DEVELOPMENTS IN NONREGULATORY OIL AND GAS LAW: THE CONTINUING SEARCH FOR ANALYTICAL FOUNDATIONS

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Reprinted from The Forty-Seventh Annual Institute on Oil and Gas Law and Taxation,
Publication 640, Release 47,

CHAPTER 1

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SYNOPSIS

(Matthew Bender & Co., Inc.)

§ 1.01. Introduction.

Many oil and gas issues seem timeless. This article surveys basic oil and gas concepts that have been the focus of recent litigation, concepts that evoke perennial disputes over their meaning and application. This article also continues the search for useful analytical foundations to explain existing law and to predict, and perhaps shape, the future course of the law.

§ 1.02. Defining that which is "Mineral."

The layman's indictment of oil and gas law could begin with the observation that a conveyance of "all minerals" does not include all minerals.[1] He would then discover that an oil and gas "lease" is not a lease,[2] and what it is varies from state to state[3] —but in no state, of course, is it a lease.[4] Not to mention that the conveyance of a "royalty" often does not convey a royalty,[5] but rather a "mineral" that entitles the owner to a royalty—of a different fraction from that which is stated.[6] What has happened to us? Isn't there something terribly

[1] *E.g.*, Miller Land & Mineral Co. v. Wyoming State Highway Comm'n, 757 P.2d 1001, 102 O. & G.R. 132 (Wyo. 1988) (reservation of "all minerals and mineral rights" did not include gravel).

[2] *E.g.*, Connell v. Kanwa Oil, Inc., 170 P.2d 631, 634 (Kan. 1946) ("[E]stablished rule of property . . . that an oil and gas lease conveys no interest in the land . . . but merely a license to explore, and is personal property—an incorporeal hereditament—a *profit à prendre*.").

[3] *E.g.*, Stephens County v. Mid-Kansas Oil & Gas Co., 254 S.W. 290 (Tex. 1923) (oil and gas lease is a conveyance of the oil and gas in the leased land to the lessee).

[4] *See* Lowe, *Oil and Gas Law in a Nutshell* 63 (3d ed. 1995) [hereinafter Lowe].

[5] *E.g.*, Temple-Island Forest Products Corp. v. Henderson Family Partnership, Ltd., 911 S.W.2d 531 (Tex. App. 1995) (court held reservation of one-sixteenth "royalty interest" was intended to be a reservation of a one-sixteenth "mineral" interest).

[6] *E.g.*, Heyen v. Hartnett, 679 P.2d 1152, 81 O. & G.R. 31 (Kan. 1984) (grant of one-sixteenth mineral interest, plus rights to one-half of the royalty under the oil and gas lease, held to convey a one-half mineral interest).

wrong with such shell game jurisprudence? Unfortunately, some of the most perverse analysis has been employed in resolving some of the most basic of issues, such as what is a "mineral."

[1] The Surface/Mineral Dilemma: The Epitome of Shell Game Jurisprudence.

Suppose we are in the State of X and we are concerned that the conveyance of "all minerals" will create potential problems for the surface owner. To protect the surface owner's interests, we could say that the grantee of "all minerals" gets "all" the minerals but no right to use the surface to extract them—unless the right is expressly stated in the conveyance. Such sleight-of-hand legal analysis would leave the mineral owner with a lot of minerals, but not much of value.

Next, suppose we give the mineral owner the minerals plus an implied easement to enter the surface to extract the minerals. This is the law of the states that have addressed the issue.[7] If the mineral owner is required to pay for damage to the surface when it is used, the surface owner will have some protection against mineral development activities when the surface value exceeds mineral values. However, this is not the course the law has followed. Instead, the mineral owner is typically given the right to use the surface without compensation to the surface owner, so long as the use relates to the legitimate extraction of the granted mineral. Not only does the mineral owner get the easement, it is "free" in the sense that no compensation will be due the surface owner for mining-related disruption or destruction of the surface.[8] The pea appears to be under the mineral owner's walnut shell at the moment—but not for long.

After giving the mineral owner a free easement to disrupt the surface, it appears the surface owner is now in need of protection. How should the State of X provide that protection? States addressing the issue have provided it by shuffling the walnut shells to take from the mineral owner "minerals" that could result in significant disruption of the surface owner's interest.[9] Three of the gamer's jurisprudential

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[7] 1 Williams and Meyers, *Oil and Gas Law* §§ 218.7 to 218.8 (1995).

[8] Many states have changed, modified, or defined the common law rule by requiring the lessee to pay the lessor for disruption to the surface pursuant to "surface damage acts." *See* Lowe, N. 4 *supra*, at 182–184. However, surface damage acts typically focus only on certain types of mineral development, such as oil, gas, or coal.

[9] *E.g.*, Reed v. Wylie, 597 S.W.2d 743, 65 O. & G.R. 286 (Tex. 1980) (refining the Texas surface destruction test), *limited by* Moser v. United States Steel Corp., 676 S.W.2d 99, 82 O. & G.R. 143 (Tex. 1984) (limited to conveyances taking place prior to June 9, 1983).

tricks for accomplishing this transfer of minerals back to the surface owner are the community knowledge test, the surface destruction test, and the rare and exceptional qualities test.[10]

[2] Traditional Analyses.

To date, instead of addressing the free easement problem that drives the surface/mineral dilemma, courts have been satisfied with plucking minerals away from mineral owners in an effort to protect the surface owner.[11] In most cases it is not a matter of preserving the homestead, but rather of identifying one of two competing parties who will enjoy

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[10] *See generally* Lowe, N. 4 *supra*, at 116–117.

[11] Arguably, the only direct attempt to recognize and address the problem is the Texas Supreme Court's opinion in Moser v. United States Steel Corp., N. 9 *supra*, 676 S.W.2d 99, 82 O. & G.R. 143 (Tex. 1984). In *Moser* the court observed:

> We have previously attempted to create a rule to effect the intent of the parties to convey valuable minerals to the mineral estate owner, while protecting the surface estate owner from destruction of the surface estate by the mineral owner's extraction of minerals . . . . In so doing, we decided that determinations of title should be based on whether a reasonable use of the surface by the mineral owner would substantially harm the surface. Application of this rule has required the determination of several fact issues to establish whether the owner of the surface or the mineral estate owns a substance not specifically referred to in a grant, reservation or exception . . . . As a result, it could not be determined from the grant or reservation alone who owned title to an unnamed substance. Determining the ownership of minerals in this manner has resulted in title uncertainty.

676 S.W.2d at 101, 82 O. & G.R. at 147. The court's solution to the problem included the following adjustments to the title and easement rules:

> We now hold a severance of mineral in an oil, gas and other minerals clause includes all substances within the ordinary and natural meaning of that word, whether their presence or value is known at the time of severance . . . . We continue to adhere, however, to our previous decisions which held certain substances to belong to the surface estate as a matter of law. [the title rule]
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> . . . .
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> We hold the limitation of the dominant mineral owner's liability to negligently inflicted damages does not control . . . in a general conveyance of "other minerals." When dealing with the rights of a mineral owner who has taken title by a grant or reservation of an unnamed substance such as this, liability of the mineral owner must include compensation to the surface owner for surface destruction. [the easement rule].

676 S.W.2d at 102, 103, 82 O. & G.R. at 150, 151. The court, however, was unwilling to undo its prior jurisprudence on the subject and limited its holding to conveyances entered into after June 8, 1983. *Id.* at 103, 82 O. & G.R. at 152.

The court recently declined an opportunity to adopt a rule for nonparticipating interests that was more in line with the goals expressed in its *Moser* opinion. Plainsman Trading Co. v. Crews, 898 S.W.2d 786 (Tex. 1995) (surface destruction test applied to nonparticipating royalty interest).

the benefits of the mining activity that is certain to occur when mineral values significantly exceed surface values.[12]

[a] Community Knowledge Test.

This test inquires about what was known concerning the mineral in dispute at the time the "mineral" conveyance was made. It has proven to be a rather fickle test and therefore custom made for the sort of result-oriented shell game jurisprudence needed to "do equity" in individual cases. The technique has been perfected in Kansas where community knowledge of a mineral's existence at the time of conveyance may indicate it was intended to be encompassed by a grant of "mineral deposits."[13] With such community knowledge, the surface owner should have contemplated that the substance was a mineral that would be included in a conveyance of all minerals.

But not so fast! If the mineral was known to exist in the community at the time of conveyance, surely the parties would have mentioned it if they had intended it to be part of the conveyance. The Kansas courts have arrived at both positive and negative presumptions concerning inclusion of a mineral, applying the same test of community knowledge.[14] Heads I win; tails you lose. Not only is the test highly factual in nature, but even if the facts are clear the outcome of the test may be totally different from case to case. Being factually driven, with the inability to predict the outcome under any given set of facts, makes the test nothing but legal fluff to support whatever result the trier of fact thinks is fair in a particular case.

[b] Surface Destruction Test.

The surface destruction test, like the other tests, requires the parties to venture outside of the conveyance document to determine what has been conveyed. The extrinsic factual inquiry is whether extracting the mineral at issue will require significant destruction of the surface. If

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[12] *E.g.*, Farley v. Booth Brothers Land & Livestock Co., 890 P.2d 377 (Mont. 1995) (the issue was whether the surface owner or mineral owner would receive payments associated with the use of scoria).

[13] In Roth v. Huser, 76 P.2d 871 (Kan. 1938), the court applied the community knowledge test to find that oil and gas could have been contemplated by the original parties to the conveyance of "mineral deposits." The conveyance was made in 1904, and the court considered evidence that oil was being produced in commercial quantities 225 miles from the land in question. *Id.* at 873.

[14] Pierce, "Toward a Functional Mineral Jurisprudence for Kansas," 27 Washburn L.J. 223, 226–238 (1988) [hereinafter "Functional Mineral Jurisprudence"].

it will, the mineral will not be included in a generic conveyance of "all minerals"' or "other minerals." If mining can be done without significant destruction to the surface, the mineral will belong to the "mineral" owner.[15]

Texas has traditionally used the surface destruction test as its main analytical tool for distinguishing between the "mineral" mineral and the "nonmineral" mineral.[16] However, in *Moser v. United States Steel Corp.*,[17] the Texas Supreme Court attempted to rationalize its jurisprudence to focus on the free easement problem instead of manipulating title to mineral substances.[18] The jurisprudential fix was prospective for conveyances after June 8, 1983;[19] certain minerals would forever be defined as "nonmineral."[20]

In *Plainsman Trading Co. v. Crews*,[21] the court had the opportunity to apply a more rational mineral analysis to interests possessing only a passive right to receive income from property. In 1949, Richardson, the owner of the land in fee, granted to the Richardson heirs a nonparticipating royalty in: "[A]ll . . . other minerals in, under and that may be produced from the . . . land."[22] The issue was whether the Richardson heirs were entitled to a royalty in uranium within 200 feet of the surface, which would require significant destruction of the surface for its extraction.[23] If the pre-*Moser* surface destruction test were applied to the 1949 conveyance, the uranium would not be "other minerals," and the Richardson heirs would not have a royalty in the uranium.[24]

The court decided to treat nonparticipating royalty interests the same as mineral interests by employing the surface destruction analysis, even though the owners of the royalty interests could never do anything that would impact the surface.[25] The court held that since a royalty interest conceptually emanates from a mineral interest, one can never have a greater interest in the royalty than he has in the

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[15] Lowe, N. 4 *supra*, at 119–121.
[16] *E.g.*, Acker v. Guinn, 464 S.W.2d 348, 38 O. & G.R. 273 (Tex. 1971).
[17] N. 11 *supra*, 676 S.W.2d 99, 82 O. & G.R. 143.
[18] *See* N. 11 *supra*.
[19] Moser, N. 11 *supra*, 676 S.W.2d at 103, 82 O. & G.R. at 152.
[20] *Id.* at 101, 102, 82 O. & G.R. at 150, 151.
[21] 898 S.W.2d 786 (Tex. 1995).
[22] *Id.* at 792.
[23] *Id.* at 788.
[24] *Ibid.*
[25] *Ibid.*

mineral.[26] The court's royalty-from-mineral analysis is unconvincing since in this case the royalty was conveyed out of the fee—the surface and the minerals together—so somewhere in that mix of rights were the sticks to grant a royalty in uranium.[27] If the conveyance to the Richardson heirs had been from a severed mineral interest, the court's analysis would be accurate. One cannot convey more than he has to convey. However, the court's analysis simply is not applicable when the royalty conveyance is out of the fee simple estate.

In *Plainsman* the court had the opportunity to avoid the shell game jurisprudence for nonparticipating royalty interests. Instead, it broadened the reach of the surface destruction analysis, which the court had found to be flawed in its *Moser* opinion. The court had the opportunity to do what it thought it could not do in 1983 with participating interests: give the *Moser* rule retroactive effect. Instead, the high-stakes shell game of who owns the "mineral" has been expanded in Texas.

[c] Rare and Exceptional Qualities Test.

Is it ordinary scoria?[28] Or is it extraordinary scoria? Depending on the answer, it is either a "mineral" or not a "mineral." In *Farley v. Booth Brothers Land & Livestock Co.*,[29] the Montana Supreme Court ventured outside of the conveyance documents to determine whether the scoria minerals at issue were "'rare and exceptional in character or possess a peculiar property giving them special value.'"[30] If the minerals were "'useful only for building and road-making purposes, [they] are not regarded as minerals in the ordinary and generally

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[26] Plainsman, N. 21 *supra*, 898 S.W.2d at 790. The court stated:

> While this court has, in the past, changed the method for determining the limits of the mineral fee [citing *Moser*], one principle should be immutable: a non-participating royalty is an interest in the mineral fee, however large or small that fee is and regardless of how its limits are determined.

Ibid.

[27] This was the focus of Justice Gammage's dissent. Plainsman, N. 21 *supra*, 898 S.W.2d at 792.

[28] "Scoria" can have several meanings. For example, in Farley v. Booth Brothers Land & Livestock Co., 890 P.2d 377, 379 (Mont. 1995), it was defined as "roof-rock" that "results from burning coal outcroppings." However, the court also acknowledged there is scoria "of the basaltic lava variety." *Ibid.* The court leaves the impression that the "mineral" character of the scoria could vary depending on its geologic origin.

