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# Post Production Expenses- I Don't Care What the Rules Are, Just Tell Me What They Are

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POST PRODUCTION  
EXPENSES-I DON'T CARE  
WHAT THE RULES ARE,  
JUST TELL ME WHAT THEY  
ARE

Bob Honea

**Post Production Expenses in Arkansas:**  
*I Don't Care What the Rule is, Just Tell me What it is.*

**I. INTRODUCTION**

The payment of royalties to the lessor in an oil and gas lease is a procedure that may seem straightforward on its face: lessor and lessee execute an oil and gas lease, lessee drills and captures oil or gas, lessee sells that gas and pays the fractional royalty price to the lessor. On paper it seems elementary - in practice it is anything but clear. The only clear-cut rule that every jurisdiction has seemed to agree upon is that production expenses are borne by the lessee - the lessor's royalty is not affected by the cost of actual drilling and the related operations. However, the major dispute regarding the calculation and payment of royalties is what post production expenses, if any, can fairly be deducted from the lessor's royalty share? Jurisdictions across the country have wrestled with this issue, leading to a myriad of approaches and theories underlying the calculation of gas royalties. At the risk of oversimplifying the approaches, I have grouped these theories into three major sub-groups: (1) at-the-well jurisdictions; (2) first marketable product jurisdictions; and (3) statutory scheme jurisdictions. As a caveat, it must be noted that these groups are not internally identical; each jurisdiction puts its own twist on the treatment of post production expenses.

Some jurisdictions use an "at-the-well" approach. It is considered to be the majority approach.<sup>1</sup> This approach has also been called the "net-back calculation" approach or the "property-centered" approach. Regardless of the moniker, the result is as follows: gas in place is real property, which is bargained for and exchanged at some rate (bonus plus royalty) via the oil and gas lease. Gas which is drilled and brought to the surface (gas that is, literally, "at-the-wellhead") becomes personal property and is therefore subject to royalty calculation at that point. The problem is that gas "at-the-wellhead" is worth nothing - without various post-production

treatment, transportation, and marketing, the lessor awaiting with his hands out for payment would collect 1/8 of zero dollars - hardly an economic incentive to lease away his real property mineral interests. Enter the "net-back calculation." The net-back calculation deducts various post-production expenses *before* calculating the fractional royalty due to the lessor. This allows for the lessee to allocate the costs of post-production between itself and the lessor, and it transforms an otherwise zero dollar fractional interest into positive dollars for the lessor.

Other jurisdictions have adopted the "First Marketable Product Doctrine." This approach has been considered a "contract-centered" approach. This doctrine relies heavily on a covenant implied in every oil and gas lease by judicial interpretation: the lessee's implied duty to market. Courts have reasoned that, without the imposition of an implied duty to market, lessees may be tempted to take only their "share" of the gas in the ground, and direct the lessor to remove its own fractional royalty interest "in-kind" (in actual gas) from the reserves still beneath the surface. Again, this would be impossible for the average lessor, and would ultimately result in a zero dollar royalty payment. The First Marketable Product Doctrine reasons that the lessee, by virtue of its obligations under the applicable lease, bears the burden of getting the gas to the point (both location and condition) at which the product is truly "marketable." The various jurisdictions have set this threshold at different points, whether in location or condition of the gas, and at least one jurisdiction has taken this doctrine to an extreme.

At least one jurisdiction has attempted to solve the post-production-expenses problem legislatively rather than judicially. That state has enacted a statute that purports to protect royalty interest holders' interests and guard against deducting post production expenses that should ultimately be borne by the lessee. A closer look at this jurisdiction, however, reveals that

the courts once again had to address the issue and the approach is no longer clear-cut even in the face of a statute directly on point.

