wellman*, 557 S.E.2d at 265.

(emphasis added). The highlighted wording is obviously an invocation of the portion of the *Wellman* opinion which certainly appears to justify defendant's request.

While the defendant offered numerous criticisms of plaintiffs' legal and factual assertions, the following examples suffice for purposes of this analysis of the *Tawney* opinion.

1. Plaintiffs' legal position reads out of the leases the "at the well," "at the wellhead" and similar wording, in contravention of applicable rules of contract construction.<sup>88</sup> This language explicitly provides that the point of valuation for the gas royalty determination purposes is at the well, not at a downstream delivery and sales location.<sup>89</sup>

2. The royalty provisions at issue are unambiguous, they clearly provide for royalty valuation "at the well" or "at the wellhead" and, thereby, for the allocation of post-production costs between the lessor and lessee. The court should not import into the contract any implied covenant to market the gas.<sup>90</sup>

3. Numerous of the lessors under leases at issue are sophisticated contracting parties and the "construe the lease against the lessee" doctrine has no application to such leases.<sup>91</sup>

4. The gas is marketable once it enters the gathering system, but some of the gas is not in a condition to be delivered to major interstate pipelines without processing.<sup>92</sup>

5. It is a common practice to collect gas gathered from numerous wells in rural West Virginia into "pools" of gas.<sup>93</sup>

6. The *Tawney* defendant pays royalties based upon the weighted average sales price of gas for gas sales from the relevant pool. This too is a common practice in West Virginia.<sup>94</sup>

7. Starting with the weighted average price of gas sold from the pool, the Defendant deducts from the weighted average pool costs "incurred between the relevant pool and the wellhead for gathering, processing, compression and line loss in order to compute the net proceeds price at the well."<sup>95</sup>

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<sup>88</sup> *See id.* at 26-28.

<sup>89</sup> *Id.* at 3.

<sup>90</sup> *Id.* at 19-21.

<sup>91</sup> *Id.* at 6.

<sup>92</sup> *Id.* at 7.

<sup>93</sup> *Id.* at 7-9.

<sup>94</sup> *Id.* at 8.

<sup>95</sup> *Id.* at 9.

8. Citing *Wellman*, the lessee argues that if it presents proper proof of the reasonableness of the subject post-production costs, the Court should hold, as a matter of law, that the royalty provisions at issue “allow the lessee to deduct the royalty owners’ proportionate share of post-production expenses . . .”<sup>96</sup>

9. The circuit court’s adoption of the *Rogers* decision “is a radical departure from existing law in West Virginia as to the deduction of post-production expenses and, as acknowledged by the circuit court, constitutes the adoption of a minority rule which has been roundly criticized by legal scholars throughout the country.”<sup>97</sup>

10. Alternatively, if the lease language is ambiguous, the lessee should be given the opportunity to present proof of the intention of the parties.<sup>98</sup> The interpretation tool of construing the lease language against the lessee is one of last resort.<sup>99</sup> Thus, defendant lessee should first be afforded the opportunity to have the intent of the leases determined by a fact-finder.<sup>100</sup>

#### D. Amicus Curiae Briefs

One unusual feature of the oil and gas business in West Virginia appears to be that the post-production costs can be very high due to rough terrain, the distance of many wells from the point of sale and other factors. This often results in high post-production costs in relation to the at the well price of natural gas. Recall that in *Wellman* the downstream sales price was \$2.24 and the at the well price was \$0.87. The *Tawney* plaintiffs also complained about the amounts of the post-production costs.

Because of the importance of the post-production costs issues to the oil and gas industry and to royalty owners in West Virginia, two industry groups filed *amicus curiae* briefs. The *amicii* are The Independent Oil and Gas Association of West Virginia, Inc. (“IOGA”) and the West Virginia Oil and Natural Gas Association (“WVONGA”). The combined input of the two *amicii* added considerably to the authorities and arguments offered in support of the Defendant.

The WVONGA brief emphasizes, *inter alia*, the:

strong public policy concerns [which] favor reading “at the wellhead” and similar language as allocating post-production costs between a lessor and lessee. These concerns range from a reduction in supply of natural gas to higher gas prices for consumers. This is a

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<sup>96</sup> *Id.* at 4.