[29] 890 P.2d 377 (Mont. 1995).

[30] 890 P.2d at 380 (quoting Holland v. Dolese Co., 540 P.2d 549, 550–551, 51 O. & G.R. 359 (Okla. 1975)).

accepted meaning of the word."'[31] The evidence presented at trial indicated that the primary use of the scoria at issue was for road-making.[32] Therefore, the scoria was not a "mineral" and belonged to the surface owner.[33]

The Montana Supreme Court expressly set out to avoid the problems noted in *Miller Land & Mineral v. Highway Commission*[34] where the Wyoming Supreme Court stated:

> The courts which have held that the general reservation of "all minerals" is inherently ambiguous have traveled over a long and tortuous path in a complex and hopeless search to discover the particular minerals the parties intended to reserve. The only reliable rule which surfaces from the confusing and inconsistent approaches taken by those courts attempting to ferret out the subjective intent of the parties is that the word "mineral" means what the court says it means. The result is title uncertainty and the need to litigate each general reservation of minerals to determine which minerals it encompasses.[35]

Unfortunately, the approach taken by the Montana Supreme Court will "result in title uncertainty and the need to litigate each general reservation of minerals . . . . "[36] Although the conveyance may not be deemed "ambiguous," the court will nevertheless have to consider evidence outside of the recorded document to ascertain its meaning. Under the rare and exceptional qualities test, the evidence will include the geologic classification of the mineral at issue, its use, its potential use, and its intrinsic and potential value. The parties to the conveyance will not know who owns the mineral until the time to appeal the most recent judgment has passed.

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[31] *Ibid.*

[32] However, the appellants tried to introduce evidence on appeal that the scoria could be used to manufacture "mineral wool" and therefore had a special value. The court rejected the evidence since it was not offered during trial. Farley, N. 29 *supra*, 890 P.2d at 381. This highlights the major weakness of the rare and exceptional qualities test: Two conveyances with the exact same language in the same jurisdiction can convey a different mix of minerals depending on the evidence that is subsequently offered concerning the possible uses of the mineral at issue.

[33] Farley, N. 29 *supra*, 890 P.2d at 381.

[34] 757 P.2d 1001, 102 O. & G.R. 132 (Wyo. 1988).

[35] Farley, N. 29 *supra*, 890 P.2d at 379 (quoting Miller Land & Mineral v. Highway Comm'n, N. 34 *supra*, 757 P.2d at 1002, 102 O. & G.R. at 132).

[36] *Ibid.*

[3] A Better Analysis.

The inherent weakness of the traditional analyses is the need to determine mineral ownership by reference to information not contained in the conveyance document. This leads to two levels of uncertainty: First, what sort of extrinsic evidence will be found, offered, and accepted by the court? Second, how will the court apply the extrinsic evidence to support a conclusion? To resolve these basic uncertainties, a trial must be held. The need to litigate these issues devalues the interests of all parties.

A better approach would be to adopt an analysis that addresses the surface/mineral dilemma without requiring manipulation of title to the mineral interest. The analysis begins with the unique concept that "mineral" means "mineral."

[a] Mineral Means Mineral.

If *A*, the owner in fee, conveys to *B* all the "minerals" in a tract of land, the following propositions can be established:

(1) *A* doesn't own all the "sticks" anymore; "minerals" have been conveyed to *B*.

(2) *B* owns "minerals" but does not own the "surface estate," which would include everything not encompassed by the grant of "minerals."

(3) *B* has certain rights to use the surface estate to extract granted minerals.

The major observation is that following the conveyance *A* and *B* each own something less than the fee in the land. The goal is to clearly define what it is each party owns.

The only workable approach to the mineral problem is to employ a practical analysis[37] to determine whether a substance is a "mineral" as opposed to a plant, animal, or other nonmineral substance. The net effect of such an analysis should be to confirm ownership in the mineral interest owner for the vast majority of "mineral" substances that have otherwise been the subject of litigated cases. For example, scoria, coal, uranium, oil, gas, limestone, sand, gravel, iron ore, surface

[37] Similar to the "ordinary and natural meaning" approach taken by the Texas Supreme Court in Moser v. United States Steel Corp., N. 11 *supra*, 676 S.W.2d 99, 102, 82 O. & G.R. 143, 150 (Tex. 1984).

shale, caliche, and lignite would all be minerals that belong to the mineral owner. The only substance that might receive special attention would be water.[38] The only real disputes that might arise under such an analysis would involve efforts to classify the less frequently disputed borderline mineral/vegetable substances such as dirt.[39]

[b] Regulation of Surface Use and Mineral Development through Economic Incentives.

To prevent a broadly defined mineral estate from consuming the surface estate, the "free" easement to make reasonable use of the surface should be eliminated.[40] The mineral owner should have an implied easement to make reasonable use of the surface to mine granted minerals, but should pay for any disruption of the surface caused by the mining activity.[41] The determination of surface damages, absent express provision in the conveyance, should be based on the *present* value of the surface *at the time the mining activity is undertaken*. Therefore, if the minerals were severed in 1930 when the land was unimproved pasture, and the mineral mining activity is proposed in 1996 when the land is a housing development, the mineral owner will have the right to conduct the surface mining activity so long as he pays the surface owner the present value of the houses and other surface improvements that will be impacted by development.

Such an approach replaces title uncertainty with positive economic incentives and addresses the real problem that has driven mineral jurisprudence to date—uncompensated surface use.[42] Once the impacted parties can readily identify the owner of the minerals, they should be able to negotiate effectively concerning the implied right to make reasonable use of the surface. For example, if the surface

[38] Water should not present a problem in states where water is in essence owned and managed by the state through a prior appropriation system. *E.g.*, Kan. Stat. Ann. § 82a–702 (1984) ("All water within the state of Kansas is hereby dedicated to the use of the people of the state, subject to the control and regulation of the state in the manner herein prescribed.").

[39] Even the dirt issue is effectively addressed when the surface use/economic incentives portion of the analysis is considered.

[40] Although this is possible for states like Kansas that have not addressed the "free" easement issue, it will be more difficult for other states that have clearly adopted the "free" easement analysis. "Functional Mineral Jurisprudence," N. 14 *supra*, at 240–244.

[41] *See* "Functional Mineral Jurisprudence," N. 14 *supra*, at 247–250.

[42] The court in Moser v. United States Steel Corp., N. 11 *supra*, 676 S.W.2d 99, 82 O. & G.R. 143 (Tex. 1984), acknowledged uncompensated surface use as the real problem when it adjusted the Texas compensation rules for certain mineral conveyances occurring after June 8, 1983. *Id.* at 103, 82 O. & G.R. at 152.

evidence that is subsequently offered concerning the possible uses of the mineral at issue.

[33] Farley, N. 29 *supra*, 890 P.2d at 381.

[34] 757 P.2d 1001, 102 O. & G.R. 132 (Wyo. 1988).

[35] Farley, N. 29 *supra*, 890 P.2d at 379 (quoting Miller Land & Mineral v. Highway Comm'n, N. 34 *supra*, 757 P.2d at 1002, 102 O. & G.R. at 132).

[36] *Ibid.*

owner wanted to build a house on land in which another party owned the minerals, he could attempt to purchase a specific limitation on the mineral owner's future surface use rights.[43] Similarly, if the mineral owner wants to ensure that the surface owner's future activities do not increase the cost of anticipated mining activities, the mineral owner can seek to purchase greater rights in the surface.

The present value compensation approach also serves an important public interest—the maximum beneficial use of property.[44] As time passes, knowledge, technology, and society change. In 1960, the maximum beneficial use of a tract of land may have been for uranium mining. In 1996, the maximum beneficial use of the same tract of land may be for a computer factory. The present value approach recognizes that since neither party has all the ownership "sticks" to the property, the best approach is to allow the parties to bid on what it should be used for at any given time. Since the mineral owner has the implied right to use the surface, the exercise of that right will be tempered by the mineral owner's decision about whether the value of the mineral to be extracted justifies paying the present value of the surface that will be disrupted by the mining activity. If the surface owner values the surface more than the mineral owner would be willing to pay to enjoy its mining rights, then the surface owner should be able to purchase the mineral owner's surface rights.

Since these rules only operate when the parties have failed to address the issue in their conveyance, the courts should enjoy considerable flexibility in fashioning rules that accommodate the parties involved without compromising public interests. Under the traditional analyses courts have compromised two important public interests: (1) maximum beneficial use of property; and (2) title certainty. The title certainty problem also impacts the parties to the conveyance. If they cannot determine from the conveyance who owns a particular substance, the value of the property interest is reduced to reflect the uncertainty. In many cases, the transaction costs associated with resolving the uncertainty will retard the beneficial use of both the

[43] Under existing implied easement analysis, it seems implicit that the surface owner cannot do anything on the surface that interferes with the mineral owner's "easement." Similarly, the mineral owner would not be required to pay for the removal of structures that were placed on the property after the date of the conveyance creating the mineral interest. *See generally* Pierce, "Incorporating a Century of Oil and Gas Jurisprudence into the 'Modern' Oil and Gas Lease," 33 Washburn L.J. 786, 794–795 (1994) [hereinafter "Century of Oil and Gas Jurisprudence"].

[44] "Functional Mineral Jurisprudence," N. 14 *supra*, at 241–242.

surface and mineral interests. Similar value-reducing title uncertainty problems are encountered with intra-mineral disputes.

§ 1.03. Intra-Mineral Disputes: Who Owns the Methane Gas in the Coal Deposit?

The Montana Supreme Court, in *Carbon County v. Union Reserve Coal Co.,*[45] had to determine whether a conveyance of "'[a]ll coal and coal rights . . . '" also conveyed methane gas found within the granted coal.[46] The deed conveying the coal reserved a royalty of $0.10 "'per ton of 2,000 pounds of coal produced and saved from said lands.'"[47] After reviewing decisions from other states, the court held: (1) "[C]oal seam methane gas is not a constituent part of coal and, thus, it may be severed from the coal estate";[48] (2) "the owners of the gas estate . . . [have] the right to drill for and to produce the coal seam methane gas at issue here";[49] and (3) the owner of the coal estate "has a mutual, simultaneous right to extract and to capture such gas for safety purposes, incident to its actual coal mining operations."[50]

Although the court's analysis of prior cases on the subject left much to be desired,[51] the result will tend to foster certainty of title. The underlying rationale was that "the express grant of one specific mineral does not imply the grant of all other minerals not referred to in the grant."[52] Therefore, since the conveyance referred to "coal" and not "gas," the grantee received only "coal."[53]

In previous writings the author has advocated a somewhat similar approach when the first conveyance is of "gas." In that situation, the gas grantee would obtain title to gas wherever it might be found, whether in a coal seam or other rock structure. However, if the "coal" were conveyed first, the author advocated that the grantee of the coal "should have the right to all substances, including methane gas, found

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[45] 898 P.2d 680 (Mont. 1995).

[46] *Id.* at 682.

[47] *Ibid.*

[48] Carbon County, N. 45 *supra*, 898 P.2d at 687.

[49] *Id.* at 689.

[50] *Ibid.*

[51] The court distinguished, unconvincingly, many prior cases addressing the methane gas ownership issue. Carbon County, N. 45 *supra*, 898 P.2d at 683–686.

[52] *Id.* at 684.

[53] The court relied on the maxim *expressio unius est exclusio alterius*—"the expression of one thing is the exclusion of another." Carbon County, N. 45 *supra*, 898 P.2d at 684. If this analysis were applied to "oil," would it exclude "gas"?

within the coal to the exclusion of a subsequent 'gas' lessee."[54] The rationale was that "[t]he coal seam not only describes the substance, but also the areal extent of the coal owner's exclusive right of control."[55] Therefore, if the gas migrated out of the coal seam, it would belong to the subsequent gas grantee, but if the gas remained within the coal seam, the prior coal grantee would have the exclusive right to conduct operations within the coal seam and remove gas that is physically entrained in the coal.

However, the Montana approach appears to be an equally workable solution to the problem. The major consideration is that since neither party expressed its intent in the conveyance document, the court's function should be to arrive at a workable rule that will promote title certainty and marketability of mineral interests. If nobody knows who owns methane gas found in coal seams, development of the resource will be impeded. The Montana Supreme Court adopted a rule that makes it possible to determine, from the chain of title, who owns coal seam methane. Whether the owner of the coal seam methane is the owner of the coal or of the balance of the mineral interests really does not matter.[56]

§ 1.04. Defining the *Nature* of the Property Interest in the Mineral: Is It "Mineral" or Is It "Royalty"?

Determining the nature of the interest owned in a mineral substance is almost as fundamental as determining ownership in the substance. The problem is determining whether the property interest is "royalty" or "mineral" in nature. Three of the most significant rights in the mineral substance turn on the following questions: Who can develop the mineral, who obtains the benefits associated with authorizing development, and how will each party's share of production be calculated? Unfortunately, the analysis in this area is as unsatisfactory as the ownership analysis.

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[54] "Century of Oil and Gas Jurisprudence," N. 43 *supra*, at 791; Pierce, "Defining Mineral Ownership in the United States: Methane Gas from Coal Seams," 11 Oil & Gas L. & Tax'n Rev. 373, 376 (1993).

[55] "Century of Oil and Gas Jurisprudence," *id.* at 791.

[56] At the time of the coal conveyance, coal seam methane apparently did not matter enough to the parties to address it in the conveyance document. Therefore, it would serve no real purpose to try to fashion a rule that prefers any individual party's interests. The goal, instead, should be to fashion a rule that is most consistent with public interests—or at least not antagonistic to them.

[1] The Texas Five-Stick Concept of "Mineral" Interest.

