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## Making a Statement without Saying a Word: What Implied Covenants Say When the Lease Is Silent on Post-Production Costs

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**MAKING A STATEMENT WITHOUT SAYING A  
WORD: WHAT IMPLIED COVENANTS “SAY”  
WHEN THE LEASE IS “SILENT” ON POST-  
PRODUCTION COSTS**

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I. INTRODUCTION

“In the beginning, God Created the Heavens and the Earth.”<sup>1</sup> Soon thereafter, attorneys created the oil and gas lease form. Over the last century, the oil and gas lease has been the standard tool used by the industry to develop

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<sup>1</sup> Genesis 1:1.

these resources in the United States. Although the widespread use of lease forms has not changed much, the oil and gas industry has experienced a number of changes during that time period. There have been volumes written on the subject, and this article will not attempt to cover everything, focusing instead on recent West Virginia case law in the context of prior law in West Virginia and other jurisdictions.

During the last ten years, several courts of other jurisdictions have taken renewed, in-depth looks into the covenants implied in oil and gas leases. While several of these implied covenants seem to be getting more attention in the court system, the most significant is the implied covenant to market. This article will give particular attention to the issue of the implied covenant to market and the deductions of post-production costs from royalty payments. This article will provide practitioners with an informative look into where West Virginia oil and gas law stands in the wake of one of the most significant decisions in recent years.

In 2001, the West Virginia high court issued its opinion in *Wellman v. Energy Resources, Inc.*<sup>2</sup> In *Wellman*, the court broke away from the traditional view on post-production costs and held that when a proceeds lease is silent on the issue of costs, the lessee has an implied covenant to market the gas produced. Included in this duty is the responsibility to incur all costs associated with exploring, producing, marketing, and transporting the gas to market. The court also left the door to the courtroom cracked, with an open invitation to litigate other issues concerning post-production costs, royalty provisions, and oil and gas lease construction.

Part II of this article will discuss some of the distinctions between production costs and post-production costs. Part III will provide a general discussion of the oil and gas lease. Included in this section will be brief discussion on the most common types of royalty provisions, the "market value" and "proceeds" clauses. Additionally, this section will briefly address the "at the well" language in the royalty clause as well as the differences between express and implied covenants. Part IV will discuss the traditional view on royalty clauses and deductions of costs. The traditional view holds that once the gas is brought to the surface "at the well," the lessee's duties to explore and produce have been fulfilled. Once the gas reaches the surface, the lessee and lessor share proportionately in the post-production costs. West Virginia followed this rule prior to *Wellman*, despite the court's traditional bias favoring the lessor.

Part V will discuss the more recent breaks from the traditional view on the deduction of costs from royalty payments. Colorado, Kansas, and Oklahoma have all broken away from the traditional position on post-production costs. These jurisdictions hold that where the lease is silent on the allocation of post-production costs, the lessee alone bears the post-production costs. Part VI will discuss the West Virginia jurisprudence on the subject, including the more re-

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

cent departure. Part VII will break down the holding in *Wellman* and discuss the implications the *Wellman* decision will have on oil and gas producers and royalty owners in West Virginia. Finally, part VIII will be a brief conclusion. If West Virginia courts are going to apply this line of reasoning to the interpretation of oil and gas leases, oil and gas producers need to explicitly spell out the allocation of all costs in the lease.

Before discussing how the typical oil and gas lease form apportions post-production costs (costs subsequent to production), it is necessary to have a basic understanding of what costs are typically categorized as production costs and what are categorized as post-production costs.

## II. POST-PRODUCTION COSTS

The starting point of discussion must be the differences between costs associated with production and actual post-production costs (costs incurred subsequent to production). As developed in Part III, the main reason for entering into an oil and gas lease is to produce the subsurface minerals to the mutual benefit and profit of the lessor and the lessee. Although the owner of a mineral estate can explore for oil and gas, very few have the technology or the capital necessary to develop these minerals.<sup>3</sup> Even if the owner was capable of conducting exploration and development, very few would be willing to take the risk associated with such operations.<sup>4</sup> It is for these reasons that the owner of a mineral estate will enter into an oil and gas lease with a production company.

Historically, the majority of the costs incurred are associated with production. The only way the lessor can earn royalty payments is if the minerals are actually produced and sold. Typical of the costs associated with production are the costs necessary to bring the minerals to the surface. The cost of production is borne completely by the lessee.

[P]roduction costs are the expenses incurred in exploring for mineral substances and in bringing them to the surface. Absent an express term to the contrary in the lease, these costs are not chargeable to the non-operating royalty interest [lessor]. Costs incurred *after* production of the gas or minerals are normally proportionately borne by both the operator [lessee] and the royalty interest owner [lessor].<sup>5</sup>

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<sup>3</sup> GARY B. CONINE, *The Future Course of Oil And Gas Jurisprudence: Speculation, Prudent Operation, And The Economics Of Oil And Gas Law*, 33 WASHBURN L.J. 670, 674 (1994).

<sup>4</sup> See *id.*

<sup>5</sup> *Parker v. TXO Prod. Corp.*, 716 S.W.2d 1986 (Tex. App. 1986). See generally PATRICK H. MARTIN & BRUCE M. KRAMER, 3 WILLIAMS & MEYERS ON OIL AND GAS LAW § 645.2 (1998).

This is consistent with the lessee (typically) retaining a seven-eighths (7/8) interest on all oil or gas produced. Included in the category of production costs are: exploration; geological surveys; drilling; development; building test wells; testing, completing, or re-working existing wells. A good way to generalize production costs is to think of all costs incurred in discovering, drilling, exploring, and developing the minerals to the point of bringing them to the surface.

Under the traditional view, once the gas is extracted from the wellhead and brought to the surface, the post-production costs are borne proportionately by the lessor and lessee. Some examples of post-production costs include: gathering, transportation, processing, and marketing, reasonably incurred by the lessee. Gathering "refers to the process of collecting gas at the point of production (the wellhead) and moving it to a collection point for further movement through a pipeline's principal transmission system."<sup>6</sup> Transportation "involves the movement of gas through a pipeline's principal transmission system, ... and is sometimes used to include exchange, backhauling, and displacement."<sup>7</sup> However, "the lessor is entitled to a royalty free and clear of costs at the wellhead; if the product cannot be disposed of at the wellhead to a purchaser, then the lessor must normally share in the expenses of transporting the product to market."<sup>8</sup>

"Processing means any process designed to remove elements or compounds (hydrocarbon and non-hydrocarbon) from gas, including absorption, adsorption, or refrigeration. Field processes which normally take place on or near the lease, such as natural pressure reduction, mechanical separation, heating, cooling, dehydration, and compression are not considered processing."<sup>9</sup> Dehydration involves the "removal of water" from oil or gas produced in wells.<sup>10</sup> Compression typically involves installing a facility that raises "the pressure of the gas. . . for transmission through pipe lines while the gas is cooled, scrubbed, and dehydrated."<sup>11</sup>

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<sup>6</sup> N. Natural Gas Co. v. Fed. Energy Regulatory Comm'n, 929 F.2d 1261, 1265 (8th Cir. 1991), *cert denied*, 502 U.S. 856 (1991) (*citing* WILLIAMS & MEYERS, MANUAL OF OIL AND GAS TERMS, 406-07 (8th ed. 1987)).

<sup>7</sup> *Id.* See 85 F.E.R.C. at 61, 768 for a discussion of the series of FERC opinions used to generate the general test used to differentiate between gathering and transportation (the Primary Function Test).

<sup>8</sup> WILLIAMS & MEYERS, MANUAL OF OIL AND GAS TERMS 1157 (*citing* *Molter v. Lewis*, 134 P.2d 404 (Kan. 1943)). See also MARTIN & KRAMER, *supra* note 5, at §§ 645-645.3.

<sup>9</sup> WILLIAMS & MEYERS, *supra* note 8, at 850. See also 30 C.F.R. § 206.101, and 30 C.F.R. § 206.151 (1991).

<sup>10</sup> WILLIAMS & MEYERS, *supra* note 8, at 269.

<sup>11</sup> *Id.* at 195.

## III. THE OIL AND GAS LEASE

A. *General Purpose of the Oil and Gas Lease*

The oil and gas lease governs the relationship between the landowners (lessors) and production companies (lessees).<sup>12</sup> It is the oil and gas lease that describes the manner in which exploration, development, and production are to be conducted. According to Professor Donley, “the primary object of both lessor and lessee is to discover, produce and market subsurface minerals to their mutual profit.”<sup>13</sup> Moreover, in his treatise, Professor Eugene Kuntz stated:

[t]he real consideration and inducement which moves the parties to enter into such a transaction is the expectation of the discovery and production of oil or gas or a related mineral, with the resulting benefit to the lessor in the form of royalties and with a resulting benefit to the lessee in the form of profits from sale of the products of the wells which the lessee might drill.<sup>14</sup>

Historically, production companies have acquired oil and gas leases from landowners who usually do not have the benefit of legal representation. In 1896, the West Virginia Supreme Court observed that companies engaged in the exploration and production of oil and gas would send out legions of agents armed with pre-printed lease forms to solicit leases from people who have no legal representation and who have little working knowledge of the day-to-day operations of oil and gas companies.<sup>15</sup> Although the oil and gas industry has gone through a number of changes, the widespread use of lease forms has not changed.

The most important clause in the oil and gas lease is the royalty clause. It is the royalty clause that establishes the basis for calculating the lessors' royalty payments when the gas is sold. However, the standard royalty clause often fails to address issues pertaining to post-production costs because historically, the major percentage of costs were related to exploration, drilling, and getting

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<sup>12</sup> For a more in depth discussion of oil and gas leases, see ROBERT TUCKER DONLEY, *THE LAW OF COAL, OIL, AND GAS IN WEST VIRGINIA AND VIRGINIA* (1951); EUGENE KUNTZ, *A TREATISE ON THE LAW OF OIL AND GAS* (1989); David A. Pierce, *Incorporating A Century of Oil and Gas Jurisprudence into the “Modern” Oil and Gas Lease*, 33 WASHBURN L.J. 786, 787 (1994).

<sup>13</sup> ROBERT TUCKER DONLEY, *THE LAW OF COAL, OIL, AND GAS IN WEST VIRGINIA AND VIRGINIA* (1951). Professor Donley's treatise on the law of oil and gas is regarded as one of the most comprehensive and thorough examinations of the law of oil and gas in West Virginia and is cited by a number of treatise, law review articles, and judicial opinions.

<sup>14</sup> EUGENE KUNTZ, *A TREATISE ON THE LAW OF OIL AND GAS*, § 38.1(a) (1989).