The myriad of approaches out there should lead you, as an Arkansas practitioner, to ask one question: Which approach has Arkansas adopted? Once again, however, the answer is anything but clearcut. In fact, a review of the applicable case law and statutes reveal that, at various points in time, Arkansas has followed all three approaches. This leads me to conclude that Arkansas has no rule at all. ~~Whether it needs one is a different story.~~

## I. STATE-BY-STATE SURVEY

### A. At-the-well States

#### 1. Texas

In Texas, the extraction of oil and gas from the ground invokes a property-centered analysis: namely, gas in the ground is real property, but when it is extracted it transforms into personal property. This rule may seem elementary on its face, but its application to the calculation and allocation of post-production expenses is pivotal in Texas. For example, in *Martin v. Glass*,<sup>2</sup> the lease at issue contained an “at-the-well”<sup>3</sup> provision.” Neither party to the lease argued that it was ambiguous. The Court held that *compression costs* were properly charged against the royalty and overriding royalty owners. The Court explained that “royalty is based on the value of all gas produced at the mouth of the well.”<sup>4</sup> It went on to state that post production costs included those costs “necessary to render the gas marketable.”<sup>5</sup> The Court also relied upon the lessee’s implied duty to market<sup>6</sup> as another basis for allocation of post production costs between lessors and lessees. In sum, it is the lessee’s duty to market - and this duty arises “at the well.” However, the Court went one step further and defined marketing as “a separate and independent step, once or more removed from product, and as such is a post-production

expense.”<sup>7</sup> It must be noted, however, that Texas holds generally that parties are free to modify this general rule through specific contract language.

## 2. Louisiana

The proper calculation of post production expenses has been discussed recently in Louisiana in the case of *Culpepper v. EOG Resources, Inc.*<sup>8</sup> In *Culpepper*, the lessors brought suit after the lessees deducted transportation costs prior to computing their royalty. The trial court found that such deductions were improper and that the lease, which utilized the phrase “computed at the mouth of the well,” was ambiguous. The Court of Appeals of Louisiana held that such language contemplated deduction of transportation costs from the well to the purchaser prior to calculation of royalty payments. The Court explained that its previous ruling in *Merritt v. Southwestern Electric Power Co.*<sup>9</sup> was controlling. In *Merritt*, the Court explicitly held that the common lease language “at the mouth of the well” meant that post production costs could be deducted. *Merritt* dealt with compression costs, but *Culpepper* extended this ruling to include transportation costs as well.

## 3. California

One case out of California is of particular note because it dealt with the State as lessor. One would think that if ever there was an argument that post production expenses were *not* deductible prior to royalty calculation, taking money from the State would offer that circumstance. However, in *Atlantic Richfield Co. v. State*,<sup>10</sup> the California Court of Appeals found just the opposite. In *Atlantic Richfield Co.*, the lessee brought an action against the State seeking a declaratory judgment allowing it to deduct processing and transportation costs. The trial court, which was affirmed on appeal, relied upon a statute in force at the time of execution of the leases. That statute provided that “royalties shall be paid in kind or as a percentage of the

current market price at the well of, and of any premium or bonus paid on, the production removed or sold from the leased land.”<sup>11</sup> The appellate court reasoned that the phrase “at the well,” when used in the context of the oil and gas industry, “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>12</sup> Based on this definition, California has explicitly held that “It is the rule in California that unless there is clear language to the contrary, the lessor of an oil and gas lease, such as the State, bears its proportionate share of processing costs incurred downstream of the well.”<sup>13</sup> Although the State argued that the technical phrase “at the well” should be ignored in the statute, the Court refused to parse the legislation in such a way.

#### 4. *New Mexico*

New Mexico has recently weighed in on the issue of post production expenses in the case of *ConocoPhillips Co. v. Lyons*.<sup>14</sup> In *Lyons*, the Court held that a “net proceeds” royalty calculation is properly computed “at the well.” The Court explained that when the term “at the well” is utilized, the point of valuation is the well and the “lessee is entitled to deduct all costs that are incurred subsequent to production, including those necessary to transport the gas to a downstream market and those costs, such as dehydrating, treating, and processing the gas, that are either necessary to make the gas saleable in that market or that increase the value of the gas.”<sup>15</sup>

The interesting point brought up by the *Lyons* case is that the leases in question did *not* provide for sale of the gas “at the well.” Instead, the leases provided for royalty payable upon “net proceeds...in the field” or “from the sale of gas from each gas well.” The New Mexico Supreme Court was faced with an issue of first impression: when are royalties calculated when the lease provides for royalty payable based on language other than “at the well.” The Court

focused on the phrase “net proceeds,” and explained that “net proceeds” meant “the amount received in a transaction minus the costs of the transaction.”<sup>16</sup> The Court looked to course of performance, course of dealing, custom in the industry, and a state statute regarding post production cost allocation between the State and State lessees in affirming the trial court’s approval of deducting post production costs before calculating royalty.