In keeping with the American property law trend of allowing owners to create and transfer almost any sort of property interest they can dream up, Texas has recognized that a mineral interest consists of five components:

(1) The right to develop;

(2) The right to lease;

(3) The right to receive bonus payments;

(4) The right to receive delay rental payments; and

(5) The right to receive a royalty on production.[57]

There is nothing special about these attributes; they just happen to represent the benefits typically granted to a mineral interest owner when he enters into an oil and gas lease. However, since the general structure of the oil and gas lease relationship is fairly standardized,[58] it is common for grantors to define the nature of the interest being conveyed by referring to these common lease benefits. The Texas Supreme Court sanctioned this practice in *Day & Company, Inc. v. Texland Petroleum, Inc.*[59] where it acknowledged that individual "sticks" constituting the mineral interest can be reserved or conveyed. The court in *Day & Company* also adopted the rule that "[w]hen an undivided mineral interest is conveyed, reserved, or excepted, it is presumed that all attributes remain with the mineral interest unless a contrary intent is expressed."[60]

[2] The Executive Right and Its Relation to the Right To Develop: Are There Five Sticks or Four?

Since Texas recognizes the right to develop as a mineral interest component distinct from the right to lease, what happens if both sticks are not expressly conveyed or reserved to the same party? Parties often address the right to lease, also referred to as the executive right,[61] but fail to specifically mention the right to develop.[62] This could result

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[57] Altman v. Blake, 712 S.W.2d 117, 118, 91 O. & G.R. 346, 349 (Tex. 1986); French v. Chevron U.S.A. Inc., 896 S.W.2d 795, 797 (Tex. 1995).

[58] Pierce, "Rethinking the Oil and Gas Lease," 22 Tulsa L.J. 445 (1987).

[59] 786 S.W.2d 667, 105 O. & G.R. 590 (Tex. 1990).

[60] *Id.* at 669 n.1, 105 O. & G.R. at 595 n.1.

[61] The right to execute oil and gas leases.

[62] *E.g.*, French v. Chevron U.S.A. Inc., 896 S.W.2d 795 (Tex. 1995) (grantee expressly denied right to "lease" the property, but conveyance was silent concerning grantee's right to develop

in the anomalous situation of a party lacking the power to lease to a third party but possessing the right to enter the property to conduct development.

The Texas Supreme Court, in *French v. Chevron U.S.A. Inc.*,[63] addressed this issue in the context of a reservation of the right to lease which provided:

> Neither the Grantee herein nor his heirs or assigns shall ever have any control over the leasing of said lands or any part thereof or the renewal or extending of any lease thereon or for the making of any lease contract to develop or prospect the same for oil, gas or other minerals, which is hereby specifically reserved in the Grantor.[64]

The court of appeals held that since the deed was silent concerning the right to develop, the right was "therefore impliedly transferred to the grantee."[65] The court of appeals relied on the interpretive rule that "[w]hen an owner conveys a mineral estate, all attributes are impliedly transferred as well unless they are specifically reserved to the grantor."[66]

The Texas Supreme Court rejected the court of appeals' analysis relying on two independent bases: First, that the express terms of the exception to the conveyance encompassed the right to develop.[67] Second, and of much broader application, that "the right to develop is a correlative right and passes with the executive rights."[68] As authority for linking the development right with the leasing right, the court cited the following passage in *Day & Company, Inc. v. Texland Petroleum, Inc.*:[69]

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the property); Bank One, Texas, Nat'l Ass'n v. Alexander, 910 S.W.2d 530 (Tex. App. 1995) (grantee expressly given the right to "control and manage and make any and all gas and oil leases or other mineral leases upon said land" without indicating whether this would include the right to develop the property).

[63] 896 S.W.2d 795 (Tex. 1995).

[64] *Id.* at 796. The same clause reserved to the Grantor "any interest in the delay or other rentals or any revenues or monies received or derived from the leasing of said lands . . . . " *Ibid.*

[65] French v. Chevron USA, Inc., 871 S.W.2d 276, 278 (Tex. App. 1994) *result aff'd*, 896 S.W.2d 795 (Tex. 1995) (court rejected court of appeals' conclusion concerning passage of the right to develop from the grantor to the grantee).

[66] *Ibid.*

[67] "[W]e read the reservations clause in this conveyance as reserving the right to develop in the grantor. It states that the grantee has no control over 'the making of any lease contract to develop or prospect.'" French v. Chevron U.S.A. Inc., 896 S.W.2d 795, 797 n.1 (Tex. 1995).

[68] *Ibid.*

[69] N. 59 *supra*, 786 S.W.2d 667, 105 O. & G.R. 590.

> Other rights and attributes of the mineral estate include the right to receive delay rentals for the deferral of commencement of drilling by the lessee, the right to receive royalty, the right to share in other benefits secured from the lessee such as shut-in royalties, minimum royalties, production payments and the like, and *correlative to the executive right, the right to develop and produce minerals.*[70]

The court's conclusion appears to run counter to the more clearly articulated *Day & Company* presumption that all mineral interest attributes remain linked to the mineral interest unless they are expressly conveyed.[71] The court in *French* appears to be reducing the five sticks to four by combining the development right with the leasing right—at least in situations where the parties fail to express an intent to separate executive and development rights.[72]

[3] The Five-Stick Redundant Language Analysis.

The five-stick "analysis" occurs when Texas courts rely on the presence or absence of one or more sticks to assist in determining whether a mineral interest or a royalty interest has been created. For example, in *French v. Chevron U.S.A. Inc.*,[73] the conveyance stated:

> That I, George Calvert, . . . do grant, bargain, sell, convey, set over, assign and deliver unto Capton M. Paul, an undivided Fifty (50) acre interest,[74] being an undivided 1/656.17th interest in and to all of the oil, gas and other minerals, in, under and that may be produced from the following described lands . . . .
>
> *It is understood and agreed that this conveyance is a royalty interest only*, and that neither the Grantee, nor his heirs or assigns shall ever have any interest in the delay or other rentals or any revenues or monies received or derived from the leasing of said lands present or future or any part thereof, or the renewal or extension of any lease or leases now on said lands or any part thereof. Neither the Grantee herein nor his heirs or assigns shall ever have any control over the leasing of said lands or any part

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[70] *Id.* at 669 n.1, 105 O. & G.R. at 595 n.1.

[71] *Ibid.*

[72] In Bank One, Texas, Nat'l Ass'n v. Alexander, N. 62 *supra*, 910 S.W.2d 530, 532–533, the court applied the *French* analysis concluding that "the right to develop passed to the grantee as a correlative right [to the right to control and manage and make . . . leases]."

[73] N. 63 *supra*, 896 S.W.2d 795 (Tex. 1995).

[74] At the time of the conveyance George Calvert owned a one-thirty-second mineral interest in a 32,808.5–acre tract. French, *id.* at 796.

> thereof or the renewal or extending of any lease thereon or for the making of any lease contract to develop or prospect the same for oil, gas or other minerals, which is hereby specifically reserved in the Grantor.[75]

The court first found that the granting clause, standing alone, conveyed a mineral interest since it conveyed a right to minerals "in, under, and that may be produced from the described lands."[76] However, the court acknowledged that the meaning of the conveyance had to be ascertained by examining all language within the "four corners" of the document.[77] Therefore, the court had to deal with the language in the "understood and agreed" clause of the conveyance, which stated, "[T]his conveyance is a royalty interest only . . . . "[78]

The court addressed the "royalty interest only" language by applying what the author calls the "five-stick redundant language analysis" to the balance of the language in the "understood and agreed" clause. The court noted that if the grantor had intended to create a royalty interest, none of the language excepting four of the mineral interest sticks would have been necessary—it would have been redundant.[79] Therefore, the court held that a mineral interest had been conveyed "stripped of appurtenant rights other than the right to receive royalties."[80] The court also noted this approach effectively "harmonizes and gives effect to all portions of the deed."[81]

The court concluded with a summary of its holding, which might portend the creation of an interpretive rule: "In other words, when a deed conveys a royalty interest by the mechanism of granting a fractional mineral estate followed by reservations, what is conveyed is a *fraction of* royalty, not a fixed fraction of total production royalty."[82] Perhaps a better summary of the rule is that one who starts

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[75] French, N. 73 *supra*, 896 S.W.2d at 796 (emphasis by the court).

[76] *Id.* at 798.

[77] *Id.* at 797. The court cites favorably, as do the other Texas courts addressing interpretive issues during this reporting period, the work of Professor Bruce M. Kramer which was the product of a research grant funded by the Oil, Gas & Mineral Law Section of the State Bar of Texas. *See* Kramer, "The Sisyphean Task of Interpreting Mineral Deeds and Leases: An Encyclopedia of Canons of Construction," 24 Tex. Tech. L. Rev. 1 (1993). French, *id.*, 896 S.W.2d at 797, n.2 ("For an exhaustive account of the various canons of construction used to interpret mineral deeds and leases . . . . ").

[78] French, N. 73 *supra*, 896 S.W.2d at 798.

[79] *Ibid.*

[80] *Ibid.*

[81] *Ibid.*

[82] *Ibid.*

out with an undisputed conveyance of a mineral interest in the granting clause will have a difficult time convincing the court that a nonparticipating royalty interest was intended. The court probably did not want to say this directly because it would seem too much like an *Alford v. Krum*[83] analysis. Instead, the court relied on the "redundant" language following the "royalty" declaration to limit the "royalty" to a royalty that would be paid under one of the sticks of a mineral interest—the right to receive a royalty on production.

The redundant language analysis presents a basic problem as a predictive tool in this area: Contrary inferences can be drawn and have been drawn,[84] from the presence of language negating rights to develop, enter into leases, or receive bonus and delay rental.[85] After studying Kansas jurisprudence on the issue, the author offered the following advice to attorneys drafting mineral and royalty conveyances:

> These conflicting inferences drawn by the court . . . make it difficult for the drafter to decide what to include in the instrument concerning the attributes of a mineral interest. For example, if we say, as a matter of law, the mineral interest owner has the right to lease, and the concomitant rights to bonus, rental, and royalty, then you need not say anything about them—assuming you have clearly created a mineral interest. Likewise, as a matter of law, the mineral interest owner has the right to develop his interest and the concomitant right of ingress and egress; you need not say anything about them—assuming you have clearly created a mineral interest. However, what if it is not "clear" that a mineral interest is intended? The courts, as we have seen in this section, will proceed to review the instrument and look for attributes of either a royalty or mineral interest. The problem is attempting to state attributes consistent with

[83] 671 S.W.2d 870, 81 O. & G.R. 189 (Tex. 1984), *overruled by* Luckel v. White, 819 S.W.2d 459, 115 O. & G.R. 121 (Tex. 1991). The *Alford* analysis, giving interpretive primacy to the granting clause, was overruled in Luckel v. White, in favor of a four-corners approach that attempts to harmonize seemingly inconsistent language in the conveyance.

[84] *E.g.*, Hickey v. Dirks, 133 P.2d 107, 110 (Kan. 1943) (language "that grantee shall have no interest in cash rentals or bonuses paid under any future oil or gas lease" held to support conclusion a royalty interest had been conveyed); Drach v. Ely, 694 P.2d 1301, 1314, 84 O. & G.R. 257, 275 (Kan. App. 1985) (inference royalty interest was created by the specific exclusion of bonus and rentals), *rev'd*, 703 P.2d 746, 87 O. & G.R. 524 (Kan. 1985) (inference mineral interest was created with the right to receive bonus and rentals excepted from the conveyance).

[85] If the language is being used merely to illustrate the attributes of a royalty interest, it could as easily be argued that it is clarifying language and not "redundant."

> the interest you wish to create and, to the extent possible, prevent the court from being able to draw inferences inconsistent with your desired interpretation.[86]

This raises an issue that has not been addressed in *French* or any of the other cases applying the *French* redundant language analysis: Should the analysis be applied retroactively to conveyances that were entered into at a time when the five-stick approach was not the recognized law of Texas?[87] For example, in the 1995 cases applying the redundant language analysis, the conveyances at issue were made in 1928,[88] 1938,[89] and 1943.[90] The five-stick analysis can be traced to the Texas Supreme Court's 1986 holding in *Altman v. Blake*.[91] Although making distinctions based on the date of the conveyance may be unwise,[92] the issue is one the courts should at least address and expressly accept or reject.

The *French* five-stick redundant language analysis was applied by the Texas Court of Appeals in *Bank One, Texas, National Association v. Alexander*,[93] to interpret the following conveyance:

> [1] Grantors . . . reserve for themselves . . . an undivided 1/16 interest in and to all minerals of every kind and description, including oil and gas, in, upon and under said land;
>
> [2] but the right to control and manage and make . . . all gas and oil leases . . . upon said land is hereby granted exclusively to grantees . . . and they shall be entitled to any and all cash bonus or bonuses paid on any and all oil and gas leases on said land together with all cash rentals under such leases;

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[86] 1 Pierce, *Kansas Oil and Gas Handbook* § 6.17, at 6–22 (1986).

[87] In prior times, the parties drafting mineral conveyances might have thought it was necessary to describe a royalty interest by expressly disclaiming attributes associated with a mineral interest.

[88] Bank One, Texas, Nat'l Ass'n v. Alexander, 910 S.W.2d 530, 531 (Tex. App. 1995).

[89] Temple-Inland Forest Product Corp. v. Henderson Family Partnership, Ltd., 911 S.W.2d 531, 532 (Tex. App. 1995).

[90] French v. Chevron U.S.A., Inc., N. 73 *supra*, 896 S.W.2d at 796.

[91] N. 57 *supra*, 712 S.W.2d 117, 91 O. & G.R. 346 (Tex. 1986). In *Altman* the five-stick analysis was applied to a 1938 conveyance, relying in part on Delta Drilling Co. v. Simmons, 338 S.W.2d 143, 13 O. & G.R. 68 (Tex. 1960) (mineral interest less the executive right and the right to receive delay rentals remains a mineral interest).

[92] The primary public interests in this area should be ensuring the certainty of title and the ability to ascertain the nature of the interest owned, when possible, from the recorded documents in the chain of title. These were also considerations articulated by the court in *Altman*. Altman v. Blake, N. 91 *supra*, 712 S.W.2d at 120, 91 O. & G.R. at 352.