<sup>15</sup> See *Bettman v. Harness*, 26 S.E. 271, 276 (1896).

the gas to the surface.<sup>16</sup> It has been observed by a few commentators that the royalty clause is the most ambiguous clause in a lease<sup>17</sup> and therefore the most litigated.<sup>18</sup> Often times, the language of the royalty clause makes it difficult to determine how the royalty is to be calculated. For this reason, the remainder of this section is devoted to a brief discussion on the “proceeds” clause, the “market value” clause, what is meant by “at the well,” express and implied covenants, and the effect of each on the deduction of post-production costs.<sup>19</sup>

### B. The “Proceeds” Clause

The proceeds lease is a “lease providing for a royalty of a portion of the proceeds of the sale of oil or gas.”<sup>20</sup> Although the language of the proceeds lease is not always the same, the operative language indicates that royalty payments are to be calculated from the money received by the actual sale of the gas.<sup>21</sup> In *Trimble v. Hope Natural Gas Co.*,<sup>22</sup> the pertinent clause of the lease provided that “the royalty for gas wells that may be drilled upon the above-described premises shall be one-eighth of the money received by the Lessee from the sale of said gas.”<sup>23</sup> Typical of a simple gas royalty clause,<sup>24</sup> Professor

<sup>16</sup> TERRENCE W. LYNAM, *Royalty and Overriding Royalty Payments and Deductible Expenses*, in 6 EASTERN MINERAL LAW FOUNDATION § 14.01 (1985).

<sup>17</sup> Laura H. Burney, *The Interaction of the Division Order and the Lease Royalty Clause*, 28 ST. MARY’S L.J. 353. Professor Burney noted that “the royalty clause generally fails to include the details necessary to calculate the lessor’s royalty . . .” *Id.* at 354. See also Comment, *The Value of Lessor’s Share of Production Costs Where Gas Only is Produced*, 25 TEX. L. REV. 641, 642 (1947). “The ordinary royalty clause pertaining to gas is one of the most ambiguous and incomplete provisions of an oil and gas lease ever to be brought before the courts.” *Id.* See also GEORGE SEIFKIN, *Rights of Lessor and Lessee with Respect to Sale of Gas and as to Gas Royalty Provisions*, in 4 INST. ON OIL & GAS LAW & TAX’N 181 (1953). “I suggest that many . . . controversies might be avoided were more thought given to drafting royalty clauses. Most of the multifarious clauses now in use are grossly ambiguous, which may account for the fact that rarely has lease language influenced the courts’ decisions. . . . Undoubtedly some problems are complicated almost beyond the power of solution by amending lease language. But many others could easily be obviated by a few well chosen words.” *Id.* at 216-17.

<sup>18</sup> David A. Pierce, *Incorporating A Century of Oil and Gas Jurisprudence into the “Modern” Oil and Gas Lease*, 33 WASHBURN L.J. 786, 787 (1994). Professor Pierce noted that “[p]ersistent litigation over the meaning of the document suggests the need for . . . a better drafted document.” *Id.*

<sup>19</sup> For a good discussion on some of the differences and similarities between “market value” and “proceeds” clauses, see *Lightcap v. Mobil Oil Corp.*, 562 P.2d 1 (Kan. 1977).

<sup>20</sup> WILLIAMS & MEYERS, *Supra* note 8, at 849.

<sup>21</sup> See *Smith v. Amoco Prod. Co.*, 31 P.3d 255, 268 (Kan. 2001).

<sup>22</sup> 187 S.E. 331 (W. Va. 1936).

<sup>23</sup> *Id.* at 335.

<sup>24</sup> “The lessee to pay for each gas well from the time and while the gas is marketed in the sum

Donley provided an example of a more common royalty provision in oil and gas leases prevalent since the 1920's forward.<sup>25</sup> Traditionally, under a proceeds lease, "courts generally permit the lessee to deduct from the amounts actually received by the lessee from the sale of the gas the lessor's proportionate share of post-production costs, such as gathering, transportation, processing, and marketing, reasonably incurred by the lessee."<sup>26</sup>

In *Lightcap v. Mobil Oil Corp.*,<sup>27</sup> the Kansas Supreme Court consolidated six cases and examined the royalty provision in each of the oil and gas leases at issue.<sup>28</sup> The court examined the language contained in the royalty clauses and determined that "one-eighth of the proceeds from the sale of the gas" to mean that "royalties under this lease are to be paid on amounts actually received and lawfully retained by the producer [lessee]."<sup>29</sup> The court held that the term "proceeds" is a significant term in the oil and gas industry because it refers to the money obtained from the sale of gas.<sup>30</sup> "[U]nder the usual lease, for every dollar the lessor receives, the lessee receives seven."<sup>31</sup>

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of one-eighth of the proceeds received from the sale thereof, payable each three months." KUNTZ, *supra* note 14, at § 40.4.

<sup>25</sup> "Should a well be found producing gas only, the full consideration to the Lessor for such gas well and its products shall be a rental [royalty] payable within 30 days after the expiration of each quarter beginning with the date when gas is marketed therefrom and continuing so long as gas is produced and marketed or used off the premises, equal to one-eighth (1/8) of the proceeds received by the Lessee from the sale of the gas if measured and sold at the well, but if not sold at the well but after transmission or commingling with gas from other properties, then equal to one-eighth (1/8) of the average prevailing price currently paid at the well in the same field by public utility companies . . . ." DONLEY, *supra* note 13, at § 159.

<sup>26</sup> MICHAEL P. IRVIN, *The Implied Covenant to Market In The Deregulated Gas Industry*, in 42 ROCKY MOUNTAIN MINERAL LAW FOUNDATION § 18.03[2] (1997).

<sup>27</sup> 562 P.2d 1 (Kan. 1977).

<sup>28</sup> *Id.* at 10.

<sup>29</sup> *Id.* at 11.

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

<sup>31</sup> *Id.* Citing *Waechter v. Amoco Prod. Co.*, 537 P.2d 228 (Kan. 1975), the *Lightcap* court reaffirmed stating, "Proceeds ordinarily refer to the money obtained by an actual sale. This connotation is not without significance in the gas business. Where the sale is at the wellhead and the lessor does not consent to the uncertainties of what the market or fair value or price of the gas may be-he is willing to take what the lessee sells it for, relying on the lessee's self-interest in obtaining the best price possible. Under the usual lease for every dollar the lessor receives the lessee receives seven. [W]here gas is sold at the wellhead there are 'proceeds' of that sale-the amount received by the seller from the purchaser." *Id.* at 30.



C. “Market Value” Clause

In a market value lease, the lessor’s royalty payment is calculated from the market value of the gas produced.<sup>32</sup> Although the meaning of market value varies across jurisdictions, the idea of market value can be stated in this manner:

[M]arket value is defined as the price property would bring when it is offered for sale by one who desires, but is not obligated to sell, and is bought by one who is under no necessity of buying it. To determine market value of gas, the gas should be valued as though it is free and available for sale.<sup>33</sup>

It has also been said that that market value is the price a willing seller would receive from a willing buyer in a free market.<sup>34</sup>

A typical market value lease clause states that lessee will pay the lessor the market value at the well of one-eighth of the gas sold or used.<sup>35</sup> What has proven to be difficult is determining when and where the market value is assessed. The majority of courts that have considered issues related to market value have concluded that market value should be determined independent of the contract price received by the lessee under a gas purchase contract.<sup>36</sup> A good example of this can be found in *Cotiga Development Co. v. United Fuel & Gas Co.*<sup>37</sup> In *Cotiga*, the plaintiff was entitled to a royalty of “1/8 of the gas produced from each gas well. . . at the rate received by the lessee for such gas.”<sup>38</sup> The court applied a literal interpretation and concluded that the royalty was to

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<sup>32</sup> See WILLIAMS & MEYERS, *supra* note 8, at 621.

<sup>33</sup> *Yzaguirre v. KCS Res. Inc.*, 53 S.W.3d 368, 374 (Tex. 2001)(citing *Exxon Corp. v. Middleton*, 613 S.W.2d 240, 246 (Tex. 1981)).

<sup>34</sup> See DONLEY, *supra* note 13, at §40.4(d).

<sup>35</sup> *Yzaguirre*, 53 S.W.3d at 372. “[t]he royalties to be paid by Lessee. . . on gas, including casinghead gas or other gaseous substance, produced from said land and sold or used off the premises or for the extraction of gasoline or other product therefrom, the market value at the well of one-eighth of the gas sold or used, provided that on gas sold at the wells the royalty shall be one-eighth of the amount realized from such sale.” *Id.*

<sup>36</sup> See, e.g., *Imperial Colliery Co. v. Oxy USA Inc.*, 912 F.2d 696 (4th Cir. 1990) (applying West Virginia law); *Piney Woods Country Life Sch. v. Shell Oil Co.*, 726 F.2d 225 (5th Cir. 1984) *on remand*, 905 F.2d 840 (5th Cir. 1990) (applying Mississippi law); *Exxon Corp., v. Middleton*, 613 S.W.2d 240 (Tex. 1981); *Montana Power Co. v. Kravik*, 586 P.2d 298 (Mont. 1978); *Lightcap v. Mobil Oil Corp.*, 562 P.2d 1 (Kan. 1977), *cert denied*, 434 US 876 (1977); *Texas Oil and Gas Co. v. Vela*, 429 S.W.2d 866 (Tex. 1968);

<sup>37</sup> 128 S.E.2d 626 (W. Va. 1962).

<sup>38</sup> *Id.* at 632.

be paid on the proceeds from the sale of the gas regardless of where the sale is made.<sup>39</sup>

The “at the well” language in a lease is important to help determine the point of valuation for the oil or gas produced.

#### D. “At the Well”

According to well known commentators, “[t]he term ‘at the well’ when used with reference to oil and gas royalty valuation, is commonly understood to mean that the oil and gas is to be valued in its unprocessed state as it comes to the surface at the mouth of the well.”<sup>40</sup> The majority of producing states hold that in a royalty clause, the term “at the well” is a point of valuation that refers to the location and quality of gas brought to the surface.<sup>41</sup>

In *Martin v. Glass*,<sup>42</sup> the court held, “to determine the amount of royalty to be paid in cash, the lease must be examined to ascertain the point at which the royalty clause fixes the price of gas.”<sup>43</sup> After examining the express language of the lease, the court concluded, “it is well settled that the phrase ‘at the well’ ... establishes the point [of valuation] at the mouth of the well.”<sup>44</sup> In *Piney Woods Country Life School v. Shell Oil Co.*,<sup>45</sup> the Fifth Circuit examined the “at the well” language contained in the royalty provision of a Mississippi oil and gas lease.<sup>46</sup> Under Mississippi law, the court interpreted the “at the well” language to denote the royalty payments are to compensate the lessor “for the value of the gas at the well: that is, the value of the gas after the lessee fulfills its obligation under the lease to produce gas at the surface, but before the lessee adds to the

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<sup>39</sup> *Id.* at 633.

