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OIL AND GAS CASE LAW UPDATE

Thomas A. Daily

RECENT DEVELOPMENTS IN ARKANSAS OIL AND GAS LAW (CIRCA 2015)

BY THOMAS A. DAILY¹

Hard as it is to believe, it is that time again. Another year has come and gone. Oil and gas prices are even lower than last year. Yada, yada. The slowdown in the industry failed to slow the litigation, as you will see. Let's get started.

SUPREME COURT HOLDS THAT ARKANSAS' INTEGRATION PROCESS IS CONSTITUTIONAL Since early in the 20th Century, states have sought to regulate the recovery of underground oil and gas within their boundaries. Such regulation is made necessary by the common law rule of capture which would otherwise prevail. At common law, as long as I stay physically within my land,² any oil or gas which comes up in my well or wells is mine to keep, without liability to you, the neighbor under whose land that oil and gas was parked, prior to being captured by me. You have a perfectly good remedy for that, you see. You may simply employ the rule of capture's "evil twin"³ the offset drilling rule, which gives you the right to drill your own wells and capture back from me. The end result was often unfair and, even worse, resulted in improvident production, thus wasting precious oil and gas.⁴

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²And its downward extension.

³So named by Professors Anderson and Kramer in their leading article, Bruce M. Kramer & Owen L. Anderson, *The Rule of Capture—an Oil and Gas Perspective*, 35 ENVTL. L. 899 (2005) (offering a thorough discussion of the application of the Rule of Capture to Oil and Gas Production).

⁴See Thomas A. Daily, *Rules Done Right-How Arkansas Brought its Oil and Gas Law Into a Horizontal World*, 68 Ark. L. Rev. 259 (2015) (offering a history of Arkansas' oil and gas regulatory development).

The statutes and rules thus developed included, in most producing jurisdictions, some sort of arrangement whereby state agencies established drilling units for the sharing of the costs and product of unit wells, along with a mechanism to require the inclusion of all owners, whether or not those owners voluntarily elected to participate.¹ The latter process is variously called “forced pooling,” “statutory pooling” or “integration,” its Arkansas name. Not surprisingly, these processes have been challenged on constitutional grounds. Those challenges have been consistently unsuccessful.² It is a bit surprising that the first and only such challenge to reach the Arkansas Supreme Court waited until 2015.³ The vehicle was *Richard Gawenis v. Arkansas Oil and Gas Commission*.^{4 5 6 7}

Richard Gawenis owns the minerals beneath a .69 acre tract, integrated by

¹Martin & Kramer, Williams and Meyers Oil and Gas Law § 905.1 (2011); Texas is a notable exception, as are some Appalachian states.

²See, e.g., *Ohio Oil Co. v. State of Indiana*, 1 U.S. 90 (1900); *Palmer Oil Corp. v. Amerada Petroleum Corp.*, 343 U.S. 390 (1952); *Hunter Co. v. McHugh*, 320 U.S. 222 (1943); *Marrs v. Oxford*, 32 F. 2d. 134 (8th Cir. 1929); *In Republic Natural Gas Co. v. Baker*, 197 F. 2d. 647 (10th Cir. 1952); *Helmerich & Payne v. Roxana Petroleum Corp.*, 136 Kan. 254, 14 P. 2d. 663 (1932); *Superior Oil Co. v. Foote*, 214 Miss. 857, 59 S.W. 2d. 85 (1952); *Nunez v. Wainoco Oil & Gas Co.*, 481 So. 2d. 1326 (La. 1986); *Sylvania Corp. v. Kilborne*, 28 N.Y. 2d. 427, 271 N.E. 2d. 524 (1971); *Layton v. Pan Am. Petroleum Corp.*, 1963 Okla. 140, 383 P 2d. 624 (1963); *Ward v. Corporation Commission*, 1972 Okla. 122, 501 P. 2d. 503 (1972); Martin & Kramer, Williams and Meyers Oil and Gas Law § 905.1 (2011); Summers Oil and Gas § 4.39 (3rd Ed., 2004); Kuntz Oil and Gas § 77.4 (a) (1991).