<sup>97</sup> *Id.*

<sup>98</sup> *Id.* at 21.

<sup>99</sup> *Id.*

<sup>100</sup> *Id.* at 22.

far-reaching consequence of the attempts to provide oil and gas lessors with undeserved windfalls.<sup>101</sup>

An incomplete summary of the “strong public concerns” discussed by WVONGA follows:

a. The royalty owner gets a windfall when the at the well valuation point is rejected by the courts.<sup>102</sup>

b. Failure to enforce the “at the wellhead” valuation to allocate downstream costs means that defendants will be required to pay lessors the same amount for gas royalties whether or not that gas was suitable for sale at the wellhead.<sup>103</sup>

c. When post-production costs are not shared, a lessor receives the same amount in royalties for gas containing high levels of hydrogen sulfide as for sweet gas.<sup>104</sup> Yet to be able to sell the gas containing hydrogen sulfide, the defendant must make additional post-production investments to treat the gas. These additional costs can be very high.

d. There might be less production of natural gas in West Virginia as a result of the lack of sharing the post-production costs.<sup>105</sup>

e. Requiring royalties on post-production costs might encourage inefficient markets, with defendants having an incentive to sell the production at the wellhead to purchasers who will conduct the post-production activities.<sup>106</sup> Such practices could have the dual effects of lowering royalty payments and increasing prices to consumers.

One other concern expressed by WVONGA encapsulates numerous elements already discussed in this presentation.

First, these approaches would move free market transactions between lessors and lessees “away from property and contract law principles toward regulation.” David W. Hardymon, “Adrift on the Implied Covenant to Market: Regulation By Implication,” 24 Energy & Min. L. Instit., n. 12 (2004). The intentions of the parties embodied in gas leases would be subverted, after the fact, by an artificial judicial construct — a vastly expanded notion of the implied duty of a lessee with regard to the gas extracted from leased property. Instead of giving force to agreements reached in a market environment, the courts adopting this approach in effect are regulating those transactions in accordance with their own

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<sup>101</sup> Brief of Amicus Curiae, West Virginia Oil and Natural Gas Association, In Support of Columbia Natural Resources at 17 (Filed Mar. 17, 2006) (“WVONGA Brief”).

<sup>102</sup> *Id.* at 18.

<sup>103</sup> *Id.* at 18

<sup>104</sup> *Id.*

<sup>105</sup> *Id.*

<sup>106</sup> *Id.* at 19.

conception of what constitutes a desirable result. However, the courts have no mandate to impose such regulation.<sup>107</sup>

The quoted paragraph addresses the concern about discarding the entire “at the well” type royalty provision and replacing it with the court’s own judgment on what the parties should have intended in executing the leases. Such a danger in contract interpretation can cut against either party (or sometimes both) depending upon the perspective and preference of the court. It is at this juncture that the court’s decision takes on more of the quality of legislation than a reasoned opinion based upon sound legal principles.

The IOGA brief addresses some of the same points as the WVONGA brief, and those will not be repeated here. IOGA provided to the court detailed legal analysis of the issue before the court, with extensive citations to legal and regulatory authorities and the history of federal government regulation of the wellhead gas pricing.<sup>108</sup> IOGA offers four (4) “assignments of error”:

1. The circuit court erred when it casually lumped all of the lease language found in Exhibit A attached to the circuit court’s order of certification into a single category of “leases under which there is no express language or provision allowing the lessee to deduct” post-production expenses.<sup>109</sup>
2. The circuit court erred when it ruled that leases that contain “at the well” or “at the wellhead” language do not clearly and unambiguously contemplate the deduction of post-production expenses.<sup>110</sup>
3. The circuit court erred when it adopted the extreme minority rule from Colorado that gas is not marketable until it is delivered to a market location.<sup>111</sup>
4. The circuit court erred when it failed to rule that Appalachian gas is in marketable condition at the well.<sup>112</sup>

IOGA traced the history of federal regulation of wellhead gas prices demonstrating that the term “wellhead” had a clear meaning under the regulations.<sup>113</sup> IOGA pointed out that for over 50 years the Federal Power Commission (“FPC”), Federal Energy Regulatory Commission

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<sup>107</sup> *Id.* at 20.