<sup>40</sup> WILLIAMS & MEYERS, *supra* note 8.

<sup>41</sup> BRIAN S. TOOLEY & KEITH S. TOOLEY, *The Marketable Gas Product Approach in the Natural Gas Royalty Case*, in 44 ROCKY MTN. MIN. L. FDN. § 21.04[2][b]. See also *id.* at n.27; *Schroeder v. Terra Energy, Ltd.*, 565 N.W.2d 997 (Mich. Ct. App. 1997); *Heritage Res., Inc. v. Nations’ Bank*, 939 S.W.2d 118 (Tex. 1996); *Hurinenko v. Chevron, USA, Inc.*, 69 F.3d 283 (8th Cir. 1995) (applying North Dakota law); *Atlantic Richfield v. State*, 262 Cal. Rptr. 683 (Cal. Ct. App. 1989); *Old Kent Bank & Trust Co. v. Amoco Prod. Co.*, 679 F. Supp 1425 (W.D. Mich. 1988); *Merritt v. Southwester Elec. Power Co.*, 499 So.2d 210 (La. Ct. App. 1986); *Piney Woods Country Life Sch. v. Shell Oil Co.*, 726 F.2d 225 (5th Cir. 1984), *cert denied*, 471 U.S. 1005 (1985) (applying Mississippi law); *Parnell, Inc. v. Giller*, 372 S.W.2d 627 (Ark. 1963); *Freeland v. Sun Oil Co.*, 277 F.2d 154 (5th Cir. 1960) (applying Louisiana law); *Clear Creek Oil & Gas Co. v. Bushmaier*, 255 S.W. 37 (Ark. 1923).

<sup>42</sup> 571 F.Supp. 1406 (N.D. Tex 1983).

<sup>43</sup> *Id.* at 1410.

<sup>44</sup> *Id.* at 1411.

<sup>45</sup> 726 F.2d 225 (5th Cir. 1984).

<sup>46</sup> *Id.* at 228.

value of the gas by processing or transporting it.”<sup>47</sup> Therefore, “at the well” determines the point of valuation where the gas is brought to the surface, and the price of such gas is based on the value before processing and does not include increases in value from processing or transportation.<sup>48</sup> Consequently, for royalties paid “at the well,” the lessors “may be charged with processing costs, . . . [meaning] all expenses subsequent to production, relating to the processing, transportation, and marketing of gas.”<sup>49</sup>

These two cases provide a few examples of the typical meaning and contract construction given to the language “at the well” in an oil and gas lease royalty provision. Additionally, these cases offer further evidence that the “at the well” language is significant when determining the point of valuation for the gas produced.

### E. *Express and Implied Covenants*

Due to the increased attention being devoted to the implied covenant to market, it is important to discuss how the implied covenants and express covenants co-exist.<sup>50</sup> Express covenants are spelled out in the actual writing of the document:

[A]s used in the oil and gas industry, [an express covenant is] a written promise in a lease. . . or other instrument. Such express covenants relate to a variety of subjects: e.g., in the lease, to the

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<sup>47</sup> *Id.* at 231.

<sup>48</sup> *See Id.* at 240.

<sup>49</sup> *Id.*

<sup>50</sup> For a good discussion of express and implied covenants, see DAVID E. PIERCE, *Exploring the Jurisprudential Underpinnings of the Implied Covenant to Market*, in 48 ROCKY MTN. MIN. L. FDN § 10.04 (2002) “Professor Merrill’s approach to implied covenants is not based upon interpreting the oil and gas lease. The foundation for his analysis is a policy of protecting the lessor to the extent the lease does not expressly, and precisely, address the matter. Therefore, he would recognize implied covenants to protect the lessor, even when the oil and gas lease expressly addresses the matter, so long as the implied obligations are not inconsistent with the express obligations.” *Id.* However, in West Virginia, if there is an express provision in a lease, an implied covenant cannot trump what is expressed in the lease. Professor Merrill’s approach is similar to the approach taken in *Garman* and *Wellman*. This point is inconsistent with general law in West Virginia on contract interpretation. *See also* RESTATEMENT (SECOND) OF CONTRACTS § 201 cmt. c (1981); JOHN S. LOWE, *OIL AND GAS IN A NUTSHELL* (3d ed. 1995); MARTIN & KRAMER, *supra* note 3, at § 803 (2001); MAURICE A. MERRILL, *THE LAW RELATING TO COVENANTS IMPLIED IN OIL AND GAS LEASES* §2, §6, §7 (2d ed. 1940) (“The objective interpretation in the general law of contracts is to carry out the understandings of the parties rather than to impose obligations on them contrary to their understanding: ‘the courts do not make a contract for the parties.’”); Jacqueline Lang Weaver, *Implied Covenants in Oil and Gas Law Under Federal Energy Price Regulation*, 34 VAND. L. REV 1473 (1981); Jacqueline Lang Weaver, *When Express Clauses Bar Implied Covenants, Especially in Natural Gas Marketing Scenarios*, 37 NAT. RESOURCES J. 491 (1997).

payment of royalty, the furnishing of free gas to the lessor, the burial of pipelines . . . .<sup>51</sup>

In the absence of express language in the contract, courts will impose implied obligations on the lessee.<sup>52</sup> Typically, there are two reasons why courts will imply covenants in oil and gas leases against the lessee. The first reason is to complete an incomplete contract (where the lease is silent), and the second reason is to make the contract fair or more fair to the lessor.<sup>53</sup> These two categories are usually referred to as “implied in fact”<sup>54</sup> or “implied in law.”<sup>55</sup> There have been a number of courts and commentators who have discussed these two categories.<sup>56</sup>

In *Yzaguirre v. KCS Resources, Inc.*,<sup>57</sup> the Texas Supreme Court provides an example of an implied-in-fact approach to analyzing the oil and gas lease royalty clause. The issue before the court turned on the interpretation of

<sup>51</sup> See WILLIAMS AND MEYERS, *supra* note 8, at 384 .

<sup>52</sup> See *Smith v. Amoco Prod. Co.*, 31 P.3d 255, 265-68 (Kan. 2001), for a discussion on the two types of implied covenants (“implied in fact” and “implied in law”).

<sup>53</sup> DAVID E. PIERCE, *Exploring the Jurisprudential Underpinnings of the Implied Covenant to Market*, in 48 ROCKY MOUNTAIN MINERAL LAW FOUNDATION § 10.04 (2002).

<sup>54</sup> *Id.* MARTIN & KRAMER, *supra* note 5, at § 803 (1998). “A covenant is implied in fact when its existence is derived from the written agreement and the circumstances surrounding its execution.” *Id.*

<sup>55</sup> *Id.* “A covenant is implied in law when it is added to the contract by a court to promote fairness, justice, and equity.” *Id.*

<sup>56</sup> See generally *id.*; *Smith v. Amoco Prod. Co.*, 31 P.3d 255 (Kan. 2001); *Yzaguirre v. KCS Res., Inc.*, 53 S.W.3d 374 (Tex. 2001); *Wellman v. Energy Res., Inc.* 557 S.E.2d 254 (W. Va. 2001); *Rogers v. Westerman Farm Co.*, 894 P.3d 887 (Colo. 2001); *Stemberger v. Marathon Oil Co.*, 894 P.2d 788 (Kan. 1995); *Garman v. Conoco, Inc.* 886 P.2d 652 (Colo. 1994); *TXO Prod. Corp. v. Comm’rs of the Land Office*, 903 P.2d 259 (Okla. 1994); *Wood v. TXO Prod. Corp.*, 854 P.2d 880 (Okla. 1993); *Schubach v. Cont’l Oil Co.*, 394 P.2d 1 (Kan. 1964); *Gilmore v. Superior Oil Co.*, 388 P.2d 602 (Kan. 1964); *Mittelstaedt v. Santa Fe Minerals, Inc.*, 954 P.2d 1203 (Okla. 1989); JOHN S. LOWE, *OIL AND GAS IN A NUTSHELL* (3d ed. 1995); MAURICE A. MERRILL, *THE LAW RELATING TO COVENANTS IMPLIED IN OIL AND GAS LEASES* §2, §6, §7 (2d ed. 1940) “Of course, the implied covenant is a fiction, used like other fictions by the law in order to achieve a desirable result. The parties have not agreed consciously upon the terms which the law implies; it is even possible that they have never consciously directed their attention to the matter. The obligations are imposed, not by the agreement of the parties, but by operation of law.” *Id.* at § 7.; *MARTIN & KRAMER, supra* note 5, at § 803. “A covenant is implied in fact when its existence is derived from the written agreement and the circumstances surrounding its execution. A covenant is implied in law when it is added to the contract by a court to promote fairness, justice, and equity.” *Id.* at § 803; *Jacqueline Lang Weaver, When Express Clauses Bar Implied Covenants, Especially in Natural Gas Marketing Scenarios*, 37 NAT. RESOURCES J. 491 (1997); *Jacqueline Lang Weaver, Implied Covenants in Oil and Gas Law Under Federal Energy Price Regulation*, 34 VAND. L. REV 1473 (1981).

<sup>57</sup> 53 S.W.3d 368, 374 (Tex. 2001).

the lease royalty provision.<sup>58</sup> The petitioners brought suit because KCS was paying royalties on the open-market value of the gas rather than the greater amount actually realized from the sale of the gas (KCS was selling the gas at a higher price under a Gas Purchase Agreement with a pipeline company).<sup>59</sup> *Yzaguirre* argued that the “market value” royalty payments should be based on the actual proceeds from the sale of gas,<sup>60</sup> while KCS argued that the “market value” royalty is “based on the prevailing market price at the time of sale.”<sup>61</sup> Because the parties disputed the meaning of the “market value” and “amount realized” language, the court began its analysis by reading the plain language of the lease.<sup>62</sup>

“[T]he parties to these leases, in unambiguous terms, based the royalty on the amount realized for gas sales at the well and on market value for sales that occurred off the premises.”<sup>63</sup> Using an implied in fact analysis, the court rejected the petitioners theory that the implied covenant to market was controlling on the issue of calculating royalty payments because the meaning of market value is well established in Texas. Additionally, the court dismissed the petitioners argument that implied covenants are necessary to “make sure the royalty owner gets the best deal.”<sup>64</sup> “[T]here is no implied covenant when the oil and gas lease expressly covers the subject matter of an implied covenant.”<sup>65</sup> The

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<sup>58</sup> The royalty clause at issue stated the following: “[T]he royalties to be paid by Lessees are: ... on gas, including casinghead gas or other gaseous substance, produced from said land and sold or used off the premises or for the extraction of gasoline or other product therefrom, *the market value at the well of one-eighth of the gas so sold or used, provided that on gas sold at the wells the royalty shall be one-eighth of the amount realized from sale.*” *Id.* at 372 (emphasis added).