#### 5. Michigan

The pivotal case in Michigan is *Schroeder v. Terra Energy, Ltd.*<sup>17</sup> In *Schroeder*, oil and gas lessors sued their lessee after the lessee deducted post production costs from their royalty payments. Although Michigan can be placed on the “at the well” side of the royalty spectrum, its rationale is strangely more contractually based, rather than property-~~entered~~centered like

Texas. The *Schroeder* Court explained that:

In construing an oil and gas lease, this Court is guided by the Supreme Court’s decision in *J.J. Fagan & Co. v. Burns*. In *J.J. Fagan*, the Court noted the widespread use of standard oil and gas lease forms. The Court further noted that the language used in those lease forms had evolved through the process of trial and error with careful attention being paid to judicial decisions interpreting the standard contractual verbiage. An oil and gas lease is not an isolated agreement drafted by uninformed neighbors to express roughly their agreement but, rather, is a technical contract reflecting the development and present status of the law of oil and gas.<sup>18</sup>

However, the Court went on to concede that the parties’ intent should ultimately resolve issues of ambiguity even in standardized oil and gas lease forms. In fact, the Court admitted that ambiguities in oil and gas leases “should be resolved in favor of the lessors as a policy matter.”<sup>19</sup> Despite these caveats, ~~however~~, the Court held that a return to basic economic theory suggested that the phrase “at the wellhead” necessarily meant ascertainable gross proceeds, and that gross proceeds from a sale elsewhere must be “extrapolated, backwards or forwards, to reflect



appropriate adjustments due to differences in the location, quality, or characteristics of what is being sold.” The Court reasoned that this interpretation exceeded the bounds of the oil and gas industry and actually applied to sales of other goods as well. Hence, the net-back calculation method was explicitly adopted in Michigan.

~~6—Mississippi~~

~~NEED A CASE ----- NYGAARD ONLY TALKS ABOUT REAL VS PERSONAL  
PROPERTY FOR PURPOSES OF CALCULATING STATUTE OF LIMITATIONS~~

~~(Maybe Pursue v. Abernathy?)~~

#### A. First Marketable Product States

##### 1. Oklahoma

Oklahoma was perhaps the first state to adopt the “First Marketable Product Doctrine” as the guiding principle regarding the allocation of post production expenses. The earliest case ~~(CHECK)~~ in which Oklahoma adopted this view was *Barton v. Laclede Oil & Mining Co.*<sup>20</sup> In *Barton*, the Court held that “where there is not a clear expression by parties to the contrary, royalty is payable at the point where the gas is first marketable.”<sup>21</sup> Further, the point *at which* gas is “first marketable” is ordinarily a question of fact. This necessarily requires a case-by-case analysis with regard to post-production costs in Oklahoma.

~~Then~~ In 1992, an Oklahoma federal court, sitting in diversity, certified the following question to the Oklahoma Supreme Court: whether an oil and gas lessee/operator who is obligated to pay the lessor 3/16 at the market price at the well for the gas sold is entitled to deduct the cost of gas compression from the lessor’s royalty interest. The Supreme Court responded in the negative in *Wood v. TXO Production Corp.*<sup>22</sup> In *Wood*, the Oklahoma Supreme Court explained that Oklahoma has held that a lessor must bear its proportionate share of

*transportation* costs where the point of sale was off the leased premises.<sup>23</sup> However, it refused to extend that obligation to include compression costs in *Wood*. The Court reasoned that “one of the risks borne by the lessee in exploring for gas is that the gas will be low pressure.” Relying once again on the well-established implied duty to market, the *Wood* Court held that because the royalty owners had no input with regard to cost-bearing decisions, the Court could not impose on them working interest ownership obligations without the attendant rights. The duty to market in Oklahoma therefore necessarily includes “obtaining a marketable product,” and that burden is borne solely by the lessee.