<sup>108</sup> See Amicus Curiae Brief on Behalf of the Independent Oil and Gas Association of West Virginia, Inc. (Filed Mar. 17, 2006) (“IOGA Brief”).

<sup>109</sup> *Id.* at 3-4.

<sup>110</sup> *Id.* at 4.

<sup>111</sup> *Id.*

<sup>112</sup> *Id.*

<sup>113</sup> *Id.* at 5-7.

("FERC"), the United States Congress and the United States Supreme Court have been interpreting and giving specific meaning to the term "wellhead."<sup>114</sup> IOGA criticized the circuit court for giving no meanings to the terms "gross" and "net" found in some of the royalty provisions.<sup>115</sup> IOGA urges that "[i]t is simply erroneous for the circuit court to ascribe no meaning to these words."<sup>116</sup>

Another argument presented by IOGA is that acceptance of the circuit court's decision is contrary to a long history of settled law in West Virginia which has given effect to the "at the wellhead," "at the well," and similar language.<sup>117</sup> Appealing to the State Supreme Court to recognize the importance of certainty in commercial transactions based upon long standing legal principles, IOGA concludes that:

IOGA submits, based on the arguments and history contained herein, that it is the plaintiffs in this case who are attempting what amounts to an assault on the status quo, and, if the circuit court's rulings on the certified questions is allowed to stand, the number of natural resource leases that would be unsettled in West Virginia would be enormous, not just for natural gas, but for all minerals. Even for coal leases, would the language "at the mine" or "at the mine mouth" in a coal lease be similarly meaningless? If a coal lease provides "net of all costs to market," is that language meaningless? What about the term "FOB mine"—does that not specify who pays the transportation costs?<sup>118</sup>

The WVONGA and IOGA briefs demonstrate the importance of the decision ultimately made by the *Tawney* Court to interested West Virginians. One must assume that the West Virginia Supreme Court understood the importance of its decision. When referring to the *amicii* briefs, the court stated:

At this point we wish to acknowledge the valuable contributions of Amici Curiae Independent Oil and Gas Association of West Virginia, Inc. and West Virginia Oil and Natural Gas Association who filed briefs in support of the position advanced by Columbia Natural Resources.<sup>119</sup>

Both *amicii* briefs contain substantial substantive analysis, and one who wants to fully understand the analyses and arguments "on the table" when the state Supreme Court decided *Tawney* will be well served to

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<sup>114</sup> *Id.* at 8.

<sup>115</sup> *Id.*

<sup>116</sup> *Id.* at 9.

<sup>117</sup> *Id.* at 17-18.

<sup>118</sup> *Id.* at 21-22.

<sup>119</sup> *Tawney*, 633 S.E.2d at 25 n. 3.

read the *amicii* briefs, along with the briefs filed by the parties.<sup>120</sup> Additionally, I believe that it is important to know that the West Virginia Supreme Court decided the *Tawney* case as it did despite the extensive education on the basic economics of oil and gas operations in West Virginia. The *Amicii* briefing made clear the potential adverse impact on the economics of the type of rule of law adopted by the court. The court's decision to declare the "at the well" type wording as ambiguous and to substitute therefor an implied marketing covenant as the Court did is a strong reason for courts to enforce the contracts as written.

### E. The Court's Opinion

In its recitation of the facts the Court stated that:

"At least since 1993, CNR [Defendant] has taken deductions from Plaintiffs' 1/8 royalty for 'post-production' costs."<sup>121</sup>

Two aspects of this statement bode ill for the defendant. The first is the assumption, without yet having provided any analysis of the "at the well" type provisions, that post-production costs are deducted "from Plaintiffs' 1/8 royalty." As discussed earlier, this is an erroneous statement of the nature of the royalty interest.<sup>122</sup> And, when stated as here by the court, that erroneous statement itself creates ambiguity, and a false sense of inequity regarding the amount of money paid to the royalty owner.