<sup>59</sup> The lease in this case is identical to the lease discussed in *Texas Oil & Gas Corp. v. Vela*, 429 S.W.2d 866 (Tex. 1968). In *Vela*, Texas Oil & Gas entered into long term agreements for the sale of gas at a fixed price. The market value of the gas eventually rose above the contract price, and the lessors sued to recover the market value price of the gas. The court held that since the market price exceeded the contract price, that the lessee’s would be required to pay a royalty at the prevailing market price. In contrast, *Yzaguirre* addresses a “Reverse *Vela*” scenario. In *Yzaguirre*, the lessee entered into a gas purchase agreement that eventually exceeded the market value of gas. *Yzaguirre* sued to recover a royalty on the greater amount received from the sale of gas. Since the market value language of the lease controlled, the lessee was only required to pay royalty based on the market value of the gas, and not the amount realized from sale.

<sup>60</sup> *Id.*

<sup>61</sup> *Id.* (citing *Texas Oil & Gas Corp. v. Vela*, 429 S.W.2d 866, 871 (Tex. 1968)).

<sup>62</sup> *Id.*

<sup>63</sup> *Id.* “The parties can draft either a ‘market value’ or a ‘proceeds’ royalty provision, and their intent will be followed by the courts.” *Id.* at 372.

<sup>64</sup> *Id.* at 374.

<sup>65</sup> *Id.* at 373. “[W]hen parties reduce their agreements to writing, the written instrument is presumed to embody their entire contract, and the court should not read into the instrument additional provisions unless this be necessary in order to effectuate the intention of the parties as disclosed by the contract as a whole.” *Id.*

court further held that implied covenants do “not override the express terms of the oil and gas lease whenever a lessee negotiates a sales contract that turns out to be especially lucrative. We will not now rewrite this lease’s plain terms to give the Royalty Owners the benefit of a bargain they never made.”<sup>66</sup>

In contrast to the rules of contract construction in Texas, the courts of Colorado seem willing to ignore the express terms of a contract and instead determine the lease to be silent on the issue in question.<sup>67</sup> The Colorado Supreme Court provides an excellent example of a covenant implied in law in its discussion in *Rogers v. Westerman Farm Co.*<sup>68</sup> In its discussion on the terms of the lease (express and implied), the court was mindful of the general rule that the lease should be construed against the party who drafted and offered the lease.<sup>69</sup> In short, the court stayed in line with this rule and construed the lease in favor of the lessor and against the lessee.<sup>70</sup> Next, the court discussed this rule in the context of the disparity in bargaining power between the lessor and lessee. “[T]his rule is generally based on the recognition that the bargaining power between a lessor and lessees is similar to that historically found between an insurance company and its customers.”<sup>71</sup> In support, the court offers that lessors are not knowledgeable of the law of oil and gas, and that the lessees are experienced in drafting and litigating oil and gas leases.<sup>72</sup>

After discussing the disparity in bargaining power between lessors and lessees, the court concluded the “at the well” language in the lease was insuffi-

<sup>66</sup> *Id.* at 374.

<sup>67</sup> DANIEL M. MCCLURE, *Royalty Valuation and Payment Issues: Where Are We And Where Are We Headed?*, in 48 ROCKY MOUNTAIN MINERAL LAW FOUNDATION § 11.02[2] (2002).

<sup>68</sup> 29 P.3d 887 (Colo. 2001).

<sup>69</sup> *Id.* at 901. See also DONLEY, *supra* note 13 at § 61. In his treatise, Professor Donley reasoned that landowners rely on the agent who brings the oil and gas lease. *Id.* Although “the law says one signing a writing must know the law of it. . . if there were any doubt, it ought not be construed ,most strongly against the lessor. . . but against him who solicited and prepared the lease.” *Id.*

<sup>70</sup> *Id.* See also *Hill v. Stanolind Oil & Gas Co.*, 205 P.2d 643, 649 (Colo. 1949) (doubt as to a contract’s meaning should be resolved against the one who prepared it); *Davis v. Cramer*, 837 P.2d 218, 225 (Colo. Ct. App. 1992) (oil and gas leases are construed liberally in favor of lessor and strictly against lessee); W.L. SUMMERS, 2 THE LAW OF OIL AND GAS § 372, at 487-94 (1959 & 2003 Supp.) (uncertainty or ambiguity as to meaning of contract will be construed against party who prepared the contract; in oil and gas that is usually the lessee);

<sup>71</sup> *Rogers v. Westerman Farm Co.*, 29 P.3d 998, 902 (Colo. 2001).

<sup>72</sup> *Id.* Professor Pierce noted that “[i]n essence the court deems each lessor to be hopelessly ignorant and incapable of comprehending that the value of gas ‘at the well’ may be less than its downstream value after it has been gathered, compressed, dehydrated, treated, processes, and otherwise aggregated, packaged, and marketed.” DAVID E. PIERCE, *Exploring the Jurisprudential underpinnings of the implied covenant to market*, in 48 ROCKY MOUNTAIN MINERAL LAW FOUNDATION § 10.05 at n.53 (2002).

cient to allocate costs and that the implied covenant to market was controlling.<sup>73</sup> By ignoring the “at the well” language in the lease (or at least determining that the “at the well” language was silent on the issue of deducting downstream marketing costs from the lessor’s royalty payment), the court applies an implied-in-law approach to protect the lessor from being taken advantage of by the lessee.<sup>74</sup> This implied-in-law approach is typical of the jurisdictions who have adopted the “first marketable product” approach to oil and gas leases.<sup>75</sup>

This section on the oil and gas lease helps to illustrate the competing views on the issues of express and implied covenants, and on the deduction of post-productions costs before calculating the royalty payment. The issue of post-production costs typically arises when the lessee calculates the royalty payment owed to the lessor. Under the traditional view, the lessee is responsible for any costs associated with production (i.e. getting the oil or gas to the surface). Once the oil and gas reached the surface, the lessee would then take whatever steps were necessary to sell the gas (compression, dehydration, transportation, etc.). The lessee then deducted these post-production costs proportionately from the lessor’s royalty payment.

Recently, however, the courts of Colorado, Kansas, and Oklahoma have departed from the traditional view. These courts have held that the lessee has a duty under the implied covenant to market to incur all costs necessary to place the gas in a marketable condition. In essence, these jurisdictions have blurred the line between costs associated with production and costs incurred subsequent to production. Basically, costs viewed as post-production costs in Texas and Louisiana have become costs associated with production in Colorado, Kansas, and Oklahoma. As a result, it will be useful to discuss in more detail the traditional position and the recent departures from this position.

#### IV. TRADITIONAL POSITION

The traditional position on the deduction of post-production costs can be found in the laws of Texas and Louisiana. The courts of Colorado, Kansas, and Oklahoma recently departed from the traditional view on post-production costs,

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<sup>73</sup> *Rogers*, 29 P.3d at 902 “[I]nstead we conclude that because the leases are silent, we must look to the implied covenant to market, and out previous decision in *Garman v. Conoco*, to determine the proper allocation of costs.” *Id.*

<sup>74</sup> *Id.* at 902-06. Professor Pierce observed “[t]he court’s analysis in *Rogers* is a pure implied-in-law approach designed to give perhaps the vast majority of Colorado lessors a cost-free royalty calculated on downstream values . . . and will affect any lease that does not expressly, explicitly, and precisely state the location of the permissible market and the specific costs that can be deducted to calculate the royalty.” DAVID E. PIERCE, *Exploring the Jurisprudential Underpinnings of the Implied Covenant to Market*, in 48 ROCKY MTN. MIN. L. INST. § 10.05 (2002).

<sup>75</sup> See *supra* notes 112-154 and accompanying text discussing the law of Colorado, Kansas, and Oklahoma.

and their departure was highly criticized in the dissenting opinions of those decisions.

A. *Texas*

A good summary of Texas law on the issue of post-production costs and royalty deductions can be found in *Martin v. Glass*.<sup>76</sup> In *Martin v. Glass*, the defendant drilled two gas-producing wells on the leased premises.<sup>77</sup> The parties stipulated that although both wells were producing, the wells produced at an insufficient pressure to move the gas into the nearby gathering lines.<sup>78</sup> Since the gas could not be marketed without entering the pipeline, the defendant had the gas compressed, and delivered the gas through a meter into a pipeline system.<sup>79</sup> The defendant then charged the royalty owner with their proportionate share of off lease compression costs based on the amount of gas delivered into the pipeline.<sup>80</sup> The central issue in this case is whether the costs of compression could be proportionately charged against the royalty owner.<sup>81</sup>

The court begins its discussion by pointing out that a royalty interest is free from all costs associated with the development and production of oil and gas, but may, however, share in post-production costs.<sup>82</sup> Consequently, in order to calculate the royalty payment it is necessary to examine the lease “to ascertain the point at which the royalty clause fixes the price of the gas.”<sup>83</sup> The pertinent part of the gas royalty provision reads as follows:

[T]he royalties to be paid by Lessee are: ... on gas, including casinghead gas or other gaseous substance, produced from said land and sold on or off the premises, one-eighth of the net proceeds from the sale thereof . . . .<sup>84</sup>

The court concluded that the key phrases expressed in the royalty provision contained the following language: “at the well received,” “net proceeds,”

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<sup>76</sup> 571 F. Supp. 1406, 1408 (N.D. Tex. 1983).

<sup>77</sup> *Id.* at 1409.

<sup>78</sup> *Id.*

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

<sup>80</sup> *Id.*

<sup>81</sup> *Id.*

<sup>82</sup> *Id.* at 1410. See MARTIN & KRAMER, *supra* note 5, at §645.

<sup>83</sup> *Martin v. Glass*, 571 F. Supp. at 1410.

<sup>84</sup> *Id.* The “at the well” language appeared in the next paragraph of the lease provision. *Id.*



and “sold on or off the premises.”<sup>85</sup> In examining each one, the court concluded that “it is well settled that the phrase ‘at the well received,’ or similar terminology, establishes the ‘point’ [of valuation] at *the mouth of the well*.”<sup>86</sup>

The court further concluded that “net proceeds” clearly suggests that certain costs are deductible. ‘Net Proceeds’ is typically defined as the sum remaining from gross proceeds of sale after payment of expenses.”<sup>87</sup> Finally, the court concluded, “the phrase ‘sold on or off the premises’ clearly implies that the value of royalty will be the same whether the gas is sold on or off the premises.”<sup>88</sup> The court reasoned that the royalty clause in the lease in question should be interpreted as follows:

Regardless of whether the gas is sold on or off the leased premises, royalty is based on the value of all gas produced at the mouth of the well. Costs incurred prior to production are to be borne by the operator, while the costs incurred subsequent to production (those necessary to render the gas marketable) are to be borne on a pro rata basis between operating and non operating interests.<sup>89</sup>

The court noted that the laws of Texas and Louisiana are the same because “both jurisdictions allow the deduction of post-production cost[s] when royalty [payments are] determined ‘at the mouth of the well.’”<sup>90</sup> Since the laws of Texas hold that gas is produced when it is severed from the land at the well-head, the compression charges were post-production costs and were properly deducted from the royalty owners’ interest.<sup>91</sup>

Louisiana also holds that costs incurred subsequent to production can be charged proportionately to the non-working interest in an oil and gas lease.