## 2. *Colorado*

One of the pre-eminent cases in Colorado dealing with the allocation of post production expenses is *Rogers v. Westerman Farm Co.*<sup>24</sup> In *Rogers*, the applicable leases provided for gas to be sold either at the well, at the pipeline, or used “in kind.”<sup>25</sup> The leases also provided language for a royalty based on an accounting “at the well.” The Colorado Supreme Court held that the “at the well” language did *not* include an allocation of *transportation* costs to the lessor. The court reasoned that the lessee’s implied duty to market included transportation and a passthrough to the lessor would be inequitable. The *Rogers* case reconfirmed the position set forth in an earlier Colorado case known as *Garman v. Conoco, Inc.*<sup>26</sup>

In *Garman*, the Colorado Supreme Court explicitly held that “overriding royalty interest owners are not obligated to bear any share of post-production expenses, such as compressing, transporting and processing, undertaken to transform raw gas produced at the surface into a marketable product.”<sup>27</sup> The Court’s rationale was this: before an inexperienced landowner could be bound by the meaning of a technical term of art, the landowner must have a “full understanding” of the term. Explaining further, the Court held that “royalty” was a

technical term, with a precise meaning in the oil and gas industry.” As such, royalties in Colorado simply cannot include a “net back calculation” within them. This case essentially adopted the “First Marketable Product Doctrine” in the State of Colorado.

~~--- (CHECK: Colorado has not wavered from this position.)<sup>28</sup>~~

### 3. *Kansas*

Kansas adopted a scheme regarding allocation of transportation costs similar to that of Oklahoma in *Sternberger v. Marathon Oil Co.*<sup>29</sup> In *Sternberger*, the Kansas Supreme Court explained that the lessee under an oil and gas lease had the implied duty to produce a marketable product and that “the lessee alone bears the expense in making the product marketable.” However, the Court went on to explain 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 burden to prove the reasonableness of those costs falls on the lessee. However, “[a]bsent a contract providing to the contrary, a nonworking interest owner is not obligated to bear any share of production expense, such as compressing, transporting, and processing, undertaken to transform gas into a marketable product.” In other words, Kansas’s stance on the issue is murky at best.

The Court ~~in *Sternberger* also was presented with a conflict of laws issue and~~ undertook an examination of Oklahoma and Texas law. With respect to Oklahoma law, ~~t~~he *Sternberger* Court explained that *Wood* merely distinguished *Johnson* based on the *nature* of the post production expenses (compression versus transportation). The Court held that Oklahoma law tracked with Kansas law: “Compression and other expenses necessary to make the product

marketable are not deductible, but transportation costs are deductible where the sale occurs off the lease premises.”

The *Sternberger* Court’s interpretation of Texas law, on the other hand, reveals that Texas is a true “at the well” state: “Post-production expenses are borne proportionately by the lessor and the lessee, while the lessee alone bears the costs of production.” Thus, the court concluded that deductions allowed in Texas ~~deduction~~ are considered to be “broader” than those allowed in Kansas. The ultimate result in *Sternberger* is a Kansas holding allowing for deduction of transportation costs, but a remand to determine whether the specific transportation costs in the case at bar were reasonable.

#### 1. *West Virginia*

The pre-eminent case on point in West Virginia is *Wellman v. Energy Resources, Inc.*<sup>30</sup> In *Wellman*, the leases provided for royalty based on “proceeds” received by the lessee. The Court held that this type of “proceeds” lease required royalty to be calculated truly at the well; in other words, the lessee would bear all post production costs. Again, the Court reasoned that the lessee’s implied duty to market burdened the lessee to fulfill its covenants under the lease out of its own pockets. However, at least one scholar has opined that the *Wellman* case took the “First Marketable Product Doctrine” to a new level - “by expanding the duty to market to require a lessee to bear all costs to the point of sale and not just to the point where a marketable product is created.”<sup>31</sup> The West Virginia approach is like a First Marketable Product Doctrine jurisdiction on steroids, with total protection for the lessor and total risk borne by the lessee.

#### **A. Pennsylvania: A Statutory “Solution” that Proved Insufficient**

The gas boom created by the Marcellus Shale Play required Pennsylvania to join in the conversation about how to allocate post production expenses, if they are allocated to the lessor at

all. Pennsylvania's answer to this nationwide confusion was statutory in nature. ~~In DATE, I~~the Pennsylvania General Assembly enacted the Guaranteed Minimum Royalty Act ("GMRA"). This Act provides:

A lease or other such agreement conveying the right to remove or recover oil, natural gas, or gas of any other designation from lessor to lessee shall not be valid if such lease does not guarantee the lessor at least one-eighth royalty of all oil, natural gas, or gas of other designations removed or recovered from the subject real property.<sup>32</sup>

As you can see, Pennsylvania attempted to skirt the "at the well" term-of-art issue ~~that arose with XX's statute~~. However, the judicial interpretation of this statute instead found a new foothold to focus upon: "removed or recovered."