The second negative is the use of quotes around the words "post-production." The opinion does not reflect any determination that any of the costs at issue were other than post-production costs. Use of the quotes appears to indicate at least some hostility of the Court towards the positions taken by the defendant. Recall that in *Wellman* the Court used quotes around the words "post-production expenses" in the same paragraph in which it spoke of the attempt of defendants to "escape" their royalty obligations.<sup>123</sup>

The *Tawney* court eliminated the "judicial stutter" in *Wellman* that royalty provision wording of the type addressed in *Wellman* (and in *Tawney*) might provide an adequate basis for allocation of post-production costs if the defendant introduces evidence to show that it actually incurred the costs and that they are reasonable.<sup>124</sup> When counsel for the defendant urged this language from the court's opinion in *Wellman*, the court responded that it did not decide in *Wellman* whether

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<sup>120</sup> The cites for retrieval of all of these briefs are listed on Appendix "A," the bibliography.

<sup>121</sup> *Tawney*, 633 S.E.2d at 25 (emphasis added).

<sup>122</sup> See *supra* Section II.B.

<sup>123</sup> *Wellman*, 557 S.E.2d at 264.

<sup>124</sup> *Tawney*, 633 S.E.2d at 29.



“at the well” type language is or is not ambiguous.<sup>125</sup> The court found no merit whatsoever to the defendant’s reliance on the court’s language in *Wellman*.<sup>126</sup>

What happened between the court’s 2001 decision in *Wellman* and the 2006 opinion in *Tawney* to convince the court that the “at the well,” “at the wellhead” and similar wording is ambiguous, and that the court should ignore such wording and look elsewhere for instruction regarding the proper royalty calculation method(s)? The *Tawney* court did not cite a single opinion from any West Virginia court decided after *Wellman* which declared the lease language at issue in *Wellman* or in *Tawney* to be ambiguous. The West Virginia rules of contract construction did not change between *Wellman* and *Tawney*. The meaning of the term “production” did not change between *Wellman* and *Tawney*, such that one would have expected the ambiguity holding in *Tawney*. In *Wellman*, the court expressed its suspicion or belief that the defendants were mischaracterizing production and post-production costs, yet there was no holding of ambiguity by the *Wellman* court.<sup>127</sup> The *Tawney* court repeated the same suspicion or belief that defendants were mischaracterizing “post-production costs.”<sup>128</sup>

Something very significant did happen between July 6, 2001, when the court decided *Wellman*, and the decision in *Tawney*. On August 27, 2001 the Colorado Supreme Court decided the *Rogers* case as modified on denial of rehearing.<sup>129</sup> *Rogers* also dealt, among other things, with whether the “at the well” and “at the mouth of the well” wording was sufficient to determine the proper allocation of costs between the parties of “post-production expenses of gathering, compressing, and dehydrating the gas prior to its entry into the interstate pipeline.”<sup>130</sup> However, *Rogers* did not shed any light on the *Tawney* court’s decision that the “at the well” and similar wording involved in *Wellman* and *Tawney* is ambiguous. Indeed, at page 4 of its *Tawney* opinion, the court explained that:

The *Rogers* court did not hinge its decision on a finding that “at the well” language was ambiguous. Instead, the court found such language to be completely silent with respect to allocation of costs.<sup>131</sup>

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<sup>125</sup> *Id.*

<sup>126</sup> *Id.*

<sup>127</sup> *Wellman*, 557 S.E.2d at 264-66.

<sup>128</sup> *Tawney*, 633 S.E.2d at 27.

<sup>129</sup> A listing of only a few of the journal articles about *Rogers* is included in the bibliography, Appendix “A.”

<sup>130</sup> *Rogers v. Westerman Farm Co.*, 29 P.3d 887, 896 (Colo. 2001).

<sup>131</sup> *Tawney*, 633 S.E.2d at 27 (emphasis added).