### B. Louisiana

*Merritt v. Southwestern Electric Power Co.*,<sup>92</sup> provides a good example of Louisiana’s jurisprudence on the deduction of post-production costs. In *Merritt*, the plaintiff (Merritt) granted a mineral lease that was subsequently as-

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<sup>85</sup> See *id.* at 1411.

<sup>86</sup> *Id.*

<sup>87</sup> *Id.*

<sup>88</sup> *Id.*

<sup>89</sup> *Id.* at 1411-12. See MARTIN & KRAMER, *supra* note 5, at §645.

<sup>90</sup> *Id.* at 1414.

<sup>91</sup> See *id.* at 1414-16.

<sup>92</sup> 499 So. 2d 210 (La. 1986).

signed to Southwestern Electric Power Company (SWEPCO).<sup>93</sup> The well produced gas at a sufficient pressure to get the gas to the well-head.<sup>94</sup> However, the transmission pipeline was in a location outside the premises covered by the lease.<sup>95</sup> Due to the location of the transmission pipeline, compression was necessary to keep the flow pressure of the gas sufficient to move the gas from the gathering lines into the transmission pipeline.<sup>96</sup> “[W]ithout the compression, the . . . [well] is capable of production but does not provide sufficient pressure to effect a sale of the gas produced.”<sup>97</sup> SWEPCO then constructed compression facilities on the leased premises, and began charging the Merritts for compression costs.<sup>98</sup> The Merritts then brought suit to dissolve the oil and gas lease and to recover the amount of royalties withheld due to deductions for compression costs.<sup>99</sup>

In Louisiana, “market value is reconstructed by beginning with the gross proceeds from the sale of the gas and deducting. . . any additional costs of taking the gas from the wellhead (the point of production) to the point of sale.”<sup>100</sup> Thus, the court concluded, “if compression charges are necessary in order for the well to produce, i.e. for the gas to reach the wellhead, then such charges are not deductible from royalty payments.”<sup>101</sup> However, the court reasoned if “compression charges are necessary only to push the gas from a producing well into the pipeline, then this cost is a post-production. . . cost and is therefore deductible from royalty payments.”<sup>102</sup> The *Merritt* court also found *Martin v. Glass*<sup>103</sup> to be directly on point.<sup>104</sup> The *Merritt* court also provided a

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<sup>93</sup> See *id.* at 211.

<sup>94</sup> See *id.*

<sup>95</sup> See *id.*

<sup>96</sup> See *id.*

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

<sup>98</sup> See *id.* at 212.

<sup>99</sup> See *id.*

<sup>100</sup> *Id.* at 213 (parenthetical supplied in original).

<sup>101</sup> *Id.*

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

<sup>103</sup> 736 F.2d 1524 (5th Cir. 1984). For a discussion of *Martin v. Glass*, see *supra* notes 76-91 and accompanying text.

<sup>104</sup> *Merritt v. S.W. Elec. Power Co.*, 499 S.O. 2d at 214. “It should be noted that while *Martin* involved the application of Texas law, the *Martin* court relied heavily on *Freeland*, . . . construing Louisiana law, and noted that Texas and Louisiana law are the same in that both jurisdictions allow the deductions of post-production costs when the royalty payment is determined ‘at the mouth of the well.’” *Id.* at 214 (internal quotations provided in original).

good discussion on other cases where courts have interpreted Louisiana law applicable to similar market value lease provisions.<sup>105</sup>

In *Freeland v. Sun Oil Co.*,<sup>106</sup> the Fifth Circuit interpreted a similar lease provision under Louisiana law stating, “in determining market value costs which are essential to make a commodity worth *anything* or worth *more* must be borne proportionately by those who benefit . . . [and] all increases in the ultimate sales value attributable to the expenses incurred in transporting and processing the commodity must be deducted.”<sup>107</sup> A number of other cases applying Louisiana law have determined that the lessee is entitled to deduct various types of costs proportionately from the royalty payments.<sup>108</sup> The court also reasoned that “the lessee has an implied obligation to market minerals discovered and capable of producing in paying quantities. . . [and] since marketing the minerals benefits both the lessee and the royalty owner [lessor], the royalty owner should bear a proportionate share of the marketing costs.”<sup>109</sup>

#### V. RECENT REVISIONIST DECISIONS ON THE TRADITIONAL POSITION

The states of Colorado, Kansas, and Oklahoma have all broken away from the traditional position that was discussed in the previous section. These jurisdictions have imposed implied covenants on oil and gas producers to absorb all costs associated with bringing the minerals to market. The West Virginia Supreme Court relied heavily on the Colorado decision in *Garman v. Conoco*.<sup>110</sup> For this reason, we will begin our discussion of the recent revisionist decisions with the state of Colorado.

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<sup>105</sup> See *id.*

<sup>106</sup> 277 F.2d 154 (5th Cir. 1960).

<sup>107</sup> *Id.* at 159 (footnote omitted).

<sup>108</sup> See *Freeland v. Sun Oil Co.*, 277 F.2d 154 (5th Cir. 1960) (extraction costs); *Phillips Petroleum Co. v. Johnson*, 155 F.2d 185 (5th Cir. 1946) (transportation and separation costs); *Sartor v. United Gas Pub. Serv. Co.*, 84 F.2d 436 (5th Cir. 1936) (transportation costs); *Crichton v. Standard Oil Co. of La.*, 150 So. 668 (La. 1933) (extraction costs); *Coyle v. La. Gas & Fuel Co.*, 144 So. 737 (La. 1932) (extraction costs); *Wall v. United Gas Pub. Serv. Co.*, 152 So. 561 (La. 1834) (transportation costs). Additionally, in *Sartor v. Ark. Natural Gas Corp.*, 321 US 620 (1944), the Supreme Court expressly noted that in determining a gas royalty payable “at the well,” Louisiana law provides for a proportionate deduction of the costs of gathering and delivering the gas to a pipeline system.

<sup>109</sup> *Merritt*, 499 So. 2d at 214.

<sup>110</sup> 886 P.2d 652 (Co. 1994).

A. *Colorado*

The recent groundbreaking decision in Colorado is *Garman v. Conoco, Inc.*<sup>111</sup> In *Garman*, the Supreme Court of Colorado responded to the following question certified to it from the United States District Court:

Under Colorado law, is the owner of an overriding royalty interest in gas production required to bear a proportionate share of post-production costs, such as processing, transportation, and compression, when the assignment creating the overriding royalty interest is silent as to how post-production costs are to be borne?<sup>112</sup>

During the period from January, 1987 to April, 1993, the Garmans received \$2.2 million in royalty payments, while during the same period Conoco withheld \$459,111 for certain post-production costs.<sup>113</sup> The Garmans asserted that post-production costs incurred in order to transform the gas into a marketable product should not be charged to the lessor.<sup>114</sup> The Garmans relied on the law from Kansas and Oklahoma, while Conoco relied on the law from Texas and Louisiana. The court then examined the competing interests theories as laid out in Kansas/Oklahoma and Texas/Louisiana.<sup>115</sup> Although the court's answer was "limited to those post-production costs required to transform raw gas into a marketable product" the court adopted the view espoused by the courts of Oklahoma and Kansas. The court stated:

As we explained at the outset, many different types of expenses may be involved in the conversion process. Upon obtaining a marketable product, any additional costs incurred to enhance the value of the *marketable* gas, such as those costs conceded by the Garmans, may be charged against nonworking interest owners. To the extent that certain processing costs enhance the value of an already marketable product the burden should be placed upon the lessee to show such costs are reasonable, and

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<sup>111</sup> 886 P.2d 652 (Co. 1994). The decision in *Garman* is cited by the courts of Oklahoma and Kansas in major decisions on the subject. Additionally, the West Virginia Supreme Court of Appeals relies heavily on the *Garman* decision in its opinion in *Wellman v. Energy Resources*, 557 S.E.2d 254 (W.Va. 2001).

<sup>112</sup> *Garman v. Conoco*, 886 P.2d at 653.

<sup>113</sup> *See id.* at 655.

<sup>114</sup> *See id.*

<sup>115</sup> *See id.* at 657-58. For a discussion of the Texas and Louisiana line of cases see *supra* notes 76-111 and the accompanying text. For a discussion of the Kansas and Oklahoma line of cases see *supra* notes 128-154 and the accompanying text.

that actual royalty revenues increase in proportion with the costs assessed against the nonworking interest.<sup>116</sup>

The most recent, and leading case out of Colorado is *Rogers v. Westerman Farm Co.*<sup>117</sup> At issue in *Rogers* was the “at the well” language in a royalty provision and whether or not that language addresses the allocation of certain costs.<sup>118</sup> The court determined that since the lease was silent on the allocation of costs, the implied covenant to market was controlling.<sup>119</sup> The court also relied heavily on *Garman* as the framework of its analysis on the issue of marketability, the first-marketable product rule, and the allocation of post-production costs.<sup>120</sup> While the court recognized the differing views of courts and commentators on the allocation of costs when the lease is silent,<sup>121</sup> it ultimately rejected the reasoning behind these decisions.<sup>122</sup> The court then reasoned that to define “marketability under the implied covenant to market ... [it is necessary to] look to the first-marketable product rule for guidance.”<sup>123</sup> To determine whether the gas is marketable is a factual inquiry that should be resolved by a jury.<sup>124</sup> The court held:

[o]nce the gas is deemed marketable based on a factual determination, the allocation of all costs can properly be determined. Absent express lease provisions addressing allocation of costs, the lessee’s duty to market requires that the lessee bear the ex-

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<sup>116</sup> *Id.* at 660-61.

<sup>117</sup> 29 P.3d 887 (Colo. 2001).

<sup>118</sup> *Id.* at 891.

<sup>119</sup> *Id.* at 896. “[W]here a lease is silent as to the allocation of costs, the implied covenant to market obligates the lessee to incur costs necessary to render the gas marketable.” *Id.* (citing *Garman v. Conoco*, 886 P.2d 652 (Colo. 1994)).