[93] N. 88 *supra*, 910 S.W.2d 530 (Tex. App. 1995).

> [3] but an undivided 1/16 of any and all oil and gas and other minerals developed from said land shall be owned by grantors . . . .[94]

The issue was whether the one-sixteenth interest reserved by the grantors was a mineral interest or a royalty interest.

The court noted that part [1] of the clause, standing alone, would reserve a mineral interest.[95] Applying the five-stick analysis to part [2], the court found that the development, leasing, bonus, and delay rental rights (sticks) had been conveyed to the grantees.[96] The court at this point paused to note: "A mineral interest stripped of many of its component parts remains a mineral interest absent additional evidence showing a contrary intention."[97] To dispose of the third clause, which reserved one-sixteenth of the minerals "developed" from the land, the court relied on the *French* redundant language analysis stating: "[I]f the grantors had conveyed the land in fee, intending to reserve a royalty interest only, a conveyance of the first four *Altman* rights to the grantees would be redundant and meaningless since a royalty interest does not encompass these rights."[98] The final analytical stroke was to "harmonize" all three portions of the conveyance to conclude that the grantors had reserved a one-sixteenth mineral interest, which entitled them to participate only in the royalty stick—the right to receive one-sixteenth *of* the royalty associated with the mineral interest.[99]

The redundant language analysis appears to have worked well in *Bank One*, with *French* being a somewhat closer case. However, in *Temple-Inland Forest Products Corp. v. Henderson Family Partnership, Ltd.*,[100] the analysis, or its application, was more problematic. The conveyance in *Temple-Inland* provided for a "grant . . . unto the said Grantee, an undivided fifteen-sixteenths (15/16ths) interest in, to and of all oil, gas and other minerals . . . on, in, under and that may be produced from the . . . land . . . . "[101] This was followed by the following reservation:

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[94] Bank One, *id.*, 910 S.W.2d at 531 (the court added the numbers in brackets to highlight the three portions of the clause).
[95] *Id.* at 532.
[96] *Id.* at 532–533.
[97] *Id.* at 533.
[98] *Id.* at 535.
[99] *Ibid.*
[100] N. 89 *supra*, 911 S.W.2d 531 (Tex. App. 1995).
[101] *Id.* at 532.

> In respect to the undivided one-sixteenth (1/16th) part of and interest in the oil, gas and other minerals retained and reserved by the Grantor . . . it is understood and agreed that said one-sixteenth (1/16th) interest is and shall always be a royalty interest, and shall not be charged with any of the costs which the Grantee may incur in exploring, drilling, mining, developing and operating wells or mines for the production of oil, gas and other minerals; . . . and, if the Grantee shall give an oil and gas mining lease thereon, shall, by his or their explorations and operations, discover and produce oil, gas and other minerals, the Grantor's one-sixteenth (1/16th) royalty interest . . . shall be delivered free of cost to the Grantor at the wells or mines or to the credit of Grantor in pipe lines or storage provided by the Grantor . . . .[102]

The issue was whether the grantors reserved a one-sixteenth mineral interest or a one-sixteenth royalty interest. The court noted that its task was to ascertain the intent of the parties from the conveyance language contained within the four corners of the deed.[103] The court recognized that the task had been complicated by vacillating interpretive rules: "Although the goal has stayed the same, the rules used to achieve that goal have continuously evolved."[104]

In this case the court added the *French* five-stick redundant language analysis to the interpretive mix and concluded that the interest retained by the grantors was a one-sixteenth mineral interest instead of a royalty interest.[105] It also appears that the court was influenced by what the author calls the "puzzle analysis." Since the grantors conveyed a fifteen-sixteenths mineral interest, the one-sixteenth interest being retained must be a mineral interest since that would be the piece necessary to fit the puzzle.

Chief Justice Walker, in a dissenting opinion, commented on the redundant language analysis as follows: "I take the majority's position to mean that the Grantors . . . simply said too much in their efforts to retain a royalty interest only."[106] Justice Walker thought that the

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[102] *Id.* at 532–533.

[103] *Id.* at 533.

[104] *Id.* at 534. "Evolved" appears to be a very charitable characterization of the process.

[105] *Id.* at 534 ("If the parties had intended the 1/16th retained interest to be a fixed royalty interest, there would have been no need to grant these attributes to the grantee.").

[106] *Id.* at 535.

six specific references to the reserved interest as a "royalty interest" should have carried the interpretive process.[107]

Maybe the wrong analysis was applied in the *Temple-Inland* case. Perhaps it was actually a multiple grant problem that could have been resolved by giving effect to each of the operative clauses. For example, the first clause would convey to the grantee a fifteen-sixteenths mineral interest and by implication retain in the grantor a one-sixteenth mineral interest. The second clause would carve out of the fifteen-sixteenths mineral interest conveyed to the grantee the right in the grantor to receive a one-sixteenth royalty. Therefore, if the property were subject to an oil and gas lease providing for a one-eighth royalty, the production would be divided as follows:

Grantee 7/128 (15/16 x 1/8 = 15/128 -1/16)

Grantor 9/128 (1/16 x 1/8 = 1/128 + 1/16)

Does this seem far-fetched? Consider the *Concord Oil* case[108] discussed below in Section 1.05.

§ 1.05. Defining the *Number* of Property Interests in the Mineral: The Two-Grant, or Multiple-Grant Theory.

Members of the Texas oil and gas bar should be careful what they wish for—their wish might come true! The author predicts that in the years to come Texas oil and gas attorneys, at least those who examine titles, may actually long for the days of *Alford v. Krum.*[109] The court in *Alford* adopted a rather crude interpretive rule that often ignored

[107] However, even Chief Justice Walker found it difficult to articulate the nature of the interest reserved when he stated, "I believe it clear and obvious that the Grantors retained only one of the five attributes applicable to a severed mineral interest, that being, the right to receive royalty payments." Temple-Inland, N. 100 *supra*, 911 S.W.2d at 536–537. This finding would seem to support the majority's holding instead of Chief Justice Walker's dissent. To find that the retained interest was a royalty interest, the court would have to conclude that no sticks associated with a mineral interest—even the right to receive royalty—were retained by the grantors. Instead, they retained a nonparticipating royalty. The descriptive problem is one of distinguishing the ultimate source of all rights in oil and gas production from the nature of the interest. All rights in oil and gas emanate from either a fee simple absolute or the separate ownership of the oil and gas minerals. The issue however, is not with the base source of the right, but rather the nature of the interest carved from the right: Is it one of the five sticks (the royalty *stick*) associated with a "mineral" interest, or is it a nonparticipating "royalty" interest disassociated with any individual mineral interest "stick"?

[108] Concord Oil Co. v. Pennzoil Exploration and Prod. Co., 878 S.W.2d 191 (Tex. App. 1994), *writ denied.*

[109] N. 83 *supra*, 671 S.W.2d 870, 81 O. & G.R. 189 (Tex. 1984).

language in the conveyance to give total effect to the structural granting clause.[110] With the demise of *Alford*,[111] courts now have the opportunity to give literal effect to the written terms of oil and gas conveyances. The author submits that this is a scary thought.[112] A preview of the fun awaiting title examiners and their clients is offered in *Concord Oil Co. v. Pennzoil Exploration & Production Co.*,[113] which illustrates some of the new complexities created by a multiple-grant approach to poorly drafted conveyance documents.[114]

In 1937, the grantor, Crosby, conveyed a mineral interest while the interest was subject to a producing oil and gas lease.[115] The conveyance provided:

> That I, A.B. Crosby . . . do Grant . . . unto Southland . . . an undivided one-ninety sixth (1/96) interest in and to all of the oil, gas and other minerals in and under, and that may be produced from [the land] . . . .
>
> While the estate hereby conveyed does not depend upon the validity thereof, neither shall it be affected by the termination thereof, this conveyance is made subject to the terms of any valid subsisting oil, gas and/or mineral lease or mineral lease or leases on above described land or any part thereof, but covers and includes one-twelfth (1/12) of all rentals and royalty of every kind and character that may be payable by the terms of such lease or leases insofar as the same pertain to the above described land, or any part thereof.[116]

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[110] The *Alford* rule provided:

> In cases involving the construction of mineral deeds, the "controlling language" and the "key expression of intent" is to be found in the granting clause, as it defines the nature of the permanent mineral estate conveyed . . . . It logically follows that when there is an irreconcilable conflict between clauses of a deed, the granting clause prevails over all other provisions.

Alford v. Krum, *id.*, 671 S.W.2d at 872, 81 O. & G.R. at 192.

[111] The *Alford* analysis was overruled in Luckel v. White, N. 83 *supra*, 819 S.W.2d 459, 461, 115 O. & G.R. 121, 127 (Tex. 1991).

[112] Scary not because of what the courts may do, but because of what drafters of conveyances have done in the past and will likely continue to do in the future.

[113] 878 S.W.2d 191 (Tex. App. 1994), *writ denied*.

[114] The oil and gas litigation bar should welcome the multiple-grant analysis since it "multiplies" the possible conveyance interpretations that can be legitimately argued.

[115] Concord Oil Co. N. 113 *supra*, 878 S.W.2d at 192. The producing oil and gas lease apparently terminated in the same year the conveyance was made, 1937. *Id.* at 197.

[116] *Ibid.*

In *Concord Oil*[117] the court had to determine whether the Crosby/Southland deed conveyed a one-ninety-sixth mineral interest or a one-twelfth mineral interest. The court held that the conveyance was unambiguous, and therefore extrinsic evidence would not be considered; interpretation would be limited to the language contained in the conveyance.[118]

An important step in the court's analysis was its recognition that two distinct grants had been made in the deed: the first in the structural granting clause and the second in the "subject to . . . subsisting . . . lease" clause. As the court noted:

> [W]e reject the notion that the deed made a single conveyance of a single estate of 1/12 of the minerals. We hold that the deed conveyed only a 1/96 mineral interest, in addition to the 1/12 interest in the existing lease which expired when the lease terminated.[119]

The court concluded that the second clause was an "existing-lease" clause instead of a "future-lease" clause,[120] and therefore its terms ceased to operate when the existing lease terminated.[121] This left the parties with one operative grant: the one-ninety-sixth mineral interest.

Since the existing lease on the property had terminated, the court did not have to deal with the difficult task of calculating the precise share of production the grantee would receive under an existing lease. For example, assume the existing lease was still in existence and provided for a one-eighth royalty. What would the grantee receive as a share of production? A strong argument could be made that the grantee should receive one-twelfth of the one-eighth royalty, under the existing lease clause, *plus* another one-ninety-sixth of the one-eighth royalty under the granting clause. Although courts applying the two-or multiple-grant approach may assume that only one grant would operate at a time, that is clearly not what the conveyances provide.

The grantee's rights under the structural granting clause will rarely be made conditional on one of the subsequent clauses not being operative. In *Luckel v. White*[122] the court indicated that neither the

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[117] N. 113 *supra*, 878 S.W.2d 191.

[118] *Id.* at 197.

[119] *Id.* at 196.

[120] *Id.* at 195, 196–197.

[121] *Id.* at 196. The court's opinion indicates the producing oil and gas lease on the property terminated in 1937. *Id.* at 197.

[122] 819 S.W.2d 459, 115 O. & G.R. 121 (Tex. 1991).

label put on a clause nor its structural placement would limit its effectiveness to convey an interest.[123] To avoid the creation of two concurrent interests through the interpretive process, the court in *Jupiter Oil Co. v. Snow*[124] engaged in the process of "[r]eading the deed as a whole and reconciling all paragraphs in order to ascertain the intent of the parties."[125] In *Jupiter* the structural granting clause conveyed a one-sixteenth mineral interest followed by an existing lease clause that provided:

> In the event the lease now on said land is forfeited or terminated . . . then the grantee herein or his assigns are to have and hold under this conveyance an undivided 1/2 of all the oil . . . gas or other mineral . . . in and under the land herein described, and it is the intention of the grantors herein that in the event said lease is forfeited, then in that event the grantee is to have and hold an equal undivided one half of all such minerals.[126]

The court concluded that the first grant gave the grantee a one-sixteenth mineral interest and the second grant in the existing lease clause gave the grantee an additional seven-sixteenths mineral interest that was triggered by the termination of the existing lease.[127] However, if the multiple grants are not linked, should the grantee have a nine-sixteenths mineral interest instead of eight-sixteenths?[128] The "it is the intention" part of the second clause suggests the two grants should be linked, but this language is often absent from this type of conveyance.

To what extent will courts be willing to give cumulative effect to each "granting" clause in the deed? For example, suppose the deed had the following clauses conveying an interest to the grantee:

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[123] Luckel, 819 S.W.2d at 463, 115 O. & G.R. at 125. The court stated:

> [T]he labels we have given the clauses of "granting," "warranty," "habendum" and "future lease" are not controlling, and we should give effect to the substance of the unambiguous provisions . . . . This language [in the future lease clause] is as effective to grant an interest as the formal "do hereby grant, bargain, sell and convey" language of what we have designated as the "granting" clause.

Ibid.

[124] 819 S.W.2d 466, 115 O. & G.R. 148 (Tex. 1991).

[125] *Id.* at 468, 115 O. & G.R. at 151.

[126] *Id.* at 468, 115 O. & G.R. at 151.

[127] *Id.* at 469, 115 O. & G.R. at 151.

[128] One-sixteenth from the structural granting clause and eight-sixteenths from the existing lease clause.

(1) Grant of one-sixteenth mineral interest.

(2) Right to one-half royalty on existing leases.

(3) Right to one-half benefits under any future leases.

Under the multiple grant approach, the grantee would receive a one-sixteenth mineral interest, including any royalty and other lease benefits associated with a one-sixteenth mineral interest. Depending on the lease status of the property, the grantee would also receive one-half of the royalty generated under existing leases and one-half of the benefits under any future leases. However, a purist's approach to the multiple grant theory would give effect to all grants that apply unless the deed expressly conditions the operation of one, typically the granting clause, on the nonoperation of another, typically an existing or future lease clause. The *Alford v. Krum* analysis tended to avoid these problems.[129] The results can be ugly under either analysis; the real issue is whether, as a matter of "justice," we should care.