In *Rogers*, the post-production costs issue arose out of leases which provided “. . . with some variation, for royalties to be paid based on the gas ‘at the well’ or ‘at the mouth of the well’.”<sup>132</sup> Some of the gas was sold at the well and some of the gas was sold downstream of the well.<sup>133</sup> Part of the dispute was whether these royalty provisions are “sufficiently clear to set forth the proper allocation between the parties of the costs of gathering, compressing, and dehydrating the gas prior to its entry into the interstate pipeline.”<sup>134</sup>

For gas sold downstream of the well, lessors argued that the defendants breached the royalty obligations by deducting from the downstream gas prices costs for gathering, compression, and dehydration.<sup>135</sup> The lessors argued further that these costs were necessary to “place the gas in marketable condition” and that the defendants must bear all of those costs.<sup>136</sup> The defendant contended, among other things, that the gas was marketable at the well, that these expenses served to increase the value of already marketable gas and that the “at the well” provisions allocated these costs between the lessor and the defendant.<sup>137</sup>

After detailed discussion of the “at the well” royalty provisions, the *Rogers* court held that the lease language was “silent” with regard to allocation of post-production costs.<sup>138</sup> The court concluded that “because the leases are silent, we must look to the implied covenant to market and our previous decision in *Garman v. Conoco* to determine the proper allocation of costs.”<sup>139</sup>

The *Rogers* court further held that under the implied covenant to market, the defendant has a duty to make the gas marketable.<sup>140</sup> The defendant must bear all costs until the gas is in marketable condition.<sup>141</sup> Thus, the determination of when gas is “marketable” is critical to any allocation of costs between the lessor and lessee.

The lessors contended that the sales of gas made at the well were not arms-length transactions by the lessees.<sup>142</sup> The lessors also argued “that the purchasers of the gas at the well, who subsequently sold the gas

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<sup>132</sup> *Rogers*, 29 P.3d at 891.

<sup>133</sup> *Id.*

<sup>134</sup> *Id.*

<sup>135</sup> *Id.* at 893-94.

<sup>136</sup> *Id.* at 894.

<sup>137</sup> *Id.*

<sup>138</sup> *Id.* at 900.

<sup>139</sup> *Id.* at 902.

<sup>140</sup> *Id.* at 902.

<sup>141</sup> *See id.*

<sup>142</sup> *Id.* at 893.

downstream at the interstate pipeline for a higher price, were closely linked with the lessees.”<sup>143</sup> These transactions, according to the lessor resulted in a breach of the lease.<sup>144</sup> The defendant argued that the gas was marketable at the well.<sup>145</sup> The royalties were calculated using the gross proceeds received by the defendant at the well.<sup>146</sup>

For gas sold downstream of the well the defendant paid royalties based upon the sales price minus deductions for gathering, compression and dehydration.<sup>147</sup> The lessors countered, arguing that the gathering, compression and dehydration costs were necessarily incurred to make the gas marketable and there should be no deductions from the downstream sales price.<sup>148</sup>

Among the holdings of the *Rogers* court are the following:

1. The “at the well” language is silent with respect to allocation of the costs.<sup>149</sup>
2. Given the silence, “we must look to the implied covenant to market,” and thus, whether the gas is marketable.<sup>150</sup>
3. If gas is marketable at the well, transportation costs may be shared between the lessor and lessee.<sup>151</sup>
4. If the gas is not marketable at the well “either because it is not in a marketable condition, or because it is not acceptable for a commercial market, then the lessee has not met its burden of making the gas marketable.” In that situation the lessee is not entitled to deduct transportation costs.<sup>152</sup>
5. “... the more accurate definition of marketability includes both a reference to a physical condition of the gas, as well as the ability for the gas to be sold in a commercial market place.”<sup>153</sup>
6. **“It is submitted that acts which constitute production have not ceased until a marketable product has been obtained. After a marketable product has been obtained, then further costs in improving or transporting such product should be shared by the**

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<sup>143</sup> *Id.*

<sup>144</sup> *Id.*

<sup>145</sup> *Id.* at 894.

<sup>146</sup> *Id.*

<sup>147</sup> *Id.*

<sup>148</sup> *Id.* at 893-94.