<sup>120</sup> *Id.*

<sup>121</sup> “[The] broader rule holds that costs incurred after a marketable product have been obtained, that either enhance the value of the product or cause the product to be transported to another location are shared by the lessee and lessor.” *Id.* at 900 (citing 3 EUGENE KUNTZ, 3 A TREATISE ON THE LAW OF OIL AND GAS, § 40.5 (2001)). However, “[I]f gas is marketable at the physical location of the well, then transportation costs may be shared between the lessee and the lessor. However, if gas is not marketable at the physical location of 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.” *Rogers*, 29 P.3d at 900. “Adopting the view that the ‘at the well’ language determines which costs are deductible from royalty payments fails to acknowledge that deductibility of costs is determined by whether the gas is marketable, not by the physical location of the gas or the condition of the gas.” *Id.* at 900-01.

<sup>122</sup> *Rogers*, 29 P.3d 901.

<sup>123</sup> *Id.* at 906

<sup>124</sup> *See id.*

penses incurred in obtaining a marketable product. Thus, the expense of getting the product to a marketable condition and location are borne by the lessee. Once a product is marketable, however, additional costs incurred to either improve the product, or transport the product, are to be shared proportionately by the lessor and lessee. All costs must be reasonable.<sup>125</sup>

*B. Kansas*

The leading case in Kansas is *Sternberger v. Marathon Oil Co.*<sup>126</sup> In *Sternberger*, the plaintiff (Sternberger) was the representative of a class of plaintiffs who owned royalty interests in oil and gas leases that were owned by Marathon.<sup>127</sup> After the Sternberger's wells were drilled, Marathon was unable to market the gas because no pipeline existed near the leased premises.<sup>128</sup> Eventually, Marathon paid the total cost (\$127, 955.88) to construct a pipeline.<sup>129</sup> In exchange for constructing the gathering lines, Marathon received a \$.10 - \$.16 discount per MCF on the transportation costs from the transmission company.<sup>130</sup> After receiving this discount, Marathon then deducted \$.12 per MCF from the lessor's royalty payments.<sup>131</sup> The plaintiff then brought suit to recover the amount deducted from the royalty payment.

In its discussion, the court stated that "[t]he lessee has the duty to produce a marketable product, and the lessee alone bears the expense in making the product marketable."<sup>132</sup> The court reasoned that absent any express contractual language, the lessor is not required to share any costs incurred to transform the gas into a marketable product (i.e. compression, dehydration, and processing).<sup>133</sup>

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<sup>125</sup> *Id.* at 906.

<sup>126</sup> 894 P.2d 788 (Kan. 1995).

<sup>127</sup> *See id.* at 792. The original lease was entered into with the TXO Production Corp. TXO subsequently merged with Marathon Oil Company. Marathon Oil acquired the lease in question during this merger with TXO. *See id.*

<sup>128</sup> *See id.*

<sup>129</sup> *See id.*

<sup>130</sup> *See id.* at 793.

<sup>131</sup> *See id.*

<sup>132</sup> *Id.* at 799.

<sup>133</sup> *See id.* at 800.

C. *Oklahoma*

There are three cases in Oklahoma that apply the principle of the implied covenant to market to issues of post-production costs.<sup>134</sup> The first case, *Wood v. TXO Prod. Corp.*,<sup>135</sup> was decided in 1992. In *Wood*, the lessee (TXO) was obligated to deliver gas into the pipeline company's gathering lines at a certain pressure specified by the contract with the pipeline company.<sup>136</sup> The wells produced at sufficient pressure for some time, but then the pressure dropped below the pressure required for entry into the pipeline.<sup>137</sup> To keep from breaching the contract with the pipeline, TXO constructed a compressor on the lease premises, and deducted the proportionate cost from the lessor's royalty payment.<sup>138</sup> The *Wood* court compared the laws of Kansas and Arkansas with the laws of Texas and Louisiana.<sup>139</sup> In electing to follow the law of Kansas, the *Wood* court "interpret[ed] the lessee's duty to market to include the cost of preparing the gas for market....," and held that "[i]n Oklahoma the lessee's duty to market involves obtaining a marketable product."<sup>140</sup> The court also reasoned that if the lessee wants the lessor to share in the post-production costs, then the lessee needs to include that provision in the lease so that the lessor can make an informed economic decision.<sup>141</sup>

Two years later in *TXO Production Corp. v. State ex rel. Com'rs of Land Office*,<sup>142</sup> the Supreme Court of Oklahoma took an appeal from the district court to examine the issue of post-production costs and royalty deductions in oil and gas leases. The Oklahoma Supreme Court answered the question certified to it from the United States District Court. The court reversed the district court's judgment, expanding the implied covenant to market as adopted in

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<sup>134</sup> See generally *Mittelstaedt v. Santa Fe Minerals, Inc.*, 954 P.2d 1203 (Ok. 1998); *TXO Prod. Corp. v. Oklahoma*, 903 P.2d 259 (Ok. 1994); *Wood v. TXO Prod. Corp.*, 854 P.2d 880 (Ok. 1992).

<sup>135</sup> 854 P.2d 880 (Ok. 1992).

<sup>136</sup> See *id.*

<sup>137</sup> See *id.*

<sup>138</sup> See *id.* at 880-81.

<sup>139</sup> See *id.* at 881-82. Colorado and Kansas represent the recent revisionist position, while Texas and Louisiana represent the traditional position on the subject. Compare *Garman v. Conoco*, 886 P.2d 652 (Colo. 1994); *Rogers v. Westerman Farm Co.*, 29 P.3d 887 (Colo. 2001); and *Sternberger v. Marathon Oil Co.*, 894 P.2d 788 (Kan. 1995); with *Martin v. Glass*, 571 F. Supp. 1406 (N.D. Tex. 1983); *Merritt v. Southwestern Electric Power Co.*, 499 So. 2d 210 (La. 1986). See also *supra* notes 76-111 and accompanying text; see also *supra* notes 113-135 and accompanying text.

<sup>140</sup> *Wood*, 854 P.2d at 882-83.

<sup>141</sup> See *id.* at 883.

<sup>142</sup> 903 P.2d 259 (Ok. 1994).

*Wood*. The court held that “[c]osts for compression, dehydration, and gathering are not chargeable to. . . [the lessee] because such processes are necessary to make the product marketable under the implied covenant to market.”<sup>143</sup>

Four years after the decision in *TXO*, the Supreme Court of Oklahoma issued its opinion in *Mittelstaedt v. Santa Fe Minerals, Inc.*<sup>144</sup> The certified question before the *Mittelstaedt* court was whether “an oil and gas lessee. . . [is] entitled to deduct a proportional share of transportation, compression, dehydration, and blending costs from the royalty interest paid to the lessor?”<sup>145</sup> In answering this question, the court concluded that the implied covenant to market “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.”<sup>146</sup>

However, in this case, the gas was already marketable at the well. The court then analyzed whether the lessor could charge the lessee a proportionate share of the post-production costs when trying to enhance the value of the product. The court’s analysis then turned to laws of Colorado and Kansas to examine the decisions in *Garman*<sup>147</sup> and *Sternberger*.<sup>148</sup> In *Garman*, the Supreme Court of Colorado examined the law of Kansas and held that:

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.<sup>149</sup>

The Supreme Court of Oklahoma agreed with both *Sternberger* and *Garman* and held that “[w]hen the gas is shown by the lessee to be in a marketable form at the well the royalty owner may be charged a proportionate expense of transporting that gas to the point of purchase.”<sup>150</sup> The court also reasoned

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<sup>143</sup> *Id.* at 263.

<sup>144</sup> 954 P.2d 1203 (Ok. 1998).

<sup>145</sup> *Id.* at 1204-05.

<sup>146</sup> *Id.* at 1205.

<sup>147</sup> *Garman v. Conoco, Inc.*, 886 P.2d 652 (Colo. 1994).

<sup>148</sup> *Sternberger v. Marathon Oil Co.*, 894 P.2d 788 (Kan. 1995).

<sup>149</sup> *Mittelstaedt v. Santa Fe Minerals, Inc.*, 954 P.2d at 1207 (citing *Garman v. Conoco, Inc.*, 984 P.2d 788, 800 (Co. 1994)).

<sup>150</sup> *Id.* at 1208.



that the burden of proving the reasonableness of costs falls on the lessee.<sup>151</sup> The lessor may be responsible for some post-production costs “when the costs are reasonable, when the 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.”<sup>152</sup>

## VI. WEST VIRGINIA

### A. *Discussion of Pre-Wellman Case Law*

Before beginning a discussion of where West Virginia now stands, it is important to understand West Virginia’s jurisprudence on implied covenants and royalty provisions. *Cotiga Development Company v. United Fuel Gas Company*<sup>153</sup> and *Berry Energy Consultants v. Bennett*<sup>154</sup> are two important cases that help illustrate where West Virginia stood on the issue of royalty provisions and the implied covenant to market before its most recent decision in *Wellman v. Energy Resources*.<sup>155</sup>

In *Cotiga*, the plaintiff (Cotiga) entered into an oil and gas lease with Woods Oil and Gas Company (Woods).<sup>156</sup> Woods then assigned the lease to United Fuel (United). At issue in this case were the royalty and marketing provisions contained in the original lease.<sup>157</sup> The thrust of Cotiga’s argument was predicated on a failure to market gas produced from wells that were already on-line.<sup>158</sup> The royalty provision provided in part that the lessee would “pay for one-eighth (1/8) of the gas produced from each gas well drilled thereon, from which gas is marketed, while the same is so marketed, at the rate received by Lessee for such gas.”<sup>159</sup>

In its discussion, the court focused on whether the language of the lease was clearly expressed and unambiguous. The court reasoned that “[a]n oil and gas lease which is clear in its provisions and free from ambiguity, either latent or patent, should be considered on the basis of its express provisions and is not

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<sup>151</sup> *Id.* at 1210.

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

<sup>153</sup> 128 S.E.2d 626 (W. Va. 1962).

<sup>154</sup> 331 S.E.2d 823 (W. Va. 1985).

<sup>155</sup> 557 S.E.2d 254 (W. Va. 2001).

<sup>156</sup> *See Cotiga Dev. Co. v. United Fuel Gas Co.*, 128 S.E.2d at 630.

<sup>157</sup> *See id.* at 631.