³The author is aware of one earlier failed attempt to attack Arkansas integration on constitutional grounds. In its unpublished opinion in *Lindquist v. Arkansas Oil and Gas Commission*, 2000 WL 696414 (2000), the Arkansas Court of Appeals affirmed the circuit court’s ruling that the constitutional argument was not properly raised before the 7 and Gas Commission, and thus refused to consider it.

⁸2015 Ark. 238, 464 S.W.3d 453 (2015).

Commission order. Gawenis was given the standard list of options from which to elect. He could lease his mineral interest to anyone willing to take it, at a price and upon terms mutually acceptable; he could be deemed leased to the participating parties on the terms which the Commission found to be fair and reasonable;⁹ he could participate in the proposed well or he could be carried as a non-consenting owner, pending recovery of 400% of drilling, completing and equipping costs, along with 100% of operations costs incurred thereafter. Mr. Gawenis elected none of the above. Rather, he challenged the authority of the Commission to integrate his interest in the first place. Boiled down, his arguments were two. First, Gawenis claimed that the integration statute constitutes a prohibited taking of his property without just compensation.

Second, he contended that the “taking” which occurred entitled him to a jury trial on the issue of compensation, which he was unconstitutionally denied.

The circuit court ruled against Mr. Gawenis, so he appealed. Because the case involved a challenge to the constitutionality of an Arkansas statute, it went directly to the Supreme Court. As expected, the Supreme Court upheld the statute and the integration process, rejecting all of Mr. Gawenis’ arguments.

There are three good reasons why an integration does not constitute an unconstitutional taking. The first is the favorite of the this author when he is thinking like a law professor. It goes back to the bad old rule of capture. Remember the plight of you, the poor neighbor. Your only remedy, when my well recovered oil and gas from ⁹

⁹A bonus of \$938.36 per mineral acre, a 1/5 royalty and a one year primary term.

beneath your land, was to drill your own well and do likewise.¹⁰ The integration of which Mr. Gawenis complained was part of Arkansas' comprehensive Oil and Gas Conservation Act.¹¹ That act, for the first time, modified the rule of capture to give owners, such as you and Mr. Gawenis, a correlative right to share in the common source of supply below your properties without having to drill your own wells. Before the Conservation Act no such right existed. Thus, had it not been for the very statute which he challenged, Mr. Gawenis had no property interest which could have been taken. It is not a "taking" if you give a right to someone that is conditioned upon it being exercised in a prescribed manner.

Good reason number two is the one most commonly recited as the basis of affirming the constitutionality of integration/pooling statutes. It is that such statutes are legitimate exercises of the states' police powers. The idea of the police power is inherent in constitutional theory. States are bound to protect the health, safety and welfare of their citizens. For that reason, individual constitutional rights are not absolute. Just as private property rights must yield to land-use regulation, such as a zoning ordinance, the state may legitimately adopt a regimen designed to exploit its fugacious natural resources more efficiently than that which would result from the unregulated rule of capture. The limit of the police power is reasonableness. A regulation must be legitimately related to a public interest and it must be reasonable in

¹⁰That Arkansas has adopted the Rule of Capture was first recognized by our Supreme Court in *Osborn et al. v. Arkansas Territorial Oil & Gas Co.*, 103 Ark. 175, 146 S.W. 122 (1912).

"Act No. 105 of 1939, codified, as amended, as Ark. Code Ann. §§ 15-72-101, et seq.

its result. For example, a regulation which prohibited drilling a well within X-feet of an existing well would be unconstitutional, unless it also provided a mechanism for the person prohibited from drilling his own well to share in the well which caused the prohibition. Arkansas' integration statutes do exactly that, so the Conservation Act and its integration provisions are valid exercises of the police power and do not constitute a "taking."

A third theory which sustains the constitutionality of integration concedes that integration effects a taking of a property right. However, it posits that the options offered to the non-consenting party constitute "just compensation." For that reason, the taking does not violate the constitution.

In some jurisdictions it may not matter which theory or combination of theories are adopted to sustain constitutionality. However, Arkansas has a constitutional provision which guarantees a jury trial to determine compensation in eminent domain cases. The Oil and Gas Commission is unequipped to provide such a jury determination. Moreover, by the nature of the integration process, the delay inherent in providing the traditional jury trial would significantly retard development.