§ 1.06. Should Courts Compromise Macro-Justice for Micro-Justice when "Interpreting" Poorly Drafted Documents?

Regardless of how courts resolve interpretive problems, their opinions and analyses will be the objects of criticism by commentators who can find fault with about any approach and conclusion. How much of the "blame" in this area should be cast on the judiciary? After all, the judges are merely attempting to deal with an admitted mess created by some anonymous scrivener. Courts engaging in the interpretive process often face a no-win situation. Therefore, their efforts should be guided more by the big picture, "macro-justice," instead of trying to do equity-in-fact, "micro-justice," in a particular case. Although it may sound a bit cruel to admittedly cast aside the pursuit of justice in individual cases, such an approach can be supported when more compelling public interests are at stake.

The interpretation of conveyances is one area where the Texas Supreme Court has exhibited a considerable preference for macro-justice at the expense of micro-justice. For example, the court in *Luckel v. White*,[130] commenting on its role in interpreting conveyances,

[129] Under *Alford* the language of the structural granting clause would be given primacy, and the grantee would own a one-sixteenth mineral interest and nothing more. Alford, N. 83 *supra*, 671 S.W.2d at 874, 81 O. & G.R. at 194.

[130] N. 83 *supra*, 819 S.W.2d 459, 115 O. & G.R. 121 (Tex. 1991).

stated: "Even if the court could discern the actual intent, it is not the actual intent of the parties that governs, but the actual intent of the parties *as expressed in the instrument as a whole* . . . . "[131] If micro-justice were the goal, courts would pursue the actual intent of the parties so interpretation of their contract would reflect their real intentions. However, ascertaining actual intent effectively means that every written document is ambiguous until the parties have an opportunity to inform the court what they really meant.[132] This would impact all mineral conveyances negatively since it would be unknown what was conveyed until a lawsuit had been concluded. By limiting its inquiry to the written document, the court aspires toward macro-justice—even though it may disappoint the micro-justice expectations of some parties to a poorly drafted document.

When dealing with the interpretation of conveyances, the court should never sacrifice macro-justice goals for micro-justice in an individual case. If a party wants to trigger a micro-justice review of his conveyance, he should be limited to a cause of action for reformation instead of seeking de facto reformation through benevolent interpretation.[133]

Courts interpreting an unartfully drafted document should ensure that whatever they do to resolve the case will not adversely impact the ability to rely on record title to define the rights of parties to unambiguous conveyances. As a matter of public policy, if someone must suffer as a result of imperfect drafting, it should be the parties to the conveyance and not the public.[134] These should be the guiding

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[131] *Id.* at 462, 115 O. & G.R. at 124 (emphasis added). This concept was perhaps best articulated in Alford v. Krum where the court stated: "[I]t is not the intention that the parties may have had but failed to express in the instrument, but it is the intention that is expressed by said instrument. That is, *the question is not what the parties meant to say, but the meaning of what they did say.*" Alford, N. 83 *supra*, 671 S.W.2d at 872, 81 O. & G.R. at 191 (emphasis added).

[132] Some courts take this approach to the kind of problem posed in Alford v. Krum. *See* Heyen v. Hartnett, 679 P.2d 1152, 1158–59, 81 O. & G.R. 31, 40–44 (Kan. 1984) (considering extrinsic evidence to conclude that a grant of one-sixteenth mineral interest, with a one-half royalty interest created by the subject to clause, actually conveyed a one-half mineral interest).

[133] Texas courts have frequently noted that if the party does not think the conveyance reflects what he intended, he should seek his remedy in reformation instead of interpretation. *E.g.*, Concord Oil Co. v. Pennzoil Exploration and Prod. Co., 878 S.W.2d 191, 194 (Tex. App. 1994) ("The issue before us is interpretation of the deed as written, not reformation to reflect subjective intent.").

[134] In addressing this issue in the context of the "other mineral" problem the author has noted:

> In reality, the burden of imperfect drafting is shifted to the public when courts look beyond the document to define the scope of terms like "gas" and "other minerals." Courts that try to ascertain the actual intent of the parties, or to "protect" the interests of a party through

principles courts use to identify the interpretive rules they will apply to any document that defines title to a property interest. If the parties fail to seek reformation, or reformation is not available, their individual interests in the interpretive process should be secondary to the impact the process will have on documents not before the court. Therefore, when evaluating interpretive rules like those created by the courts in *Alford v. Krum*,[135] *Luckel v. White*,[136] *French v. Chevron U.S.A. Inc.*,[137] and *Plainsman Trading Co. v. Crews*,[138] the measure of the "good" rule should not be whether it most likely effectuates the intent of the parties—but whether it effectively resolves an interpretive problem for all mineral owners and eliminates the need for future litigation of the issue.

§ 1.07. The Oil and Gas Lease: Elusive Analytical Foundations.

Cases decided during 1995 addressed fundamental principles under each of the three major oil and gas lease clause categories: the granting clause, habendum clause, and royalty clause. The issues under each category, as is always the case, focus on the three questions lessees and lessors try to address in the oil and gas lease: What has been granted to the lessee? When will the grant terminate? What is the lessor's royalty? All the remaining individual lease clauses can be placed in one of these three categories as refinements of the rights granted, their duration, and the lessor's royalty.[139] The first case addresses an issue with potential impact on all three categories—dirty pooling.

> "interpretation," are more likely to sacrifice the certainty of title and the integrity and usefulness of the recording system. Courts that limit their interpretation to the literal terms of the document are more likely to sacrifice the actual intent of the parties and may leave one party surprised to learn that the grant of minerals includes the right to use the surface to extract the mineral—often without any compensation for disruption of the surface. However, as a matter of public policy, if someone must suffer as a result of imperfect drafting, it should be the parties to the conveyance and not the public. The "equity model" [of benevolent interpretation] places the burden of imperfect drafting on the public at large by limiting the usefulness of the recording system which in turn will impair the marketability of mineral properties.

"Century of Oil and Gas Jurisprudence," N. 43 *supra* at 790.

[135] N. 83 *supra*, 671 S.W.2d 870, 81 O. & G.R. 189 (Tex. 1984), *overruled by* Luckel v. White, 819 S.W.2d 459, 461, 115 O. & G.R. 121, 127 (Tex. 1991).

[136] N. 130 *supra*, 819 S.W.2d 459, 115 O. & G.R. 121 (Tex. 1991).

[137] N. 73 *supra*, 896 S.W.2d 795 (Tex. 1995).

[138] N. 21 *supra*, 898 S.W.2d 786 (Tex. 1995).

[139] "Century of Oil and Gas Jurisprudence," N. 43 *supra* at 787–788.

[1] Lessee Abuse of Pooling Clause Rights.

The pooling clause can expand the scope of the granting clause by giving the parties to the lease rights in lands not encompassed by the leased land. Similarly, the pooling clause can expand the area from which the required production or other lease-maintaining activities can take place to maintain the lease in effect. Finally, the pooling clause impacts royalty rights by letting the lessor share in production from wells on other lands—or forcing the lessor to share production from a well on his land with other owners. Therefore, the use and operation of the pooling clause has the potential to reorder fundamental lessor and lessee rights created by the oil and gas lease. Often the pooling clause gives the lessee considerable discretion on when and how the pooling power created by the clause will be exercised. With discretion comes the opportunity for indiscretion, along with judicial interpretive concepts to protect those who would be injured by another's abuse of discretion. In *Circle Dot Ranch, Inc. v. Sidwell Oil and Gas, Inc.*,[140] the court struggled to define the interpretive concepts it used to protect the lessor from the lessee's dirty pooling.

Circle Dot granted an oil and gas lease, covering a 643.23–acre section of land, to Vise Energy, which was subsequently acquired by Sidwell Oil and Gas, Inc.[141] The lease pooling clause granted the lessee:

> the right and option to consolidate the lands covered hereby, or any portion or portions thereof, with other lands . . . to form a unit for the production of (1) oil and casinghead gas, or (2) dry or gas well gas, . . . the unit or units to be in such shape and of such dimensions as Lessee may elect; provided that such unit . . . formed for the production of oil and casinghead gas shall not exceed forty (40) acres in surface area plus a tolerance of ten per cent (10%) thereof; and any such unit formed for the production of dry gas or gas well gas . . . shall not exceed six hundred forty (640) acres in surface area plus a ten per cent (10%) tolerance thereof.[142]

Sidwell obtained a permit to drill a gas well on the Circle Dot lease and indicated, in its Form W–1 submitted to the Railroad Commission, that all of the Circle Dot lease, containing 643.23 acres, was the

[140] 891 S.W.2d 342 (Tex. App. 1995), *writ denied.*
[141] Circle Dot, *id.* 891 S.W.2d at 344–345.
[142] *Id.* at 344.

drilling unit for the well.[143] The well was completed as a gas producer in August 1988 and began producing in October 1988.[144]

In April 1989, Sidwell executed a "Designation of Consolidated Gas Leasehold Estate" creating the "Circle Dot Ranch No. 1 Gas Unit." The court described the resulting pooled unit as follows:

> The unit was irregular in shape, its diagonal corners being in excess of 11,000 feet apart, and contained 668.23 acres. Included in the pooled 668.23 acres were 123.23 acres under the Circle Dot lease, carved out of the southwest corner of the Circle Dot property where the Circle Dot 103 well was located, and 545 acres covered by six leases on three contiguous sections of land. Except for the consolidation, the primary term of one of the six leases would have expired in three months, and the primary terms of four of the leases would have expired within 18 months.[145]

The net effect of the pooling to Circle Dot was an 81 percent *decrease* in its royalty.[146] The net effect to Sidwell was an *increase* in its net revenue interest since 25 percent of the 545 acres pooled with Circle Dot's lease provided for a one-eighth royalty instead of the Circle Dot lease royalty of three-sixteenths.[147]

Perhaps the most amazing aspect of this case is that after Circle Dot presented its evidence to the jury, the trial court entered a directed verdict in favor of Sidwell, finding no evidence had been presented to indicate Sidwell had failed to exercise good faith in creating the pooled unit.[148] Although the trial court's ruling was reversed on appeal, the court of appeals had difficulty defining the standard that should be applied when evaluating lessee performance under a pooling clause. The issue presented to the court initially was whether Sidwell "exercised its pooling authority in fairness and good faith, taking into account the interests of both the lessor and lessee."[149] During oral argument, Sidwell convinced the court that the Texas Supreme Court's holding in *Amoco Production Co. v. Alexander*[150] established the

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[143] *Ibid.*

[144] *Ibid.*

[145] *Ibid.*

[146] Circle Dot, N. 140 *supra*, 891 S.W.2d at 344 n.2, 347.

[147] *Id.* at 348 (concurring opinion of Justice Dodson).

[148] *Id.* at 345. Justice Dodson, in a concurring opinion, indicated that if anybody was entitled to a directed verdict under the facts, it was Circle Dot. *Id.* at 349.

[149] Circle Dot, N. 140 *supra*, 891 S.W.2d at 345.

[150] 622 S.W.2d 563, 72 O. & G.R. 125 (Tex. 1981).

standard of care as "that of a reasonably prudent operator under the same or similar facts or circumstances."[151]

The court's analysis began by noting that "the bare language of the express covenant of consolidation *implies a covenant of the standard of care for the performance of the lessee in the exercise of his pooling authority* . . . ."[152] This was used as the premise for applying the *Alexander* implied covenant prudent operator standard.[153] However, the court noted that the "good faith" standard is merely a component of the prudent operator inquiry.[154] This conclusion was stated as follows: "The material fact in this cause is whether Sidwell exercised the pooling option as a reasonably prudent operator would do under the same or similar circumstances by, among other things, using good faith, taking into account its and Circle Dot's interests."[155]

It probably does not matter what analytical route the court takes to establish the "smell test" for dirty pooling in this case; Sidwell's actions smell bad under any test. However, it was Sidwell who argued that the *Alexander* implied covenant test should be applied. This should not have bothered Circle Dot since a fundamental portion of the *Alexander* analysis states:

> The reasonably prudent operator standard is not to be reduced to the Alexanders because Amoco has other lessors in the same field . . . .
>
> . . . .
>
> Amoco owed the Alexanders the duty to do whatever a reasonably prudent operator would do if the Alexanders were its only lessor in the field.[156]

Therefore, the *Circle Dot* "same or similar circumstances" under an *Alexander* analysis would require the court to answer this question: Would a prudent operator give away 81 percent of its share of production and 81 percent of the lessor's share of production when it was not required to do so and no benefit would accrue to either

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151 Alexander, *id.*, 622 S.W.2d at 567–568, 72 O. & G.R. at 132.

152 Circle Dot Ranch, Inc. v. Sidwell Oil and Gas, Inc., N. 140 *supra*, 891 S.W.2d 342, 346 (emphasis added).

153 *Ibid.*

154 *Ibid.*

155 Circle Dot, N. 152 *supra*, 891 S.W.2d at 347. Justice Dodson, concurring, was not ready to abandon the good faith standard that had been applied in prior cases. *Id.* at 347–348.

156 Amoco Prod. Co. v. Alexander, N. 150 *supra*, 622 S.W.2d at 569, 570, 72 O. & G.R. at 134, 135 (Tex. 1981).

party under the lease?[157] Once the issue is properly stated, applying the single lease component of the *Alexander* analysis, the answer is obvious.[158]

Another argument that might be available to a lessor in Circle Dot's position is that Sidwell's formation of the unit was not authorized by the *express terms* of the pooling clause. The pooling clause authorized consolidation "to form a unit for the production of [oil or gas] . . . . "[159] Is this a limitation on the pooling power? If it is not necessary to "form a unit" to obtain a full allowable from a well on the lease, is there any basis for pooling under the pooling clause? Although the clause gives the lessee some discretion concerning the size and shape of the units being formed, this authority is contingent on the ability to form a unit in the first place. Section 1.07[2], *infra*, addresses interesting problems that can arise for lessees when express lease terms are given literal effect without the tempering effects of prudent operator notions.

[2] The Shut-In Royalty Scare.