<sup>158</sup> *See id.*

<sup>159</sup> *Id.* at 630.

subject to a practical construction by the parties.”<sup>160</sup> The court also reasoned that so long as a contract is valid it must become operative as the deliberate acts of the parties, regardless of the reasonableness or fairness of the contract.<sup>161</sup> “It is not the right or province of a court to alter, pervert or destroy the clear meaning or intent of the parties as plainly expressed in their written contracts or to make a new and different contract for them.”<sup>162</sup>

Next, the court focused on the marketing covenant contained in the lease. The marketing covenant of the lease provided that the lessee is required “to proceed with due diligence to . . . market the production. . . to the end that the Lessor and the Lessee may derive the speediest return practicable for the . . . gas recoverable thereunder, due consideration being always given to the condition of the industry as a whole.”<sup>163</sup> After examining the marketing provision and reviewing the record of the trial court, the court concluded that in a mineral lease, the lessee “must be accorded a reasonable discretion in the rate of development, production, and marketing.”<sup>164</sup>

In *Berry*, the West Virginia Supreme Court seemed willing to consider the implied covenant to market. In *Berry*, the lessors (the Bennetts) entered into a lease with the lessees “for the purpose of ‘exploring and operating for’ and ‘producing and marketing’ oil and gas.”<sup>165</sup> The lease also provided that the lessors “were to receive a royalty for the marketing of gas from their property.”<sup>166</sup> The Bennetts then brought suit against *Berry* for abandoning the lease.<sup>167</sup> The thrust of their argument was that the lessees failed to market the gas or pursue opportunities to sell the gas.<sup>168</sup> The lessees, however, asserted that they made diligent efforts to sell the gas, despite the fact that there were no transmission lines available where the well was located.<sup>169</sup> The court reasoned that the lessees were obligated to put forth a reasonably diligent effort to market the gas.<sup>170</sup> The court further reasoned that where:

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<sup>160</sup> *Id.* at 634.

<sup>161</sup> *See id.* at 634-5.

<sup>162</sup> *Id.* at 633.

<sup>163</sup> *Id.* at 635.

<sup>164</sup> *Id.* at 636.

<sup>165</sup> *Berry Energy Consultants v. Bennett*, 331 S.E.2d 823, 824 (W.Va. 1985) (internal quotations provided).

<sup>166</sup> *Id.* at 824.

<sup>167</sup> *See id.* at 825.

<sup>168</sup> *See id.*

<sup>169</sup> *See id.*

<sup>170</sup> *See id.*

[a] lessor and a lessee have entered into a lease for the purpose of “exploring and operating for” and “producing and marketing” oil and gas, and a well has been drilled by the lessee and gas discovered, the payment or tender by the lessee of delay rental for the leased premises does not relieve the lessee from an implied obligation to exercise reasonable diligence in marketing gas from the leased premises.<sup>171</sup>

The case was remanded for determination of whether the lessees exercised reasonable diligence to market the gas.<sup>172</sup>

These two cases are important for two reasons. These cases illustrate that prior to the decision in *Wellman*, West Virginia impliedly recognized that the lessee has an implied obligation to exercise reasonable diligence in marketing gas. These cases also show that in West Virginia, if an oil and gas lease is clear and unambiguous in its express provisions, the court will not interpret it, but instead will enforce the express provisions.

In an article, one commentator suggested that the “court hopefully will have an opportunity in the near future to fully consider the marketing issues in more detail.”<sup>173</sup> Sixteen years later, the West Virginia Supreme Court took up the marketing issues as they relate to the ability to deduct post-production costs before paying royalties. In July 2001, the West Virginia Supreme Court of Appeals rendered a decision in the case of *Wellman v. Energy Resources, Inc.*<sup>174</sup>

### B. *Discussion of Wellman Facts*

Benny Wellman owned two tracts of land located in Logan County, West Virginia.<sup>175</sup> Consisting of 200 acres and 23.5 acres respectively, Wellman executed two oil and gas leases for these two tracts with Energy Resources, Inc.<sup>176</sup> The appellees, James T. Wellman and Grace Wellman, acquired their interest in the two tracts of land from Benny Wellman subsequent to the execution of the oil and gas leases.<sup>177</sup> Both leases were identical land contained provisions which were critical to the litigation.<sup>178</sup> The leases were to run for a pe-

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<sup>171</sup> *Id.* at 829.

<sup>172</sup> *See id.*

<sup>173</sup> F.T. GRAFF, JR, *Implied Covenants to Market Natural Gas in a Changing Economy*, in 6<sup>TH</sup> ANNUAL INSTITUTE EASTERN MINERAL LAW FOUNDATION §17.02, §17.02[3], at 17-8 (1985).

<sup>174</sup> 557 S.E.2d 254 (W. Va. 2001).

<sup>175</sup> *See id.* at 257.

<sup>176</sup> *See id.*

<sup>177</sup> *See id.*

<sup>178</sup> *See id.*

riod of ten years “and for so long thereafter as drilling or working operations for the oil and gas were conducted, or for so long as oil or gas were produced from the leased premises.”<sup>179</sup> More importantly, “the leases required Energy Resources to pay a [1/8] royalty [interest to the Wellman’s] on any oil and gas produced.”<sup>180</sup> The royalty provision of the lease stated:

Lessee agrees to deliver to Lessor, in tanks, tank cars, or pipe line, a royalty of one-eighth (1/8) of all oil produced and saved from the premises, and to pay to Lessor for gas produced from any oil well and used by Lessee for the manufacture of gasoline or any other product as royalty 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>181</sup>

Energy Resources failed to commence drilling a well on either of the two leased tracts during the primary (ten year) term of the lease.<sup>182</sup> However, Energy Resources did re-open an abandoned well on the 23.5 acre tract after the expiration of the primary term of its leases with the Wellmans, and the natural gas produced from the re-opened well was then sold to the Mountaineer Gas Company.<sup>183</sup> Energy Resources received \$2.22 per thousand cubic feet (“mcf”) of gas that it sold to Mountaineer Gas.<sup>184</sup> In return, Energy Resources paid the Wellmans 1/8 of \$0.87 for each thousand cubic feet of gas it sold to Mountaineer.<sup>185</sup> Energy Resources subtracted certain post-production costs incurred producing and bringing the gas to market, and maintained that it was able to deduct certain expenses from the \$2.22 that it received from the sale to Mountaineer Gas.<sup>186</sup> In essence, Energy Resources subtracted \$1.35 from the \$2.22 it sold the

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<sup>179</sup> *Id.* at 257.

<sup>180</sup> *Id.*

<sup>181</sup> *Id.* at 257-8.

<sup>182</sup> *See id.* at 258. Under the primary term of the lease, the lessee was required to commence drilling oil and gas wells, and so long thereafter as oil and gas are produced. If the lessee failed to drill wells during the ten year period, then the lease would terminate. Energy Resources failed to drill any wells during the primary term of the lease, however, they re-worked an abandoned well so that it began producing gas again.

<sup>183</sup> *See id.*

<sup>184</sup> *See id.*

<sup>185</sup> *See id.*

<sup>186</sup> *See id.*

gas for to compensate for alleged post-production costs. Nothing in the record shows why these costs were deducted or that \$1.35 was a reasonable deduction for post-production costs.

The Wellmans then brought suit against Energy Resources for, among other things, failure to pay proper royalties on the existing well. The Circuit Court of Logan County granted the Wellmans' motion for summary judgment.<sup>187</sup> In granting the Wellmans' motion for summary judgment, the court found that Energy Resources failed "to pay a proper one-eighth royalty on the production from the re-worked well."<sup>188</sup> In awarding the Wellmans' substantial damages, the court concluded that Energy Resources short-changed the Wellmans because it failed to pay a proper royalty on the gas produced, and Energy Resources produced no evidence of the basis for the alleged post-production expenses to show that it was entitled to deduct post-production expenses from the market value of the gas sold.<sup>189</sup>

### C. *Discussion of Wellman Court's Analysis*

Although the decision in *Wellman* will have a significant impact on the way oil and gas leases are viewed and administered in West Virginia, this article focuses on the court's discussion of royalty deductions and post-production costs. The royalty provision on the lease provided in part that Energy Resources was to pay the Wellmans "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" when the gas produced was sold as natural gas.<sup>190</sup> As discussed earlier, Mountaineer Gas paid Energy Resources \$2.22 per mcf from the Wellmans' well.<sup>191</sup> Energy Resources then paid the Wellmans one-eighth of \$.87 rather than the \$2.22.<sup>192</sup> Although this fact was not disputed, Energy Resources asserted that it was entitled to deduct certain expenses before calculating the Wellmans' royalty.<sup>193</sup> In rejecting this argument, the West Virginia Supreme Court of Appeals reasoned that:

[t]here 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

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<sup>187</sup> *See id.*

<sup>188</sup> *Id.*

<sup>189</sup> *See id.*

<sup>190</sup> *Id.* at 263 (emphasis added).

<sup>191</sup> *See id.*

<sup>192</sup> *See id.*

<sup>193</sup> *See id.*

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.<sup>194</sup>

These expenses are typically referred to as “post-production costs.”<sup>195</sup> The court then went on to discuss the policy reasons for not allowing a lessee to charge post-production costs to the lessor.<sup>196</sup> The court reasoned that the lessee has a duty (either express or implied) to market the oil or gas produced and to get the oil or gas into a marketable condition prior to transport.<sup>197</sup> The court then went into an in depth discussion of the recent Colorado Supreme Court decision in *Garman v. Conoco*.<sup>198</sup> In conclusion, the court held that:

[W]est Virginia holds that a lessee impliedly covenants that he will market oil or gas produced. Like the courts of Colorado,<sup>199</sup> Kansas,<sup>200</sup> and Oklahoma,<sup>201</sup> the Court also believes that historically the lessee has had to bear the cost of complying with his covenants under the lease. It, therefore, reasonably should follow that the lessee should bear the costs associated with marketing products produced under a lease.<sup>202</sup>

The court went on to hold that “[i]f an oil and gas lease provides for a royalty based on proceeds received by the lessee, unless the lease provides otherwise, the lessee must bear all costs incurred in exploring for, producing, marketing, and transporting the product to the point of sale.”<sup>203</sup> The court further noted, however, that the lease provides that the royalty was to be calculated at the mouth of the well and held:

[i]f an oil and gas lease provides that the lessor shall bear some part of the costs incurred between the wellhead and the point of

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<sup>194</sup> *Id.* at 264. The court also recognized that only two jurisdictions (Texas and Louisiana) have allowed a lessee to properly charge the lessor with a pro-rata share of these post-production costs. *Id.*

<sup>195</sup> For a discussion of post production costs see *infra* Part II.

<sup>196</sup> See *Wellman v. Energy Resources, Inc.*, 557 S.E.2d at 264.

<sup>197</sup> See *id.*

<sup>198</sup> See *supra* notes 112-118 and accompanying text.

<sup>199</sup> For a discussion of the Colorado cases, see *supra* notes 113-127 and accompanying text.

<sup>200</sup> For a discussion of the Kansas cases, see *supra* notes 128-135 and accompanying text.

<sup>201</sup> For a discussion of the Oklahoma cases, see *supra* notes 136-154 and accompanying text.

<sup>202</sup> *Wellman*, 557 S.E.2d at 265.