In sustaining the constitutionality of the Arkansas statute, the Supreme Court relied upon the first two reasons above. The Court's opinion, authored by Chief Justice Hanna, noted that Arkansas had adopted the Rule of Capture in *Osborn*¹² and then quoted from the early Oklahoma Supreme Court decision in *Anderson v. Corporation*

¹²Supra.

*Commission*¹³ which had upheld that state's force pooling process for reasons numbered one and two. Thus, Chief Justice Hanna's opinion also held that the integration process was a legitimate exercise of this state's police power.

The opinion rejected Mr. Gawenis' jury trial argument. Since no "taking" had occurred, the constitutional guarantee of a jury trial was inapplicable to the integration process.

The Supreme Court's decision was not unanimous. Justice Hart dissented. She concluded that Mr. Gawenis was unconstitutionally deprived of a jury trial. Her short dissenting opinion is interesting, though confused. Here it is, in full:

Richard G. Gawenis argues that he is entitled to a jury trial under the Arkansas Constitution. The majority, however, declines to address the issue. Because Gawenis is correct, I respectfully dissent.

The Arkansas Constitution provides as follows:

No property, nor right of way, shall be appropriated to the use of any corporation, until full compensation therefor shall be first made to the owner, in money; or first secured to him by a deposit of money; which compensation, irrespective of any benefit from any improvement proposed by such corporation, shall be ascertained by a jury of twelve men, in a court of competent jurisdiction, as shall be prescribed by law.

Ark. Const., art. XII, § 9.

The Commission approved SEECO's application to integrate all unleased and uncommitted mineral interests. There is no jury trial at the Arkansas Oil & Gas Commission. Thus, if the integration process appropriates Gawenis's property, then the whole integration system is unconstitutional.

Though the majority does not address the issue, it concludes that the forced-integration provisions of the Arkansas Conservation Act do not

¹³327 P.2d 699 (1957).

take anything away from Gawenis because the integration order allowed Gawenis to lease his interest in the drilling unit in exchange for compensation or to participate in the drilling of the well and receive monetary benefits.

The integration order, however, does not account for secondary recovery methods that SEECO will utilize to cause the gas to migrate to SEECO's well. Minerals are fugacious when there is escape, seepage, or drainage that occurs as a result of the tapping a common reservoir; in the Fayetteville Shale, however, the gas is primarily nonfugacious, thus owing to the need for secondary recovery methods. See *Young v. Ethyl Corp.*, 521 F.2d 771, 774 (8th Cir.1975) (discussing fugacious and nonfugacious brine). In *Jameson v. Ethyl Corporation*, 271 Ark. 621, 609 S.W.2d 346 (1980), this court stated that the law should not “permit those persons who are in an economically advantaged posture to be able to gain negotiating clout by being allowed to undertake, with impunity, processes that go beyond extracting transient minerals or [gases] which have drained or flowed by natural process to their drilling sites.” *Id.* at 626, 609 S.W.2d at 350. The *Jameson* court cited *Osborn v. Arkansas Territorial Oil & Gas Company*, 103 Ark. 175, 146 S.W. 122 (1912), where this court adopted the rule of capture, noting that petroleum, gas, and oil belong to the owner of the land and are part of it so long as they are part of it or in it or subject to his control, but when they escape and go into other land or come under another's control, the title of the former owner is gone. The *Jameson* court, however, noted that *Osborn* did not involve a secondary recovery process. The *Jameson* court recognized the obligation of the extracting party to compensate the owner for any special damages that may have been caused to the property. Similarly, Gawenis is entitled to compensation for any special damages that may be caused to his property by secondary recovery methods, such as fracking. See *O'Brien v. Primm*, 243 Ark. 186, 419 S.W.2d 323 (1967) (concluding that defendants were negligent in conducting the sand-frac operation and that such negligence was a proximate cause of damage to a water well); *Young*, 521 F.2d at 775 (concluding that a landowner had a vested existing property right in the brominated salt water underlying his land and that a party's act of forcibly removing the solution by means of injection and production wells constituted an actionable trespass). Thus, SEECO has appropriated Gawenis's property, and Gawenis is entitled to a jury trial to determine his full compensation.