Few things are as scary to an oil and gas lessee as the guillotine/time bomb nature of the habendum clause.[160] A missed payment, a failure to produce, or a failure to act within a stated period of time can each result in the automatic termination of the oil and gas lease. However, the situation becomes even more risky when the lease can terminate for a bad judgment call—such as an improvident assessment of a gas marketing opportunity.

In *McDowell v. PG & E Resources Co.*[161] the lessee had been marketing wet gas from the McDowell lease by mixing it with dry gas from the adjacent Breedlove lease. The lessee, PG & E, had an interest in both leases, but McDowell had no interest in the Breedlove

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[157] The answer is rather simple once the collateral interests of the lessee in other leases are divorced from the question.

[158] It is interesting that the court did not mention Amoco Production Co. v. Underwood, 558 S.W.2d 509, 58 O. & G.R. 578 (Tex. App. 1977), *writ ref'd n.r.e.*, which affirmed a jury verdict in favor of the lessors, finding that the lessees had acted in bad faith in creating the pooled unit. One of the lessors in that case was Circle Dot Ranch, Inc., and the tract of land involved was apparently the same 643.23 acres on which Sidwell would practice its own brand of gerrymandered pooling a decade later.

[159] Circle Dot, N. 152 *supra*, 891 S.W.2d at 344.

[160] "Century of Oil and Gas Jurisprudence," N. 43 *supra* at 801 ("The Habendum Clause: Guillotines and Time Bombs").

[161] 658 So.2d 779 (La. App. 1995).

lease. When production ceased from the Breedlove well, the gas transporter refused to transport the wet gas from the McDowell well. PG & E responded to the situation by trying to regain dry gas production from the Breedlove lease so it could resume the mixing program to market the McDowell lease gas. When PG & E's attempt to rework the Breedlove well failed, it drilled a replacement well on the Breedlove lease, which turned out to be a dry hole. During the eleven months in which PG & E unsuccessfully attempted to regain production from the Breedlove lease, PG & E had two offers to market gas from the McDowell well if it would build the necessary pipeline. Ultimately, when the Breedlove mixing option was eliminated, McDowell constructed the pipeline at a cost of $82,236 and resumed marketing gas from the McDowell lease.[162]

While PG & E pursued marketing options for the McDowell lease, it paid shut-in royalty to McDowell under the following clause:

> If Lessee obtains production of minerals on said land . . . and if, during the life of this lease . . . all such production is shut in by reason of force majeure or the lack either of *a market at the well* or wells or of an available pipeline outlet in the field, this lease shall not terminate but shall continue in effect during such shut-in period as though production were actually being obtained on the premises . . . , and [at indicated times] Lessee shall pay or tender . . . to the royalty owners [the appropriate shut-in payment].[163]

The trial court held that PG & E had breached its implied covenant to market and canceled PG & E's McDowell leases.[164] The court of appeals reversed the trial court, finding that the plaintiffs had failed to formally place the defendants in default prior to filing suit.[165] However, the court noted that even on the merits the record did not disclose any breach of the lessee's implied covenant to market.[166]

The plaintiffs also asserted that the lease had terminated under the ninety-day cessation of production clause[167] since the lessee's failure

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[162] *Id.* at 781, 782.

[163] *Id.* at 782 n.5 (emphasis by the court).

[164] *Id.* at 780.

[165] *Id.* at 783.

[166] *Id.* at 784.

[167] *Id.* at 783 n.6 ("[I]f production previously secured should cease from any cause after the expiration of the primary term, this lease shall remain in force so long thereafter as Lessee . . . is engaged in drilling operations or reworking operations with no . . . cessation of production and additional operations of more than ninety consecutive days . . . . ").

to market was not encompassed by the terms of the shut-in royalty clause. "[P]laintiffs contend that the gas purchase offers, eventually secured from Crystall and Tex/Con, contravene a finding that no market existed and preclude application of the shut-in clause."[168] However, the court noted that under the express terms of the shut-in royalty clause only a market "at the well" would prevent the lessee from relying on the clause. Each purchase offer required the lessee to construct a pipeline; the sales would not take place at the well.[169] Therefore, the court held that PG & E had the authority to rely on the shut-in clause to maintain the lease while it pursued its gas marketing options.

Although the court ultimately held in the lessee's favor, Judge Brown dissented, stating that he believed there was a market at the well site, and therefore PG & E could not rely on the shut-in clause to maintain the lease.[170] Judge Brown essentially questioned whether PG & E was actually pursuing the mutual interests of the lessor and lessee. However, to evaluate the marketing options properly, the court would have had to determine whether PG & E had an obligation to spend $82,236 to build a pipeline as part of its implied covenant to market. Neither the majority nor the dissent addressed this issue.

This case illustrates how courts may weave prudent operator concepts into the analysis to determine whether an express lease term has been satisfied. When dealing with the shut-in royalty clause, such an analysis is an improvement over the approach taken by the Kansas Supreme Court in *Tucker v. Hugoton Energy Corp.*,[171] where the court held that the shut-in royalty clause would apply only when there was "no market" for the gas. The court in *Tucker* stated:

> The "shut-in" royalty clause applies to circumstances where "a well capable of producing a profit is drilled but for the time being *no* market for the gas exists." . . . . There is a mutual interest

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[168] *Id.* at 782.

[169] *Id.* at 782, 784.

[170] *Id.* at 786. Judge Brown stated:

> Evidence shows that Resources [PG & E] initially pursued and remained aware of alternative means to transmit the McDowell gas to an ultimate buyer. Resources chose to devote its efforts to restoring production *in an unrelated oil and gas unit* in another field *which benefitted only Resources' interest* rather than to avail itself of the means to readily restore the McDowell well to a producing status.

Ibid.

[171] 855 P.2d 929, 125 O. & G.R. 301 (Kan. 1993).

> between the lessor and lessee when no market for the gas exists. However, *once a market for gas is secured, that mutual interest no longer exists because the lessor's interest is in securing royalty payments from production, while the lessee's interest is divided between receiving revenues and minimizing expenses associated with that production.* Thus, the "shut-in" royalty clause serves the interests of both parties *only in situations where no market exists for the gas.*[172]

The court's analysis of the parties' respective interests is flawed. Clearly, the lessor will have a continuing interest in the markets available to the lessee. For example, if the royalty clause provides for a royalty of "one-eighth of the proceeds at the well," the lessor will be concerned with the lessee's decision to pursue a market of $1 per Mcf instead of $2 per Mcf. Even when the royalty is "one-eighth of the market value at the well," the lessor will be concerned with the lessee's decision to pursue a low volume/high price marketing option instead of a high volume/low price market.

The court in *Tucker* held: "Because, in this case, at the time of shut-in there was a *limited market* available to defendants-lessees for the gas producible from the six wells at issue, the shut-in royalty clauses could not be invoked to perpetuate the leases."[173] The court did not evaluate whether the lessee's refusal to participate in the "limited market" was prudent. Instead, the court's opinion leaves the impression that once a gas marketing opportunity is presented, the lessee must accept it or risk losing the lease under a common form of shut-in royalty clause frequently encountered in Kansas.[174] In an apparent effort to protect the lessor from the lessee's broad discretion under the clause, the court limited the lessee's marketing freedom to the mutual detriment of the lessor and lessee.

Although not expressly reflected in the reported facts of the *Tucker* case, it appears that the lessee was attempting to negotiate a better

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[172] Tucker, *id.* at 936, 125 O. & G.R. at 311 (emphasis added).

[173] *Ibid.* (emphasis added).

[174] The clause in *Tucker*, on its face, provided the lessee with considerable discretion concerning when a well could be shut-in and maintained by shut-in royalty payments:

> Where gas from a well or wells, capable of producing gas only, *is not sold or used* for a period of one year, lessee shall pay or tender, as royalty, an amount equal to the delay rental . . . payable annually at the end of each year during which such gas is not sold or used, and while said royalty is so paid or tendered this lease shall be held as a producing . . . [lease].

Tucker, N. 171 *supra*, 855 P.2d at 934, 125 O. & G.R. at 307–308 (emphasis added).

gas contract with its gas purchaser.[175] Apparently, the purchaser was only sporadically taking gas from the lessee's wells, causing the lessee operational problems and additional expense.[176] However, the Kansas Supreme Court saw it differently:

> To obtain the maximum profit from its use of gas, the lessee chose not to produce gas from the wells that required constant maintenance. Because, in this case, at the time of shut-in there was a limited market available to defendants-lessee for the gas producible from the six wells at issue, the shut-in royalty clauses could not be invoked to perpetuate the leases. Thus, the trial court erred in finding the shut-in royalty clauses were properly invoked.[177]

The court addressed the issue as one of whether there was "no market" or a "limited market" for the gas. If there was a limited market, the lessee could not rely on the shut-in royalty clause, so the leases terminated when the lessee failed to produce gas from the wells. The weakness in this analysis is that the court never evaluated the basis for the lessee's decision not to participate in the limited market. Since the lessee was given considerable discretion under the shut-in royalty clause concerning when to shut in, the court should have employed a prudent operator analysis to determine whether the lessee's rejection of the limited market would have actually served the mutual interests of the lessor and lessee.

Under pre–1990 marketing regimes, the analysis was much simpler because the gas purchaser typically made the daily decisions as to which well to produce, and how much. If the gas purchaser decided not to take gas from a well, there was "no" market. However, with the sweeping gas marketing changes that have occurred since 1985, it is often the lessee who makes the critical decisions as to which well to produce, and how much. Therefore, there will often be many "limited" markets that the lessee must evaluate—and it is in the lessor's best interests to have his lessee choose markets to maximize either production volumes or price or both. The court's analysis in

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[175] The original contract was a product of KN Energy, Inc.'s spinning down producing properties to its wholly owned subsidiary, Plains Petroleum Company. KN entered into a gas purchase contract with Plains covering the wells at issue. Plains subsequently became an independent company, unrelated to KN, and transferred the wells at issue to a third party who transferred its interests to Hugoton Energy. Tucker, *id.*, 855 P.2d at 932–933, 125 O. & G.R. at 303–304.

[176] The trial court held that the limited market available under the existing gas contract did not justify making the lessee conduct the maintenance required to deliver gas from the wells when requested by its gas purchaser. Tucker, *id.*, 855 P.2d at 933, 125 O. & G.R. at 305–306.

[177] *Id.* at 936, 125 O. & G.R. at 311.

Tucker fails to account for these gas marketing realities and the mutual interests of the parties to the oil and gas lease relationship.

[3] When Does Drilling "Commence"?

In many ways the oil and gas lease is similar to an option contract. The lessee acquires the option to explore and develop the leased land for a period of time specified in the habendum clause. Lessees will typically have a portfolio of undeveloped leases with varying primary terms. Among the many factors that influence when a lease will be explored is the critical date when the lease can no longer be maintained by the payment of delay rental—the date when the lessee must either have production from the leased land or be engaged in activities in pursuit of the necessary production. Lessees frequently want to know what they must be doing at the end of the primary term to extend the oil and gas lease into its secondary term. The answer to the lessee's question has become simpler in Kansas.

In *Hall v. JFW, Inc.*,[178] the lease provided: "If the lessee shall commence to drill a well within the term of this lease . . . the lessee shall have the right to drill such well to completion with reasonable diligence and dispatch."[179] Prior to the end of the primary term, the lessee obtained a drilling title opinion, staked the well location, surveyed the drill site, obtained a drilling permit, and entered into a signed contract with a drilling company. Prior to the end of the primary term, the drilling company dug drilling pits and leveled a drill site location, drilled a water supply well, prepared the rotary hold and run-around, and picked up surface casing to use in the well.[180] One day after the end of the primary term, the drilling contractor moved a drilling rig onto the lease and began drilling the well. Within thirty days following the end of the primary term the well was drilled to the targeted depth, production casing was installed and cemented, and a completion rig was brought onto the lease. The lessor filed suit asserting the lease had terminated before the well was completed.[181]

The court in *Hall* held that "[u]nder the plain terms of the lease, actual drilling was required prior to the termination date."[182] Since

[178] 893 P.2d 837 (Kan. App. 1995).
[179] *Id.* at 839.
[180] *Ibid.*
[181] Hall, N. 178 *supra*, 893 P.2d at 839–840.
[182] *Id.* at 842.

the actual drilling took place the day after the primary term, the lease terminated. The lease required the lessee "to commence to *drill* a well," which the court found was a more demanding standard than "commence *operations* for the drilling of a well" or "commence drilling *operations*."[183]

Counsel for the lessee, relying on this author's "unambiguous irrevocable commitment" theory,[184] argued that the lessee's actions constituted an unambiguous, irrevocable commitment to drill a well on the leased land. The court considered the theory, quoting the following passage from the *Kansas Oil and Gas Handbook*:

> In *Herl v. Legleiter* [668 P.2d 200, 78 O. & G.R. 19 (Kan. App. 1983)] the Kansas Court of Appeals suggests something less than actual drilling may be sufficient to satisfy a commencement clause. However, it appears where something less than actual drilling is being relied upon, the lessee should be required to demonstrate what amounts to an irrevocable commitment to conduct operations, to completion, on the leased land. The best evidence of this, absent actual drilling on the premises, is an enforceable contract with a third party to drill a well on the leased land. However, the lessee runs a risk when something less than an appropriate rig is in place on the lease.[185]

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[183] *Ibid.*

[184] In 1986 the author offered a theory in the *Kansas Oil and Gas Handbook* to try to reconcile cases in which the Kansas Supreme Court had granted and denied a lessee relief from automatic termination under the delay rental clause. The classic case was Kays v. Little, 175 P. 149 (Kan. 1918), where the rental was due December 2, but was not received until December 5. Under existing Kansas law, the lease would have terminated. However, the court held that the lease had not terminated because the lessee proved it had sent the payment by registered mail on November 27, and therefore it should have arrived on November 28. The author also noted that when the issue was whether operations had been commenced, Kansas courts generally took a hard line, requiring substantial commitment to drill the well contemplated by the clause. From these cases the author offered the following analysis:

> It appears, in each case, the court is looking for lessee's clear objective manifestation of an intent to maintain the lease either by payment of delay rental or commencement of operations. A delay rental payment, mailed prior to the delay rental due date but lost in the mail, is an objective manifestation by the lessee that he intends to keep the lease in effect . . . . The requisite objective manifestation by commencement of operations is more difficult to identify because up to a point the lessee may be performing certain acts merely as a pretense with no intent to drill a well . . . . Here too Kansas courts have looked for what can be called an irrevocable intent to continue the lease. If you have a rig on site or contracted to drill a well, and the operations are being diligently pursued, this would seem to clearly indicate an intent to commence operations.