<sup>149</sup> *Id.* at 902.

<sup>150</sup> *Id.*

<sup>151</sup> *Id.* at 900.

<sup>152</sup> *Id.*

<sup>153</sup> *Id.* at 903.

lessor and lessee if royalty gas is delivered in kind, or such costs should be taken into account in determining market value if royalty is paid in money.”<sup>154</sup>

7. Gas is marketable when it is in the physical condition such that it is acceptable to be bought and sold in a commercial marketplace, and in the location of a commercial marketplace, such that it is commercially saleable in the oil and gas marketplace.<sup>155</sup>

8. Thus, the lessee bears the costs incurred in getting the gas in marketable condition.<sup>156</sup>

The *Rogers* approach totally ignores the “at the well” language, expands the concept of “production” beyond any rational description of this longstanding understanding in the oil and gas industry and applied consistently in state and federal courts (*i.e.*, production ends with severance of the gas), relies upon an overly broad articulation of an implied marketing covenant, and combines the quality of the physical condition of the gas with placement of the gas in the market in which it is sold in determining when the gas is marketable. Some commentators describe this approach as the most extreme position yet taken by the supreme court of any state.<sup>157</sup> While true that it is an extreme position, the more loosely worded *Tawney* opinion, and its extremely detailed suggested wording of a royalty clause which would be adequate to allocate the post-production costs might be more extreme than the *Rogers* decision.

The *Tawney* court endorsed the *Rogers* court’s SILENCE excuse for relying upon the implied covenant to market to provide the controlling terms between the parties.<sup>158</sup> The *Tawney* court also cites the *Rogers* holdings that:

- a. the implied covenant to market the gas governs the allocation of costs;<sup>159</sup> and
- b. under the implied covenant to market the gas, the lessee alone must bear the expenses necessary to make the gas marketable, when the gas is not marketable at the physical location of the well.<sup>160</sup>

Earlier in the presentation I questioned the accuracy of the assertion by some that the *Tawney* court relied upon “settled” West Virginia law in

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<sup>154</sup> *Id.* at 905 (emphasis added).

<sup>155</sup> *Id.*

<sup>156</sup> *Id.* at 906.

<sup>157</sup> See Keeling and Gillespie *supra* note 5 at 74 citing Owen L. Anderson, 2001: *A Royalty Odyssey*, 53 INST. ON OIL & GAS L. & TAX’N § 4.03, at 14-15.

<sup>158</sup> *Tawney*, 633 S.E.2d at 27.

<sup>159</sup> *Id.*

<sup>160</sup> *Id.*

formulating its opinion. The question was prompted by the following statement in the opinion:

This Court finds it unnecessary to adopt wholesale the reasoning of either of the Courts above [Oklahoma, Texas, Colorado and Michigan] in answering the question before us. **Instead we simply look to our settled law.**<sup>161</sup>

Contrary to the highlighted statement, prior to *Tawney* it was not settled law that the “at the well” and “at the wellhead” type leases were ambiguous, silent regarding post-production costs and/or that they failed to effectively address the allocation of post-production costs.

Returning to *Wellman* we know that the “judicial stutter” left the door open for the supreme court to hold that these royalty provisions were in all respects adequate as written to allocate the costs between the lessors and the lessee, if the lessee presents appropriate evidence establishing that it incurred the costs and that the costs are reasonable. Prior to *Wellman* these terms had not been declared by the West Virginia courts to be ambiguous, silent or lacking in sufficient detail to allocate post-production costs. The *Wellman* court did not declare the “at the well” royalty provisions to be ambiguous, silent or inherently inadequate to deal with post-production cost issues.

What about the implied covenant to market? Prior to *Tawney*, was West Virginia law “settled” that the implied marketing covenant was so broad that it controlled the allocation of post-production costs in a manner similar to the covenant as interpreted and applied by the *Rogers* court? The only West Virginia opinion which it appears that the *Tawney* Court cited as authority on the covenant to market is the *Wellman* case. However, given the “judicial stutter” in *Wellman*, *Wellman* does not qualify as “settled law” on any aspect of the opinion, including the implied covenant to market, if a lessee presents proper evidence of the costs actually incurred and which are reasonable.