Justice Hart misunderstands both “fugacious” and “secondary recovery.” In general usage, the word “fugacious” means “[F]lying or disposed to fly; fleeing away;

hence, lasting but a short time; evanescent; volatile.¹⁴ As used in the context of mineral law, “fugacious” means liquid or gaseous minerals, as opposed to solid minerals. As thus defined, gas is clearly fugacious, though, admittedly, gas does not move through shale as easily as through sandstone. Justice Hart confused contents with their container, apparently concluding that because gas within the relatively impermeable Fayetteville Shale does not easily migrate, it is not fugacious. That is like saying soda in a bottle is not fugacious, because it has become trapped there. That is not correct but, after some head-scratching, I got the point. By trapping a fugacious substance you do not make it non-fugacious. You just trap it. Let it out and you will see how fugacious it remained.¹⁵ Still, I know what she meant, so let us go on.

Justice Hart also misunderstands the meaning of “secondary recovery.” Secondary recovery is a process which involves injecting substances into a separate borehole in order to force their movement into a production well.¹⁶ Secondary recovery takes place in oil reservoirs, not dry gas reservoirs such as the Fayetteville Shale, because liquids can be pushed, but gases cannot. Still, Justice Hart appears certain that SEECO intends to remove gas from beneath Mr. Gawenis’ tract by use of secondary recovery. I suspect that she is actually referring to SEECO’s plan to frack

¹⁴Webster’s New International Dictionary, Second Edition.

¹⁵Justice Hart is not alone in her misuse of “fugacious.” She cites to *Young v. Ethyl Corp.*, 521 F.2d 771, 774 where the Eighth Circuit Court of Appeals concludes that unlike oil and gas, brine is not a fugacious mineral, apparently because, like oil, it responds to waterflood style secondary recovery. *Young* was a good decision but its misuse of “fugacious” has puzzled many over the years.

¹⁶See Howard R. Williams and Charles J. Meyers, *Manual of Oil and Gas Terms* (Sixteenth Edition), LexusNexus, 2015, pp. 962-3.

the reservoir during completion of its wells. Apparently, Justice Hart thinks that fracking is a type of secondary recovery. Not so. Fracking is a process used in well stimulation. Stimulation of a well is not secondary recovery.¹⁷ Contrary to her apparent conclusion, SEECO will never use secondary recovery to produce gas from the Fayetteville Shale or from anywhere else. However, it will frack its wells, to be sure.

Next, Justice Hart misapplies the decisions upon which she relies. *Young v. Ethyl Corp.*¹⁸ and *Jameson v. Ethyl Corp.*¹⁹ were cases involving a brine operator's use of brine injection wells, using brine disposal wells to inject previously processed brine and thus force unprocessed bromine-enriched brine in the direction of its brine production wells. That process certainly qualifies as secondary recovery. However, it is neither a violation of rights nor a taking, per se. The legal problem in those cases was that Ethyl Corp. had no leases from Young or Jameson and, at that time, Arkansas had no statutory mechanism to include such owners into brine production units.²⁰ Indeed, The supreme court's majority opinion in *Jameson* says just that:

While Arkansas' unitization laws are not, as previously noted, involved in this case, we do believe that the underlying rationale for the adoption of such laws, i. e., to avoid waste and provide for maximizing recovery of

"Manual of Oil and Gas Terms, supra, p 1014, which defers to W. Va. Code § 22-4-1(u) (Cum. Supp. 1980) as "any action taken by well operator to increase the inherent productivity of an oil or gas well including, but not limited to, **fracturing**, shooting or acidizing, but excluding cleaning out, bailing or workover operations." (Emphasis added).

¹⁸Supra.

¹⁹271 Ark. 621, 609 S.W.2d 346 (1980).

²⁰That was remedied by the enactment of Arkansas' Brine Conservation Act, Act No. 937 of 1979, codified as Ark. Code Ann. §§ 15-76-301 et seq.

mineral resources, may be interpreted as expressing a public policy of this State which is pertinent to the rule of law of this case. Inherent in such laws is the realization that transient minerals such as oil, gas and brine will be wasted if a single landowner is able to thwart secondary recovery processes, while conversely acknowledging a need to protect each landowner's rights to some equitable portion of pools of such minerals.