1 Pierce, *Kansas Oil and Gas Handbook* § 9.30, at 9–40 (1986).

[185] Hall, N. 178 *supra*, 893 P.2d 837, 841–842 (quoting 1 Pierce, *Kansas Oil and Gas Handbook* § 9.34 (1991)).

However, the court rejected the argument, holding that actual drilling was required by the express terms of the commencement clause.[186]

Although the court's rule appears to be a harsh result under the facts, it has the virtue of simplicity. The lessor can walk out on the leased land on the critical date, and if he does not see a rig on site drilling a well, he will know the status of his lease—as will the lessee. However, it remains to be seen how the Kansas courts will address other variants of the commencement clause and whether the Kansas Supreme Court will follow the court's reasoning in *Hall*.

[4] Calculating Royalty under the Royalty Clause: The Deduction of Costs Issue.

Few subjects generate as much high-stakes litigation as the calculation of royalty. Although the lease form and its drafters are frequently cited as the cause of the unrest,[187] this does not explain disputes over royalty clauses the courts find to be unambiguous and capable of ready interpretation. The real problem in this area may be a lack of judicial consensus on a workable analytical framework for evaluating royalty calculation disputes. For example, the "marketable product" analysis for determining deductible costs may yield widely varying results depending on how it is applied.

Most royalty clauses provide for the delivery of royalty owner compensation either as a percentage of the extracted mineral or as a percentage of money that represents the extracted mineral. Disputes seldom arise over the delivery of a stated percentage of production,[188] but frequently occur when the royalty is paid in cash.

[a] The Express Overrides the Implied: Value "At the Well."

The express terms of the oil and gas lease determine the lessee's royalty obligations and the lessor's rights.[189] A standard lessor tactic is to argue that the lease terms are ambiguous. If the royalty clause is found to be ambiguous, courts tend to rely on rules of construction

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[186] *Id.* at 842.

[187] *E.g.*, "Century of Oil and Gas Jurisprudence," N. 43 *supra* at 786–787, 828 (1994).

[188] However, disputes could occur over whether the lessee's obligation is satisfied by tendering the production at the wellhead as opposed to delivering to storage tanks provided by the lessor, the lessee, or to a purchaser's pipeline connection.

[189] *See, e.g.*, Hurinenko v. Chevron, USA, Inc., 69 F.3d 283 (8th Cir. 1995) ("market value at the well" designates basis for calculating lessor's royalty).

and implied covenants to construe the lease—typically in favor of the lessor and against the lessee. The implied covenant to market is frequently used in an effort to move the all-important royalty valuation point as far downstream from the wellhead as possible. During 1995, these arguments worked for lessors in Oklahoma[190] but failed in Kansas.[191]

When the express terms of the lease are clear, there is no need for roughshod rules of construction and implied covenants to "interpret" the lessee's express royalty obligations. For example, in *Sternberger v. Marathon Oil Co.*[192] the lessors objected to gas gathering system expenses incurred by their lessee to move gas from the lease to markets off the lease. The expenses related to gathering system construction and operation costs incurred by the lessee, Marathon, who owned and operated the gathering system.[193] The case was filed as a class action, and the court ultimately interpreted the law of Kansas, Oklahoma, and Texas.[194]

The parties stipulated that the rights of all members of the class would be governed by the terms of the Sternberger/Marathon royalty clause in which the lessee agreed:

> [t]o pay lessor for gas of whatsoever nature or kind produced and sold, or used off the premises, or used in the manufacture of any products therefrom, one-eighth (1/8), at the market price at the well, (but, as to gas sold by lessee, in no event more than one-eighth (1/8) of the proceeds received by lessee from such sales), for the gas sold, used off the premises, or in the manufacture of products therefrom, said payments to be made monthly.[195]

The parties also agreed, and the court found that "[t]here was no market for gas at the wellhead, and TXO [Marathon's predecessor] was unable to induce a gas purchaser to construct a pipeline to the well bore."[196]

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[190] TXO Production Corp. v. Oklahoma, 903 P.2d 259 (Okla. 1994), *as amended on reh'g* (Oct. 5, 1995).

[191] Sternberger v. Marathon Oil Co., 894 P.2d 788 (Kan. 1995). The author participated in the drafting of the amicus curiae brief filed on behalf of the American Petroleum Institute in the *Sternberger* case.

[192] 894 P.2d 788 (Kan. 1995).

[193] *Id.* at 792.

[194] *Id.* at 792, 801–805.

[195] *Id.* at 792.

[196] *Ibid.*

a well, and the operations are being diligently pursued, this would seem to clearly indicate an intent to commence operations.

1 Pierce, *Kansas Oil and Gas Handbook* § 9.30, at 9–40 (1986).

[185] Hall, N. 178 *supra*, 893 P.2d 837, 841–842 (quoting 1 Pierce, *Kansas Oil and Gas Handbook* § 9.34 (1991)).

Sternberger argued, and the trial court held, that since the royalty clause was "silent as to deductions" it was "ambiguous and therefore must be construed in her favor to preclude the deductions made by Marathon."[197] The Kansas Supreme Court rejected this approach, holding the lease was not ambiguous because "the lease clearly specifies that royalties are to be paid based on 'market price at the well.'"[198] The court tacitly agreed with the position taken by the American Petroleum Institute (API) that since the lease required a determination of "market price at the well," and that had not been done, the case should be remanded to the trial court to address the valuation issue. The trial court had improperly become embroiled in the collateral issue of whether certain costs could be deducted when the only issue to be decided was the market value of the gas "at the well."

The characterization of the issue to be decided is critical. If the issue is properly framed by the court as the value of something at a stated point, then the focus of the inquiry is whether the evidence offered tends to assist in identifying that value. For example, if the issue is the market value of gas "at the well," only evidence that tends to establish that value should be considered. Actual sales at the well would be relevant. If there were no wellhead sales, the next best evidence would be sales away from the wellhead that have been adjusted to reflect the enhanced value of the gas at the actual point of sale as compared to its value at the valuation point dictated by the oil and gas lease. This makes the deduction of costs an evidentiary issue, not an entitlement issue. The express terms of the royalty clause provide the formula for calculating value; all the court needs to do is marshal the evidence that will provide relevant information concerning the market value of the gas "at the well."

Therefore, the deduction of costs issue must be approached with the ultimate goal in mind of making the inquiry: What is the market value of the gas at the well? If it is not addressed in this manner, the focus improperly shifts from "value" to interpretive problems that are not the object of the inquiry. The Kansas Supreme Court appreciated this distinction when it addressed the issues presented in the *Sternberger* case. The court observed:

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[197] Sternberger, N. 192 *supra*, 894 P.2d at 794.

[198] *Ibid.*

> The parties in this case dispute Marathon's deduction of transportation expenses, *but there has been no evidence or finding as to what the market price at the well was.* Because sale occurred away from the well or the lease premises, we assume that royalties were paid based on the market price at a distant market rather than market price at the well. *Amicus* API seems to recognize this. API suggests that this court should remand the case to the district court "to determine the 'market price at the well' by determining the reasonable cost to transport gas from the wellhead to a point where it could be sold off the lease under circumstances where no market existed at the well and the lessee had to build its own connecting pipeline."[199]

Applying the foregoing analysis, the court held: "Transportation expenses may properly be deducted from royalties where royalties are payable based on market price at the well and where there is no market at the well and transportation to a distant market is necessary."[200]

Such a value analysis also avoids the unnecessary functionalization game of trying to determine whether a pipeline being used to move gas is a "gathering" line or a "transportation" line. If the issue is properly posed as the value of gas at the well, it simply should not matter how equipment and structures are classified. The only issue is whether their presence and use added value to the gas in its journey from the wellhead to a valuation point. Although the court in *Sternberger* articulated the correct analysis and applied it properly, it almost fell prey to the functionalization inquiry. In the first portion of its opinion, the court talked about "gathering" pipelines.[201] In the latter

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[199] Sternberger, N. 192 *supra*, 894 P.2d at 806 (emphasis added). Marathon argued against a remand stating that neither party to the litigation had requested it and that the court had adequate information in the record to resolve the valuation issue. *Id.* at 806–807. The case was remanded by the court, and in a subsequent proceeding the trial judge entered judgment in favor of Marathon finding that "(1) the method of calculating deductions from royalty and overriding royalty at issue was reasonable, and (2) the costs and expenses included in calculating those deductions were reasonable and necessary." Journal Entry of Judgment, No. 91–CV–01 (Nov. 28, 1995).

[200] Sternberger, N. 192 *supra*, 894 P.2d at 806. The court relied on three early Kansas cases to support its conclusion stating:

> *Scott*, *Voshell*, and *Molter* are dispositive of the issue in this case. These cases clearly show that where royalties are based on market price "at the well," or where the lessor receives his or her share of the oil or gas "at the well," the lessor must bear a proportionate share of the expenses in transporting the gas or oil to a distant market.

Sternberger, *id.*, 894 P.2d at 796.

[201] *Id.* at 792–793.

portion of its opinion the court referred to Marathon's "transportation" pipelines and stated: "[T]he deductions made by Marathon are properly characterized as 'transportation' rather than 'gathering' or other production costs."[202]

The court also had to engage in some functionalization since it left the *Gilmore*[203] and *Schupbach*[204] cases relatively unscathed by its decision. In *Gilmore* and *Schupbach*, the court held the lessees could not deduct compression costs to calculate royalty due under leases requiring payment of "one-eighth of the proceeds of the sale thereof at the mouth of the well."[205] However, in each case the court found the leases were ambiguous and were therefore open to interpretation "in favor of the lessor and against the lessee."[206] The court's analysis in *Sternberger* is just the opposite: "The lease's silence on the issue of post-production deductions does not make the lease ambiguous."[207] The "market price at the well" language clearly established the basis for calculating royalty.[208]

In an effort to functionalize around *Gilmore* and *Schupbach*, the court offers the following puzzling statement: "There is no evidence that Marathon engaged in any activity designed to enhance the product, such as compression, processing, or dehydration."[209] Clearly the transportation that the court approved would "enhance the product." Instead, the court's statement appears to be an attempt to deal with another confusing concept used by lessors to try to avoid the real valuation issue—the "marketable product" concept.

[b] The "Marketable Product" Game.

In *Sternberger* the court stated: "The lessee has the duty to produce a marketable product, and the lessee alone bears the expense in making the product marketable."[210] The notoriously malleable concept of "marketable product," when joined with general notions of lessee implied marketing obligations, can be used as a false analytical tool

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[202] *Id.* at 800.

[203] Gilmore v. Superior Oil Co., 388 P.2d 602, 20 O. & G.R. 457 (Kan. 1964).

[204] Schupbach v. Continental Oil Co., 394 P.2d 1, 21 O. & G.R. 304 (Kan. 1964).

[205] Gilmore, N. 203 *supra*, 388 P.2d at 604, 605, 20 O. & G.R. at 461, 463; Schupbach, *id.*, 394 P.2d at 2, 21 O. & G.R. at 308.

[206] Gilmore, *id.* at 605, 20 O. & G.R. at 463; Schupbach, *id.* at 4, 21 O. & G.R. at 308.

[207] Sternberger, N. 192 *supra*, 894 P.2d at 794.

[208] *Ibid.*

[209] Sternberger, N. 192 *supra*, 894 P.2d at 799.

[210] Sternberger v. Marathon Oil Co., N. 192 *supra*, 894 P.2d at 799.

to arrive at about any conclusion a court desires. Some courts may join the marketable product analysis with a lease ambiguity finding so they do not appear to be totally ignoring the express terms of the royalty clause.[211] The court in *Sternberger* resisted the temptation of the marketable product analysis but felt compelled to try to distinguish Marathon from the lessees in the *Gilmore* and *Schupbach* cases.

The court noted that in *Gilmore* and *Schupbach*: "There was no market for the gas at the mouth of the well, *and gas was being vented and wasted*. To make the gas marketable, the lessee installed a large compressor station on the leased premises . . . . "[212] It appears the court may be trying to place *Gilmore* and *Schupbach* in the category of cases where compression is necessary to *produce* the gas.[213] Placing such a judicial gloss on these cases would permit the court at least to harmonize the results in *Gilmore* and *Schupbach* with the value analysis the court employed in the *Sternberger* case. However, other courts recently addressing the issue have elected to follow a marketable product analysis.

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[211] This would explain the approach, and results, in Gilmore v. Superior Oil Co., N. 203 *supra*, and Schupbach v. Continental Oil Co., N. 204 *supra*. For example, in the *Schupbach* case, Justice Fontron, in a concurring opinion, felt compelled to write:

> I find it extremely difficult to accept the rationale of Gilmore v. Superior Oil Co., 192 Kan. 388, 388 P.2d 602 [20 O. & G.R. 457]. It offends my sense of logic to say that the market value of gas at the mouth of the well is the price for which it is ultimately sold after having been so processed that it has become marketable. I would consider that market value of gas at the well would be that amount for which it could be sold, after deducting such reasonable expense as was required to render it saleable.
>
> However, I recognize that the point has been decided otherwise by this court, and for such reason will concur in the result reached in this case.

Schupbach, N. 204 *supra*, 394 P.2d at 7, 21 O. & G.R. at 312.