In *Kilmer v. Elexco Land Servs., Inc.*, the Pennsylvania Supreme Court considered whether the deduction of post production expenses, which resulted in less than a 1/8 royalty going to the lessor, violated the GMRA. In *Kilmer*, the lessee used a net-back calculation method to deduct post production expenses. The Court held that although the GMRA set a minimum royalty fractional interest in Pennsylvania, the statute was "silent regarding the definition of royalty and the method for calculating royalty." The Court noted that the statute did not contain any of the typical industry-standard terms such as "at the wellhead," "postproduction costs," or "point of sale."

Explaining that in 1979, when the GRMA was adopted, the legislature could have intended *both* parties' intentions: that royalty be calculated at the wellhead (favorable to the lessee) *and* that royalty be calculated at the point of sale (favorable to the lessor). This splitting- the-baby rationale resulted in the *Kilmer* Court holding that royalty never includes production expenses but it can include a deduction for post production expenses, including "production or

gathering taxes, costs of treatment of the product to render it marketable, and costs of transportation to market.”<sup>33</sup>

The Pennsylvania Supreme Court grappled with the GMRA again—and more recently, in *Katzin v. Central Appalachia Petroleum*.<sup>34</sup> In *Katzin*, the lessee argued that the lease at issue was so vague as to *which* post production costs were deductible from his royalty that it was rendered void under the GMRA. The Court reasoned that when a contract is silent as to whether it is violative of a statute, the parties impliedly assume that the agreement satisfies the statute and that an implied promise to do whatever act necessary to carry out the contract exists. Because the lease included a 1/8 royalty, in line with the statutory language, the Court held that any complaint by the lessee was better suited for a breach of contract action than a total invalidation based on a statutory violation.

### III. ARKANSAS: WHAT IS THE RULE?

At least one scholar has grouped Arkansas in with the minority approach, declaring that it falls within the “First Marketable Product” jurisdictions.<sup>35</sup> However, it is clear that, in actuality, Arkansas has no rule at all. Alternatively, it might be said that Arkansas has no rule because it has, in effect, adopted every rule mentioned in this paper.

#### A. The Statutes

Although never discussed in a reported decision in the context of post-production expenses, Act 222 of 1929 would appear on its face to be at least relevant to the discussion. The pertinent language of the Act is as follows:

“All purchasers of oil and gas shall pay to the royalty interest the same premium or bonus above the posted market price for oil or gas they pay to the lease holder or working interest under any oil, gas, or mineral lease on lands from which oil or gas may be purchased under contract with the lease owner or operator. A.C.A. §15-74-703.

It shall be unlawful for any purchaser of oil or gas to enter into any contract with any lessee or operator under any oil, gas, or mineral lease whereby the purchaser undertakes to pay any of the cost or expense of operation or production, steaming, treating, or running oil or gas or any other bonus or premium under any name or subterfuge whatsoever, without providing for paying to the royalty interest its proportionate share according to interests therein. A.C.A. §15-74-704.

It shall be the duty of both the lessee, or his assignee, and any pipeline company, corporation, or individual contracting for the purchase of oil or gas under any oil, gas, or mineral lease to protect the royalty of the lessor's interest by paying to the lessor or his assignees the same price- including premiums, steaming charges, and bonuses of whatsoever name for royalty or gas that is paid the operator or lessee under the lease for the working interest thereunder. A.C.A. §15-74-705.

It shall be unlawful for any pipeline Company, Corporation, or individual purchasing oil or gas from the operator or lessee of any oil, gas, or mineral lease to enter into any contract with the operator or lessee whereby the purchaser acquires the royalty oil or gas reserved in the oil, gas, or mineral lease for any price less than the price paid the operator or lessee of the lease. A.C.A. §15-74-706.”

\_\_\_\_\_ The Act also includes provisions making it a crime (a misdemeanor) to violate the provisions of the Act, and further provides for the forfeiture of oil and gas leases and trouble damages for violations of the Act. A.C.A. §15-74-701 and 708.