Of course, the constitutionality of one of Arkansas' unitization laws is exactly what

Gawenis is about. Unlike Young and Jameson, Mr. Gawenis was included in the unit and stands to receive his share of unit production. It is difficult to imagine how "a public policy of this State" is unconstitutional.

If there is a lesson to be learned from Justice Hart's dissenting opinion in *Gawenis*, it has nothing to do with law. Rather, the lesson is that most judges do not have a clue about oil and gas law. Whenever in court, spoon-feed everything like it was pabulum and pray.

**ARKANSAS COURT OF APPEALS RULING CONFIRMS COMMON LAW PRINCIPLE THAT
POSSESSION OF ONE CO-TENANT IS NOT ADVERSE TO OTHER CO-TENANTS**

*SEECO, Inc. v Holden*²¹ was an ownership dispute between two owners. One owned both the surface and a one-half mineral interest. The other was the descendant of a previous owner who sold the land to the surface owner's predecessor in 1912, reserving the other one-half mineral interest. The surface owner claimed title to the severed interest, as well, by virtue of tax deed resulting from a purported 1958 forfeiture of that severed one-half interest.

However, that 1958 forfeiture was clearly void for failure of the tax assessor to properly assess the severed interest, prior to the purported forfeiture. The owner

²¹2015 Ark. App. 555.

whose severed interest was purportedly forfeited sued to quiet title to that interest. In response, the surface owner contended that the suit was barred by limitations. She contended that her possession (her lessee had commenced drilling wells on the contested lands more than two years prior to commencement of the quiet title suit) precluded the suit. An Arkansas statute bars a person who has been dispossessed by a tax purchaser for more than two years from maintaining a quiet title suit.²²

The trial court ruled in favor of the surface owner, but the Arkansas Court of Appeals reversed. In so doing, the appeals court confirmed that Arkansas adheres to the majority rule that production of minerals by a co-tenant does not constitute adverse possession against non-producing co-tenants. Since, under the two-year statute, exclusive possession is required to begin the running of the limitations period, the statutory period never began to run. Thus, the severed one-half owner could quiet title and set aside the void tax sale.

Entirely too often these days a lawyer who should know better claims that production from a unit where his client was neither leased nor integrated constituted a trespass. There may even be a few poorly written appellate opinions out there which thus misuse the T word in that fashion. Wrong, Wrong, Wrong. The integration order made all owners within the unit into co-tenants.²³

FEDERAL APPEALS COURT AFFIRMS SUMMARY JUDGMENT DISMISSING LEASE CANCELLATION SUIT BECAUSE OF LESSORS' FAILURE TO GIVE NOTICE OF ALLEGED BREACH AND OPPORTUNITY TO CURE

²²Ark.Code Ann. § 18-61-106(a) (Repl. 2003).

²³ As discussed above, prior to the integration statute, such conduct was licensed capture, which is not an actionable trespass either.

In 2013, United States District Judge Susan Hickey dismissed a lease cancellation suit based upon alleged failure to develop formations outside of an existing secondary recovery unit, because the lessors had not given notice of the alleged breach to the lessees prior to filing suit.²⁴ The Eighth Circuit Court of Appeals has now affirmed that ruling.^{25 26 27} Several of the plaintiffs' leases contained express "notice and cure" provisions, with which they failed to comply. As to leases without such provisions, the court applied the common law requirement of notice of breach prior to suit for cancellation. The appeals court refused to consider arguments based upon the Arkansas Supreme Court's decisions in such cases as *Byrd v. Bradham*²⁶ and *Mansfield Gas Co. v. Parkhiii*²⁷ both of which had held that such common law notice was not required after inactivity for an unreasonable duration, because those arguments were not raised by the lessors in the district court.