[212] Sternberger, N. 192 *supra*, 894 P.2d at 798 (emphasis added). The court also stated that in *Schupbach* "a similar result was reached where the compression took place off, rather than on, the leased premises." Sternberger, 894 P.2d at 798. From the court's characterization of the cases, one can conclude that it does not matter whether the compression takes place on or off the leased premises. In *Gilmore* the compression clearly took place on the leased premises. However, it was never clear from the *Schupbach* opinion whether the compression was on or off the leased premises. The *Sternberger* dicta suggest that the *Schupbach* case should be read as though the compression took place off the leased premises.

[213] The reported facts in *Gilmore* and *Schupbach* suggest that compression was not necessary to produce the gas but rather was required to move it from the wellhead into a pipeline located on the lease. However, no specific finding was made concerning whether the compression was needed to aid the production of gas—as distinguished from the marketing of gas. The Kansas courts in future cases may be inclined to limit the *Gilmore* and *Schupbach* rule to situations where the compression is required to extract the gas from the ground. This would permit Kansas courts addressing future royalty calculation issues to employ the *Sternberger* value analysis instead of the marketable product analysis.

The "marketable product" analysis is illustrated by the holding of the Oklahoma Supreme Court in *TXO Production Corp. v. Oklahoma.*[214] The oil and gas lease required the lessee to pay "[w]ithout cost into pipelines, a royalty of one-eighth part of the oil or gas produced from the leased premises . . . or in lieu thereof, pay to lessor the market value thereof, as the Commissioners may elect."[215] The lessor elected to be paid "the market value thereof" for gas production. In calculating the lessor's royalty, the lessee deducted compression, dehydration, and gathering expenses incurred prior to delivering the gas to the gas purchaser's pipeline. The Oklahoma Supreme Court held the royalty clause reference to "market value thereof" referred to the value of the royalty "without cost into pipelines."[216] Therefore, the court held that the express terms of the lease indicated that the gas would be delivered to the pipeline "without cost" to the lessor.[217] Since the compression, dehydration, and gathering expenses occurred before the gas entered the purchaser's pipeline, the court concluded that they could not be deducted when calculating royalty.

Although the court could have ended its opinion with its express lease language interpretation, it proceeded to employ a marketable product analysis to further support its conclusion.[218] Relying upon its prior opinion in *Wood v. TXO Production Corp.*,[219] the court identified the following elements of Oklahoma's version of the marketable product rule:

(1) The lessee's implied obligation to market includes the obligation to obtain a marketable product.

(2) This includes an obligation to bear the cost of preparing the gas for market.

(3) This includes an obligation to get the gas to the place of sale in marketable form.[220]

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[214] 903 P.2d 259 (Okla. 1994), *as amended on reh'g* (Oct. 5, 1995).

[215] TXO, *id.*, 903 P.2d at 260.

[216] *Id.* at 261.

[217] *Ibid.*

[218] The court stated:

> Thus, TXO may not deduct any cost for the royalty payment which results from processes necessary to get the product into pipelines. This is further supported by and seen in this Court's approach to the implied covenant to market owed by TXO as explained in *Wood, supra* [Wood v. TXO Production Corp., 854 P.2d 880, 125 O. & G.R. 139 (Okla. 1992)].

TXO, N. 214 *supra*, 903 P.2d at 261.

[219] 854 P.2d 880, 125 O. & G.R. 139 (Okla. 1992).

[220] TXO, N. 214 *supra*, 903 P.2d at 262.

The court then applied its *Wood* analysis and found that the compression, dehydration, and gathering expenses were "necessary to make the product marketable and involve costs incident to delivering the product into pipelines."[221]

The royalty clause in *Wood* provided for: "3/16 at the market price at the well for the gas sold."[222] Nevertheless, the court observed: "Consequently, under our pronouncement in *Wood* the costs for compression, dehydration and gathering are not chargeable to Commissioners because such processes are necessary to make the product marketable under the implied covenant to market."[223] The court noted that a different result would be obtained under Texas and Louisiana law "because those jurisdictions view the lessee's duty to market differently than we view it in Oklahoma."[224] After *Sternberger*, Kansas would have to be added to the Texas/Louisiana list of states that view the implied covenant to market differently from Oklahoma.

Colorado, like Oklahoma, employs its own version of the marketable product analysis. For example, in *Garman v. Conoco, Inc.*,[225] the clause being interpreted by the federal court required the following royalty calculation: "Said overriding royalty shall be computed and paid on the basis of the *market price for oil, gas and casinghead gas prevailing in the field where produced* for oil, gas and casinghead gas of like quality . . . . "[226] No attempt was made to ascertain the "market price for . . . gas . . . prevailing in the field" as specified in the relevant clause. Instead, the following certified question was posed to the Colorado Supreme Court:

> [I]s 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*?[227]

The court answered the question as follows:

> [A]bsent an assignment provision to the contrary, overriding royalty interest owners are not obligated to bear any share of

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221 *Ibid.*
222 TXO, N. 214 *supra*, 903 P.2d at 261.
223 *Id.* at 263.
224 *Ibid.*
225 886 P.2d 652 (Colo. 1994).
226 *Id.* at 664 (emphasis added).
227 *Id.* at 653 (emphasis added).

> post-production expenses, such as compressing, transporting and processing, undertaken to transform raw gas produced at the surface into a marketable product.[228]

However, "[u]pon obtaining a marketable product, any additional costs incurred to enhance the value of the marketable gas . . . may be charged against nonworking interest owners."[229] Instead of addressing the issue required by the express terms of the assignment—the market price for gas in the field—the court invited the parties to try to distinguish between "raw" gas and a "marketable product." What if the "raw gas produced at the surface" is salable without any further value-enhancing activities? One of the more common definitions of "marketable" is "readily salable."[230]

This tyranny of language also caused the Kansas Supreme Court to struggle with the concept of "marketable" when it observed: "This case turns on the fact that the royalty was to be paid based on 'market price at the well' and *the gas was marketable at the well, but there was no market at the well.*"[231] The court's holding supports the concept that one can have a marketable product without having anyone willing to buy it at a particular location. The same concept could apply to other physical characteristics of the gas in addition to its location, such as Btu content, water content, or pressure. The lessee's implied obligation would focus on seeking out a sale for the gas so that volumes can be produced, thereby triggering the obligation to pay a fractional share of the value of the gas sold, determined at the wellhead. Whether the lessee, an affiliated entity, or a third party undertakes to compress, dehydrate, gather, or otherwise enhance the value of the gas should not impact the basic issue of its value at the wellhead.

The Oklahoma and Colorado approaches to the marketable product analysis tend to assume that the actual point of sale determines when a marketable product has been achieved. The Kansas analysis of the marketable product issue employs a more intellectually honest appraisal of the situation by noting that something can be marketable

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228 *Id.* at 661.

229 *Ibid.*

230 Urdang, *The Random House Dictionary of the English Language* 818 (College ed. 1968).

231 Sternberger, N. 192 *supra*, 894 P.2d at 806 (emphasis added). Other statements by the court indicate it would distinguish between a marketable product and a present market for the product. For example: "[T]here is no evidence in this case that the gas produced by Marathon was not marketable at the mouth of the well other than the lack of a purchaser at that location." *Id.*, 894 P.2d at 799.

even though it has not been sold. For example, the court in *Sternberger* stated:

> In the case before us, the gas is marketable at the well. The problem is there is no market at the well, and in that instance we hold the lessor must bear a proportionate share of the reasonable costs of transporting the marketable gas to its point of sale.[232]

The court in *Garman* identified the implied covenant to market as the underlying basis for its marketable product rule, noting that it "obligates the lessee to incur those post-production costs necessary to place gas in a condition acceptable for market."[233] But note that resort to the "implied" in cases like *Garman* is not necessary to identify the assignee's royalty obligation. Instead, the "express" terms of the assignment provide the formula for measuring the royalty obligation—the market price for gas in the field. Since there is express language to direct the inquiry, there is no need to resort to implied covenant concepts.[234] When courts apply a marketable product analysis, they tend to push the royalty valuation point further downstream from the wellhead into separate business enterprises in which the lessor was never intended to participate. Often the result is that the lessor shares in the rewards of such separate businesses without exposure to any of the risks.

[c] The Oil Industry Comprises Many Separate Businesses.

If lessees merely wanted to extract oil and gas and then sell it to a third party at the well, their actions would be unassailable so long as they obtained the best price available for the production at the well.[235] The price received may be considerably less than if they compressed, dehydrated, gathered, treated, processed, transported, aggregated, packaged, and marketed the gas to end users. However,

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[232] 894 P.2d at 800.

[233] Garman, N. 225 *supra*, 886 P.2d at 659.

[234] The court specifically refused to apply its analysis to any specific set of facts but merely purported to state "general principles of Colorado law applicable to the issue." Garman, *id.*, 886 P.2d at 654. The court also proceeded under the assumption that "every oil and gas lease contains an implied covenant to market . . . . " *Ibid.*

[235] Depending on the state's approach to the market value royalty issue, the price the lessee receives for production may not matter so long as it pays royalty based on market value at the time of production. *See* Pierce, "Royalty Calculation in a Restructured Gas Market," 13 *Eastern Min. L. Inst.* 18–1, 18–43 (1990) ("[U]nder the *Vela* approach, the value of the gas will be determined without regard to the lessee's particular marketing arrangements.").

it is highly doubtful that lessees would be required to engage in any of those activities so long as there was someone willing to purchase the gas in its unenhanced form at the point of production. When the implied covenant to market is viewed from the perspective of what the lessee must do, instead of what the lessee can deduct as costs, the true nature of the covenant is brought into focus. It is a covenant to produce oil and gas to generate income for the parties to the lease, either in the form of a share of the actual production or payment of a sum of money. If there is no production, there is no royalty.[236]

The obligation to produce and sell at the wellhead neatly defines the business enterprise in which the royalty owner enjoys a risk-free interest. In other writings the author has referred to this phase as the "extraction" business.[237] The lessor enjoys a risk-free and cost-free share of the gross returns generated by the extraction business. However, absent express lease language stating otherwise,[238] the lessor should not share in any other business enterprises which the lessee pursues. For example, if the lessee decides to invest in a compressor, dehydrator, or pipeline to enhance the value of the gas coming from the well, this should be viewed as a distinct business enterprise that involves a separate investment of lessee capital, effort, and expertise. The lessor should neither be permitted nor obligated to share in the risks or rewards associated with such a separate business enterprise.[239] Although the lessee may decide to give its lessor the

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[236] For example, in Howerton v. Kansas Natural Gas Co., 106 P. 47 (Kan. 1910), *rev'd in part*, 108 P. 813 (1910) (reversed as to remedy for breach of covenant; damages adequate in this case), the lessee asserted it was under no obligation during the primary term of the lease to produce or market production from a commercial gas well completed on the lease. The court held the lessee had an implied obligation to produce and market gas from the well for the mutual benefit of the lessor and lessee. This is the essence of the covenant: the obligation to extract production so royalty can be paid.

[237] "Century of Oil and Gas Jurisprudence," N. 43 *supra* at 820.

[238] In most situations, the oil and gas lease will expressly limit the lessor's rights to the extraction business with language requiring valuations "at the well" or similar language.

[239] The courts in *Gilmore*, *Schupbach*, *TXO*, and *Garman* each noted that the lessees had not consulted their lessors concerning the expenses they incurred to purchase compressors, dehydrators, and gathering systems. Gilmore v. Superior Oil Co., N. 203 *supra*, 388 P.2d at 606, 20 O. & G.R. at 461 ("The lessee . . . did not consult with the lessor on any details pertaining to the location of the compressing station . . . . "); Schupbach v. Continental Oil Co., N. 204 *supra*, 394 P.2d at 5, 21 O. & G.R. at 309 ("Continental . . . constructed its compressor station at a central location on one of its leases and commenced compressing the gas from its adjoining leases in the area without consulting the lessors and royalty owners as to the location of the compressor station or as to the size or number of stations or as to any intention on its part to charge compression costs to the royalty owners . . . . "). In *TXO* the court stated:

benefit of such facilities, it should have no obligation to do so under the oil and gas lease.[240]

§ 1.08. Conclusion.

The oil and gas issues discussed in this article have not changed much through the years. Unfortunately, for some issues, the analysis has not changed much either. Too often, courts and litigants find themselves engaging in trench warfare as they deepen the ruts of past analysis to fuel ongoing battles. It is hoped that this article offers some useful thoughts on new ways of looking at these perennial problems.

> We consider also that working interest owners who share costs under an operating agreement have input into the cost-bearing decisions. The royalty owners have no such input after they have leased. In effect, royalty owners would be sharing the burdens of working interest ownership without the attendant rights.

TXO Production Corp. v. Oklahoma, N. 214 *supra*, 903 P.2d at 262. This observation is clearly wrong. Unlike a working interest owner, the royalty owner shares in none of the financial risk associated with the postproduction activity. Even a nonconsenting working interest owner under a joint operating agreement merely avoids the initial capital risk. If the operation or facility turns out to be profitable, the nonconsenting party will have to pay a risk "penalty" equal to some multiple of the costs of the operation to which he elected not to consent. As the court observed in *Garman*, the lessor can be charged a share of marketable product-enhancing costs only to the extent they actually enhance the lessor's overall net return. Garman v. Conoco, Inc., N. 225 *supra*, 886 P.2d at 661. However, the court in *Garman* similarly, and incorrectly, suggests the lessor has less protection than a working interest owner under an operating agreement. Garman, *id.* at 660. Contrary to the statements by the courts in *TXO* and *Garman*, the lessor is never going to have to put up money for anything, and the lessee will be entitled to charge the lessor a proportionate share of the reasonable costs of the service *only to the extent the service enhances the lessor's overall royalty return* from what it would have been without the service and the related charge.

[240] Similarly, the lessor should not be negatively impacted by having its gas run through such facilities. For example, if the wellhead price of the gas actually exceeds the value of the gas after it is run through the lessee's separate facilities, the lessee could not give the lessor access to the facilities merely to subsidize the lessee's bad investment. The court in Garman v. Conoco, Inc., N. 225 *supra*, 886 P.2d 652 (Colo. 1994), commented on this issue stating: "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 that actual royalty revenues increase in proportion with the costs assessed against the nonworking interest." *Id.*, 886 P.2d at 661.