\_\_\_\_\_ Although Arkansas authority with respect to post production expenses is scant, it is nevertheless a wonder that these statutes are not discussed in those decisions. Any reasonable reading of these statutes would suggest that they are at least relevant to the discussion. Nevertheless, at this point in the development of Arkansas law, what you see is what you get - these are the, statutes, you tell me what they mean. \_\_\_\_\_

**B. Two Cases Purportedly “On Point”**

In Arkansas, many practitioners and scholars argue that only two cases have dealt with post production expenses, and neither has provided a lasting rule for use in future instances.<sup>36</sup> In

*Hanna Oil & Gas Co. v. Taylor*,<sup>37</sup> the lessee began deducting gas compression costs from the lessor's royalty payments. The Arkansas Supreme Court held that the lessee was not entitled to do this because the royalty clause contained in the contract was a "proceeds" royalty clause. The Court looked to the specific contract language which provided that: "Lessee shall pay Lessor one-eighth of the proceeds received by Lessee at the well for all gas (including all substances contained in such gas) produced from the leased premises and sold by Lessee." The Court noted that this was an issue of first impression with regard to that particular royalty clause language.

The Court reasoned that, unless the agreement stated otherwise, "proceeds" are generally defined as "total proceeds." Unlike many of the First Marketable Product jurisdictions, the Court did *not* find the lease language ambiguous. Instead, it explained that proceeds was clear and if the lessee had desired to deduct post production costs such as compression costs then it should have referenced those costs in the lease or referred instead to "net proceeds." In dicta, the Court went on to say that even if the language was found to be ambiguous the lease language should be construed in favor of the lessor. The Court also added course of dealing and course of performance rationale to bolster its holding, although such evidence would be improper if no ambiguity existed. [\*Hanna did not discuss or mention Act 222 of 1929.\*](#)

The other, older, case that is oft-cited is *Clear Creek Oil and Gas Co. v. Bushmaier*.<sup>38</sup> In *Clear Creek Oil*, the Arkansas Supreme Court addressed whether a fixed rate royalty should be subject to deductions for transportation and distributing charges. The lease in question provided that royalty would be calculated at the well at the market price. However, testimony in the case revealed that no market existed at the well. The Court explained:

...if there be no market value at the place of delivery, the value of the goods or other product should be determined at the nearest place where they have a market value, deducting the extra expense of delivering them



there. The prices prevailing at the nearest place where the product can be sold, less transportation and distributing charges, show the value of such product at the place of delivery as nearly as it is possible to show such value.<sup>39</sup>

The Court remanded the case for a calculation of what royalty was due the lessor. *Clear Creek* seems to align Arkansas with the Texas “at-the-well” approach, but *Hanna* falls on the opposite side of the spectrum. Thus, Arkansas essentially has no rule because it has used both rules.

#### **CB. The “Real” Cases and Statutes to Look to for a Rule Hillard and Hales**

If the statutes, *Hanna*, and *Clear Creek Oil* leave a practitioner scratching his head, the addition of two more cases may leave him considering a different legal specialty.

Hillard v. Stephens<sup>40</sup> was primarily a case involving the question of whether a long term gas purchase contract effectively established the “market price at the well” for purposes of royalty calculations. The court in *Hillard* held that “as long as the gas purchase contracts were reasonable when entered into” the contracts establish the “market price at the well” and that royalties are properly paid on the basis of the proceeds paid under the long term gas purchase contract. In discussing this topic, the court never mentioned Act 222 of 1929.

The court then went on to discuss the impact of Act 222 of 1929 on fixed price leases. Some of the leases involved in the *Hillard* case were fixed price leases, which specified that the royalty would be paid on the basis of seven cents (\$0.07) per MFC. The lessors argued that this language was in direct conflict with Act 222 of 1929, and that the royalty should therefore be calculated based on what the lessee actually received under the long term gas purchase contracts. The court rejected the argument, and held that Act 222 of 1929 was irrelevant.

“If, as the trial court held, [Act 222] converts all “fixed price” gas leases into “proceeds” leases, it follows that fixed price leases favorable to a lessor or higher “fixed price” leases would be converted into “proceeds” leases. That is not the intent of the statute. Nor is it to prohibit fixed price contracts for oil and gas leases.”