ARKANSAS COURT OF APPEALS AFFIRMS SUMMARY JUDGMENT DISMISSING CASE INVOLVING CONFLICTING OIL AND GAS LEASES BETWEEN SAME PARTIES

Sabine River Land Company, leasing for XTO Energy Inc., obtained a ten-year oil and gas lease (the "first lease") from the McDougals on January 11, 2005. Sabine apparently then discovered that the McDougals' interest was subject to a life estate vested in an unleased party and thus informed the McDougals that their lease was

²⁴*Lewis v. EnerQuest Oil & Gas, LLC*, 2013 WL 222568.

²⁵*Lewis v. EnerQuest Oil & Gas, LLC*, 792 F.3d 872, (8th Cir. 2015).

²⁶280 Ark. 11, 655 S.W.2d 366 (1983).

²⁷114 Ark. 419, 169 S.W. 957 (1930).

“invalid.”

On March 29, 2005 the McDougals obtained a conveyance from the life tenant. Then, on March 30, 2005 they executed another lease (the “second lease”), also in favor of Sabine, this time for a five year term. For unknown reasons, the second lease was never recorded. On March 31, 2006, Sabine assigned the first lease to XTO Energy Inc., but not the second lease. XTO recorded the assignment on April 6, 2006.

Shortly before the March 30, 2010 expiration of the second lease, the McDougals contacted XTO, inquiring whether XTO wished to renew the lease. XTO answered that its lease (the first lease) was still well within its primary term. The McDougals sued in May 2013, contending that the second lease, which had expired, was the only valid lease. The trial court dismissed the complaint, holding that Arkansas’ five-year statute of limitations on written contracts barred the action. In *McDougal v. Sabine River Land Company*²⁸ the Arkansas Court of Appeals affirmed, holding that the latest date from which limitations began to run was April 6, 2006, the date XTO recorded the ten-year lease, which was more than five years prior to suit being filed.

ARKANSAS APPEALS COURT AFFIRMS SUMMARY JUDGMENT FOR SEVERED MINERAL OWNER-REJECTS SURFACE OWNER’S “ABANDONMENT” THEORY

Myrtle Stevens is the current owner of the surface, but not the minerals, of a forty-acre tract, owned by her family since 1904. All of the minerals beneath the tract were conveyed by a 1930 mineral deed from her grandfather in favor of W.E. Hall, a prolific mineral buyer in the area at that time. Ms. Stevens nevertheless claimed the minerals, contending that the 1930 deed to Hall was void for irregularities or,

²⁸2015 Ark. App. 281.

alternatively, that Hall's heirs had abandoned the mineral interest. Ms. Stevens sued the Hall heirs' lessee, SEECO, Inc., which had developed the unit in which the tract was located. The trial court ruled that the mineral deed was valid and entered summary judgment for SEECO.

In *Stevens v. SEECO, Inc.*²⁹ the Arkansas Court of Appeals affirmed. The appeals court agreed that the deed was valid and it refused to consider Ms. Stevens' abandonment argument as not adequately raised in the lower court.

The most important feature of the decision was the concurring opinion of Judge Brandon Harrison. Judge Harrison explained that there was no Arkansas precedent for abandonment of a severed mineral interest, nor does Arkansas have statutory termination of mineral interests through non-use. He then expressed doubt whether, absent such a statute, a severed mineral interest, being a perpetual interest in the oil and gas in place, could ever be subject to abandonment.

ARKANSAS COURT OF APPEALS VOIDS 1984 QUIET TITLE DECREE FOR FAILURE OF SERVICE

*XTO Energy, Inc. v. Thacker*³⁰ was a complicated case with numerous parties asserting numerous claims. Central was a 1984 quiet title decree which purported to extinguish a 1929 mineral severance. XTO and other appellants argued that the decree, though 31 years old, was void because necessary parties, the ancestors of XTO's lessors, were not actually served and it could not be established that the successful plaintiffs at the time had exercised due diligence in their efforts to locate

²⁹2015 Ark. App. 322.

³⁰2015 Ark. App. 203, 467 S.W.3d 161.

those parties, prior to constructive service by warning order. There also were other procedural irregularities in the 1984 suit mentioned in the appeals court's opinion, authored by Judge Abramson. While the Court of Appeals expressed reluctance to void a decree which had long been relied upon, it nevertheless reversed the circuit court's ruling which had upheld the decree.

Well, that wraps up the 2015 report. Hopefully we will all be back next year for more.