<sup>203</sup> *Id.*

sale, the lessee shall be entitled to credit for those costs to the extent that they were actually incurred and they were reasonable. Before being entitled to such credit, however, the lessee must prove, by evidence of the type normally developed in legal proceedings requiring an accounting, that he, the lessee, actually incurred such costs and that they were reasonable.<sup>204</sup>

In summary, the court held that a lessee impliedly covenants to market oil and gas produced and that a lessee should bear the costs associated with marketing the oil and gas produced under a lease. The court also held that on a proceeds lease, unless the lease provides otherwise, the lessee must bear all the costs associated with exploring, producing, marketing, and transporting the oil and gas to a point of sale. However, the court also held that if the lease provides that the lessor bear part of the costs incurred between the wellhead and the point of sale, that the lessee will be entitled to a credit so long as the costs incurred are reasonable and actually incurred.

In the aftermath of *Wellman*, many West Virginia oil and gas producers are left scratching their heads trying to figure out where to go from here. The next section of this article will attempt to break down the court's decision and provide some guidance as to the implications of the holding on oil and gas producers in West Virginia.

## VII. PRACTICAL APPLICATION OF *WELLMAN*

The court correctly identified the widely adopted view that the lessor is "not chargeable with any of the costs of discovery and production."<sup>205</sup> The court then implies that in recent years, the production companies have engaged in a practice of avoiding their obligation to discover and produce oil and gas by charging the lessor for transportation and other costs associated with producing a marketable product.<sup>206</sup> The court concludes that production companies invented a category of "post production costs in order to escape the obligation to pay for marketing and transportation."<sup>207</sup>

This rationale exemplifies West Virginia's long standing practice of construing oil and gas leases in favor of the lessor.<sup>208</sup> It also exemplifies an ex-

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<sup>204</sup> *Id.*

<sup>205</sup> *Id.* at 263-64. See also *infra* Section II for a discussion on production costs and post-production costs.

<sup>206</sup> See *id.* at 264.

<sup>207</sup> See *id.*

<sup>208</sup> See *Cotiga Dev. Co. v. United Fuel*, 128 S.E.2d 626, 630 (W. Va. 1962). "An oil and gas lease which is clear in its provisions and free from ambiguity, either latent or patent, *should be considered on the basis of its express provisions* and is not subject to practical construction by the parties." *Id.* at 630. "It is not the right or province of a court to alter, pervert or destroy the clear

tension of law based on bad facts and beyond the issues raised in the trial court. This underlying bias exemplifies the pro-plaintiff bias that many West Virginia judges have against businesses operating within the state.<sup>209</sup>

The duty to explore and produce oil and gas is fulfilled when the subsurface minerals are severed from the earth and brought to the surface at the wellhead. As discussed in Part II *supra*, the majority of costs associated with producing oil and gas are incurred during the exploration and discovery phase of development. The reason the lessee retains a seven-eighths interest in the oil and gas produced is so the lessee can recover its investment and make a profit producing the minerals. As Professor Donley stated, “the primary object of both the lessor and lessee is to discover, produce, and market subsurface minerals to their *mutual profit*.”<sup>210</sup>

The phrase “mutual profit” implies that the lessor and lessee are involved in a cooperative venture. If no minerals are produced, then neither the lessee nor the lessor is able to share in the profit. Additionally, if no minerals are produced, the lessee is out substantially more than is the lessor. Due to the cooperative nature of the exploration and production of natural gas, in order to encourage the mutual benefit for both parties, the better reasoned policy is that once the minerals are brought to the surface, the lessor and lessee should share proportionately in the post-production costs incurred. The Texas and Louisiana policy more equitably divides the burdens in the exploration and production of oil and gas.

By ignoring the fact that the lessor and lessee share in the profits, the court seems to set the jurisprudential base line of giving the lessors a free ride. The court in *Wellman* has now made it potentially less profitable for the lessee. This free-rider policy is not what West Virginia needs if it wants to continue to encourage development, this policy may create a financial impediment to the continued production of marginal wells.

Implicit in West Virginia jurisprudence is the concept that a lessee has an implied covenant to market the oil and gas produced. If the lessee was not obligated to market the gas, then neither the lessee nor the lessor would be able to share in the profits received from the sale of oil and gas. In *Wellman*, the court holds that a “lessee impliedly covenants that he will market oil or gas produced . . . and the lessee should bear the costs associated with marketing prod-

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meaning or intent of the parties as plainly expressed in their written contracts or to make a new and different contracts for them.” *Id.* at 633. “The 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.” *Martin v. Consol. Coal and Oil Corp.*, 133 S.E. 626 at syl. pt. 1 (W.Va. 1926). *See also supra* notes 69-70.

<sup>209</sup> In particular, the Court’s dicta regarding lessees in this state charging “post-production costs in order to escape the obligation to pay. . .” also seems to reflect the jurisprudential bias, which is so often cited by its contemporary critics. *Wellman*, 557 S.E.2d at 264.

<sup>210</sup> *See* DONLEY, *supra* note 13.



ucts produced under a lease.”<sup>211</sup> The court however, confuses the implied covenant to market with an obligation to enhance and transport to downstream location, where the price is higher than it would be if purchased at the well. The court never explicitly says that the lessee has an implied covenant to pay royalty on an enhanced downstream value. The fact that these two concepts were confused by the court will ultimately cause more litigation to come before the court.

The court’s holding in *Wellman*, as stated, pertains only to a proceeds lease. In footnote 3, the court stated, “[w]here leases call for the payment of royalties based on the *value* of oil or gas produced, and sold directly, the Court perceives that there are possibly different issues, and they are excluded from this discussion.”<sup>212</sup> The court correctly realizes that value or market value leases present different issues and limited the decision to deal only with the proceeds lease. Since the court refused to discuss market value lease clauses, that issue will more than likely have its day in court in the near future.

However, since *Wellman* addresses only proceeds leases, it is important to dissect the holding in relation to these types of leases. In Syllabus Point 4, the court holds “[i]f an oil and gas lease provides for a royalty based on *proceeds received* by the lessee, *unless the lease provides otherwise*, the lessee must bear all costs incurred in exploring for, producing, marketing, and transporting the product to a point of sale.”<sup>213</sup> The court makes no specific mention of costs for gathering, processing, compression, and dehydration. However, syllabus point 4 is important because the court at least implies that an express provision in the lease pertaining to costs will trump the implied covenant to market, and that “at the well” language may be such an express provision.

This is consistent with the law of contract interpretation in West Virginia. In *Cotiga*, the court held that “*an oil and gas lease which is clear in its provisions and free from ambiguity, either latent or patent, should be considered on the basis of its express provisions and is not subject to a practical construction by the parties.*”<sup>214</sup> The *Cotiga* court went on to hold that “[i]t is not the right or province of a court to alter, pervert or destroy the clear meaning or intent of the parties as plainly expressed in their written contracts or to make a new and different contracts for them.”<sup>215</sup> Therefore, if a proceeds based oil and gas lease plainly expresses that post-production costs will be borne proportionately by the lessee and lessor, the court should not alter that express provision but instead enforce the provision. As a result, production companies in West

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<sup>211</sup> *Wellman*, 557 S.E.2d at 265. For this idea, the court cites DONLEY *supra* note 12 at §70 and §104.

<sup>212</sup> *Id.* at 264 n.3.

<sup>213</sup> *Id.* at Syl. Pt. 4. (emphasis added).

<sup>214</sup> *Cotiga Dev. Co. v. United Fuel*, 128 S.E.2d 626, 630 (W. Va. 1962) (emphasis added).

<sup>215</sup> *Id.* at 633.

Virginia should seriously consider drafting new lease forms that expressly, clearly, and precisely address the issues of post-production costs.

Another interesting point on contract construction revolves around the intent of the parties. The *Wellman* court believed “the language of the leases in the present case indicat[ed] that the ‘proceeds’ shall be from the ‘sale of gas at the mouth of the well’ . . . might be language indicating that the parties intended that the Wellmans, as lessors, would bear part of the costs of transporting the gas from the wellhead to the point of sale.”<sup>216</sup> The court at least impliedly recognizes that the language “at the wellhead” in the royalty clause establishes a point of valuation for the gas produced, but declined to address the issue. The main reason the court declined to address this issue is because Energy Resources failed to introduce any evidence to show that post-production costs were actually incurred or that they were reasonable.<sup>217</sup>

It would be interesting to see how the court would have dealt with this issue had Energy Resources presented any evidence in opposition to the *Wellman*’s summary judgment motion because it is not the “province of the court to alter, pervert, or destroy the clear meaning or *intent*” of the parties.<sup>218</sup> If Energy Resources had presented evidence to show the actual costs incurred, the court might have been willing to consider that this language implies that the lessor and lessee will share proportionately in the cost of transportation away from the wellhead to a market.

In syllabus point 5, the court holds, “[i]f an oil and gas lease provides that the lessor shall bear some part of the costs incurred between the wellhead and the point of sale, the lessee shall be entitled to credit for those costs to the extent that they were actually incurred and that they were *reasonable*.”<sup>219</sup> Again, this point is important because it recognizes that the express terms of a lease on the issue of cost will trump the implied covenant to market. However, what this point leaves open to interpretation is the issue of reasonable costs. The court never implicitly or explicitly states what reasonable costs are and leaves the door wide open for the issue to be litigated.

## VIII. CONCLUSION

The holding in *Wellman* leaves many issues pertaining to oil and gas leases, royalty provisions, and post-production costs undecided. What we do know is that when the lease is silent on the issue of post-production costs, the lessee in a proceeds based oil and gas lease has an implied duty to market the gas. Additionally, we know that if there is an express provision that addresses

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<sup>216</sup> *Wellman*, 557 S.E.2d at 265.

<sup>217</sup> *Id.*

<sup>218</sup> *Cotiga*, 128 S.E.2d at 633.

<sup>219</sup> *Wellman*, 557 S.E.2d at Syl. Pt. 5 (emphasis added).

the allocation of costs, the express provision will be given its clear and plain meaning as expressed in the four corners of the lease. Therefore, it would be wise for oil and gas producers to retire the old "Producers 88" and replace it with a lease that clearly and expressly allocates costs.

What we do not know is where the court will draw the line on market value leases. The court recognized that market value leases present a different set of issues than proceeds leases but does not go into any detail on what the different issues are. The court also leaves open for interpretation what exactly constitutes reasonable costs. Also, the court makes no mention of costs for gathering, processing, compressing, and dehydrating. These costs do fall into the broad category of post-production costs, but are not included in exploring, producing, transporting, or marketing. It is likely that in the near future the court will be required to declare what constitutes reasonable costs and who incurs the costs for gathering, processing, compressing, and dehydrating of the gas produced.

Finally, in West Virginia, what the lease "says" when it is "silent" on the issues of post-production costs is that the lessor will no longer be responsible for sharing proportionately in any costs incurred bringing the gas to market. Oil and gas producers in West Virginia now need to crank up the volume and make sure that the lease clearly and expressly "says" what costs the parties will share in.

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