\_\_\_\_\_ The foregoing represents the sum total of the court’s analysis of the interplay between Act 222 and negotiated contracts (oil and gas leases). Apparently, the court was of the opinion that the parties are free to enter into contractual agreements which directly contradict the result mandated by Act 222. This seems a little odd, to say the least, particularly in light of the discussion of Act 222 in *SEECO v. Hales*.

\_\_\_\_\_ *SEECO v. Hales*<sup>41</sup> likewise involved royalty owner litigation arising out of a long term gas purchase agreement. One of the claims the royalty owners asserted was that they were entitled to be paid royalty on take or pay settlements pursuant to long term gas purchase contracts. The royalty owners specifically relied on Act 222 in support of their contention. The court agreed with the royalty owners, finding that Act 222 did in fact govern.

“Arkansas has a statute, §15-74-705, that appears to decide this issue. In their reply brief, the appellants counter that the statute refers “to premiums or bonuses” paid to an operator for royalties on gas that has been produced or sold. However, the statute does not specify that the gas has to have been produced or sold. It only states that the premiums or bonuses must be paid when any money is paid the lessee. It follows that if *SEECO* had received a settlement on the take or pay deficiencies, *SEECO* would have then been obligated to pay “to the lessor or his assignees the same price... for royalty oil or gas that is paid the operator or lessee under the working lease thereunder” under the statute.”

\_\_\_\_\_ On its face, the *Hales* case therefore appears to say that Act 222 says what it means and means what it says - the lessee pays royalty based on what the lessee puts in his pocket at the end of the day.

\_\_\_\_\_ How you apply *Hillard* and *Hales* to classic post production expenses is anyone's guess. *Hillard* seems to stand for the proposition that contract language may defeat Act 222. *Hales*, on the other hand, appears to say that Act 222 is to be given affect literally, i.e., that every oil and gas lease is to be read as if the statutes were part and parcel of the lease.

#### **D. Conclusion**

There is a reason the title of this paper is "I Don't Care What the Rule is, Just Tell me What it is." As far as this author is concerned, Arkansas has no rule, or perhaps more accurately has every rule. Unfortunately, the most likely outcome is that Arkansas will continue to meander through the post production wilderness making up the rules as it goes along, without ever providing any clear cut guidance as to what the rule is. For the moment, however, the most logical approach is to assume that Act 222 governs (lessees are required to treat the royalty owners the same way they treat themselves), but at the same time recognizing that the parties have the ability to enter into a contract (the language of the oil and gas lease) which mandates a result contrary to the dictates of Act 222.

Robert M. Honea  
Hardin, Jesson & Terry, PLC

on point, but rarely discussed, may leave him considering a different legal specialty. Although *Hanna* and *Clear Creek* both discussed compression or transportation costs, the *Hillard* and *Hales* cases touch on the typical gas purchase contract.

1 ----- *Hillard*

If Arkansas has adopted an at the well approach, it is most recognizable in *Hillard v. Stephens*.<sup>42</sup> The *Hillard* case involved a gas purchase contract between Stephens Production Company and Ark La. That contract provided that ..... FINISH FACTS HERE. MENTION STATUTE AND IDEA IT "TRANSFORMS" FIXED PRICE LEASES INTO PROCEEDS LEASES (theory which court rejects).

----- In *Hillard*, the Arkansas Supreme Court held that the "contract price" that lessess received via gas purchase contracts was the "prevailing market price at the well." This interpretation prohibited the lessors from gaining any excess royalty based on the gas purchase contract price. In true slight of hand, *Hillard* adopted an at the well approach without ever explicitly mentioning it.

*Hales*

----- While *Hillard* adopted an at the well approach, another case decided in 2000 seems to adopt a First Marketable Product approach. In *SEECO, Inc. v. Hales* the Arkansas Supreme Court considered whether the statute mentioned above had any impact on take or pay contracts. The Arkansas Supreme Court discussed the lessee's implied duty to market, and reasoned that XXXXXX.

----- 3 ----- Statute?

- Section 15-74-703

All purchasers of oil and gas shall pay to the royalty interest the same premium or bonus above the posted market price for oil or gas they pay to the leaseholder or working interest under any oil, gas, or mineral lease on lands from which oil or gas may be purchased under contract with the least owner or operator.

----- What does this mean???