How might one explain the court’s choice of words in describing the source (“our settled law”) of its extremely broad ruling with respect to the allocation of costs under the leases at issue in *Tawney*? I offer the following potential explanations.

First, the court was faced with explaining its decision in the face of the “judicial stutter” in *Wellman*. To the extent that the new decision is viewed as a continuation of prior settled legal principles, the less dramatic the appearance of change in the court’s position as between *Wellman* and *Tawney*.

Second, the *amicii* briefs placed the court in a somewhat defensive position, especially when the pleas in those briefs are combined with the

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<sup>161</sup> *Id.* at 27 (emphasis added).

extensive criticism of *Rogers* and similar pre-*Tawney* decisions expressed by courts in other jurisdictions and commentators. The court appeared to take great care not to say or suggest that it actually adopted *Rogers* or any other specific case.

Third, it is my opinion that the court, in effect, “backed into” this opinion after first concluding that it would be unfair to the royalty owners to permit the defendant to pay the royalties on the price of the gas at the well. At that point, the court used the declarations of silence and ambiguity, which enabled it to impose a version of a covenant to market to prohibit the deductions in most circumstances. Taking great comfort in the contract interpretation rule that ambiguities are construed against the lessee, the court was finished. There was no need to further antagonize lessees and the oil and gas producers by declaring that the court adopted the marketable product rule as it exists in *Rogers* or any other case.

After eviscerating the “at the well” type leases before it, the court offered the following suggestions for drafting a royalty provision which would pass muster under *Tawney* to permit the lessee to make deductions from the downstream sales price to get a Royalty Price or Royalty Value (to be multiplied by the royalty fraction or percentage to determine the royalty amount).

[L]anguage in an oil and gas lease that is intended to allocate between the lessor and the lessee the costs of marketing the product and transporting it to the point of sale must expressly provide that the lessor shall bear some part of the costs incurred between the wellhead and the point of sale, identify with the particularity the specific deductions the lessee intends to take from the lessor’s royalty (usually 1/8), and indicate the method of calculating the amount to be deducted from the royalty for such post-production costs.<sup>162</sup>

Given the vintage and large number of outstanding “at the well” type leases in West Virginia, and in the absence of modification of the *Tawney* decision, *Tawney* will continue to dominate post-production cost issues for many years into the future. It will likely be a long time before new forms of leases written with the guidance provided in the above-quoted suggestions from the court will be producing and under which royalties will be paid.

## VII. Conclusion

The skepticism and criticism expressed in this paper are not in any way personal attacks on any of the members of the West Virginia Supreme Court or of the members of the other courts which have, in my opinion, gone too far in altering the bargains reflected in the “at the well”

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<sup>162</sup> *Id.* at 30.

and “at the mouth of the well” type royalty provisions involved in the relevant litigation. Words really do mean something, especially when used for over 100 years (in many instances) with generally accepted meanings in the oil and gas industry in the context of royalty determinations. *Tawney* is, unfortunately, a “poster child” for tampering too much with legal concepts that have served royalty owners and lessees well for extremely long periods of time.

### APPENDIX “A”: Bibliography

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The briefs related to the *Tawney* case can be found on Westlaw at the following cites:

- Petitioners/Plaintiffs' Reply Brief Regarding Certified Questions (Filed Mar. 31, 2006) 2006 WL 1403754
- Amicus Curiae Brief on Behalf of the Independent Oil and Gas Association of West Virginia, Inc. (Filed Mar. 17, 2006) 2006 WL 1403748
- Brief of Amicus Curiae, West Virginia Oil and Natural Gas Association, in Support of Columbia Natural Resources (Filed Mar. 17, 2006) 2006 WL 1403750
- Brief of Defendant Columbia Natural Resources, LLC, on Certified Questions ( Filed Mar. 17, 2006) 2006 WL 1403752
- Plaintiffs' Brief in Support of Affirming Trial Court's rulings on Certified Questions (Jan. 27, 2006) 2006 WL 1403751

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