**C ----- Reconciling *Hanna* with *Hillard* and *Hales***

----- *Hanna* seems to speak definitely on the issue of post-production expenses, and alas many scholars have been duped by this seemingly straightforward holding. But, what out of state practitioners and scholars do not realize is that *Hanna* merely a means to an end. When read in the context of the *Hillard* and *Hales* cases, it becomes clear that *Hanna* is a backdoor attempt to allow judicial interpretation and construction of every oil and gas lease rather than setting forth broad, sweeping rules or, worse, broad prospective legislation that could transform only leases written after the effective date of the statute. What *Hanna* does is offer the Court a tool—a tool that allows the Court to switch seamlessly between the irreconcilable *Hillard* and *Hales* opinions. It also leaves open the door for the applicable statute to be used in the context of post-production expenses, although that has not been clearly tested by our Courts as of the date of this paper.

<sup>1</sup> See Wheeler, Brain S., *Deducting Post-production Costs when Calculating Royalty: What does the Lease Provide?* 8 Appalachian J.L. 1, 8 (Winter 2008).

<sup>2</sup> 571 F. Supp. 1406 (N.D. Tex. 1983).

<sup>3</sup> Explain "at the well" as a term of art

<sup>4</sup> CITE

<sup>5</sup> CITE

<sup>6</sup> Explain implied duty to market

<sup>7</sup> CITE

<sup>8</sup> 92 So.3d 1141 (La. App. 2d Cir. 2012).

<sup>9</sup> 499 So.2d 210 (La.App. 2d Cir. 1986).

<sup>10</sup> 214 Ca. App.3d 533 (Ct. App. Cal. 2d Dist. 1989).

*Id.* at 540 (quoting Stats. 1955, ch. 1724 § 7, Historical Note, West's Ann. Pub. Resources Code § 6827).

<sup>12</sup> *Id.* at 541 (citing *Piney Woods Country Life Sch. V. Shell Oil Co.* (5th Cir. 1984).

<sup>13</sup> *Id.* at 541.

<sup>14</sup> 2012 WL 3711550, \_\_ P.3d \_\_ (N.M. Aug. 24, 2012).

<sup>15</sup> *Id.* at \*5.

<sup>16</sup> *Id.* at 8 (citing *Black's Law Dictionary* 1325 (9th ed. 2009)).

<sup>17</sup> 565 N.W.2d 887, 223 Mich. App. 176 (Mich. App. 1997).

<sup>18</sup> *Id.* at 891, 223 Mich. App. at 182-83.

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

<sup>20</sup> 112 P. 965 (Okla. 1910).

<sup>21</sup> ~~CITE~~

<sup>22</sup> 8 54 P.2d 880 (1992).

<sup>23</sup> *Id.* at 881 (citing *Johnson v. Jernigan*, 475 P.2d 396 (Okla. 1970)).

<sup>24</sup> 29 P.3d 887 (Colo. 2001).

<sup>25</sup> Explain "in kind"

<sup>26</sup> 886 P.2d 652 (1994).

<sup>27</sup>

<sup>28</sup> ~~CITE~~

<sup>29</sup> ~~CITE STRING CITE THAT REAFFIRMS GARMAN~~

<sup>30</sup> ~~2-5-7 Kan.-315, 894 P.2d 788 (1995).~~

<sup>31</sup> 5 5 7 S.E.2d 254 (W.Va. 2001).

<sup>32</sup> *Wheeler, supra*, at 22.

<sup>33</sup> 58 P.S. § 33.

<sup>34</sup> *Id.* at 429 (citing Bibikos, George A. & Jeffrey C. King, *A Primer on Oil and Gas Law in the Marcellus Shale States*, 4 Tex. J. Oil, Gas & Energy L. 155, 168-69 (2008-2009).

<sup>35</sup> 29 A.3d 307 (2012).

<sup>35</sup> See Wheeler, *supra*, at 10.

<sup>36</sup> Hanna

<sup>37</sup> 297 Ark. 80, 759 S.W.2d 563 (1988).

<sup>38</sup> 165 Ark. 303, 264 S.W. 830 (1924).

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

<sup>40</sup> [Hillard v. Stephens, 276 Ark. 545, 637 SW. 2d 581 \(1982\)](#)

<sup>41</sup> [SEECO v. Hales, 341 Ark. 673, 22 SW. 3d 157 \(2000\)](#)

<sup>42</sup> ~~276 Ark. 545, 637 S.W.2d 581 (1982).~~