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Royalty Valuation: Should Overriding Royalty Interests and Nonparticipating Royalty Interests, Whether Payable in Value or In Kind, Be Subject to the Same Valuation Standard as Lease Royalty

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ROYALTY VALUATION: SHOULD OVERRIDING ROYALTY INTERESTS AND NONPARTICIPATING ROYALTY INTERESTS, WHETHER PAYABLE IN VALUE OR IN KIND, BE SUBJECT TO THE SAME VALUATION STANDARD AS LEASE ROYALTY?

Owen L. Anderson[*]

I. INTRODUCTION

In 1994, I wrote my first article devoted exclusively to royalty valuation. The issue I addressed was whether a lessee could deduct a rate of return after taxes when calculating so-called "post-production" costs to be charged through royalty accounting to a lessor pursuant to the provisions of commonly encountered lease royalty clauses.[1] I concluded that a rate of return after taxes was inappropriate, but that a reasonable cost-of-money charge may be reasonable, provided that the net royalty payment was reasonable.[2] This first article was based upon the assumption that most courts would continue to take a property-law approach to royalty valuation, thereby allowing the lessee to deduct the cost of all post-extraction or post-wellhead activities. Shortly thereafter, the Supreme Court of Colorado

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1. Owen L. Anderson, *Calculating Royalty: "Costs" Subsequent to Production— "Figures Don't' Lie, But, . . ."* 33 WASHBURN L.J. 591, 591 (1994) (hereafter Anderson I).

2. *Id.* at 637-38.

adopted a contract-law approach to royalty valuation, requiring the lessee to pay royalty on the basis of a first-marketable product.[3] In addition, appellate courts in Kansas[4] and Oklahoma[5] reaffirmed their first-marketable product approaches to market value. I then wrote a two part royalty-valuation article discussing royalty history, analyzing both approaches to royalty valuation and concluding that the contract-law or first-marketable product approach to royalty valuation was preferable. I also argued that lessees should be permitted to deduct the reasonable cost of gathering and transportation costs, including transportation-related compression.[6] I recently completed an article addressing the actual calculation of gathering, transportation, and transportation-related compression costs in a marketable product jurisdiction.[7] In December 1998, although Oklahoma is a marketable-product lease royalty[8] valuation state, the Oklahoma Supreme Court, in contrast to decisions in Colorado and Kansas, adopted a property-law approach in the case of an overriding royalty[9] payable in kind on gas.[10] The purpose of this article is to address the wisdom of valuing an overriding royalty payable in-kind under a property approach, while valuing lease royalty payable in value under a contract-law approach.[11] Under the provisions of typical overriding royalty interests, I conclude that a contract-law approach is not only appropriate for typical overriding royalty interests, but is also appropriate for typical nonparticipating royalty interests.[12]

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3. Garman v. Conoco, Inc., 886 P.2d 652 (Colo. 1994) (construing an overriding royalty provision). *See also* Rogers v. Westerman Farm Co., 1998 WL 895887 (Colo. Ct. App., Dec. 24, *1998 modified on denial of reh'g* March 11, 1999) (construing a lease royalty provision).

4. Sternberger v. Marathon Oil Co., 894 P.2d 788 (Kan. 1995) (construing a representative lease royalty provision in a class action that included both lessors and overriding royalty owners as class members).

5. Mittelstaedt v. Santa Fe Minerals, 954 P.2d 1203 (Okla. 1998) (construing a lease royalty provision); TXO Prod. Corp. v. State, 903 P.2d 259 (Okla. 1994) (construing a lessor-drafted lease royalty provision in a state lease); Wood v. TXO Prod. Corp., 854 P.2d 880 (Okla. 1992) (construing a lease royalty provision).

6. Owen L. Anderson, *Royalty Valuation: Should Royalty Obligations Be Determined Intrinsically, Theoretically, or Realistically? Part 1 Why All the Fuss? What Does History Reveal?*, 37 NAT. RESOURCES J. 547, 572 (1997) (published in August 1998) (hereafter Anderson II); Owen L. Anderson, *Royalty Valuation: Should Royalty Obligations Be Determined Intrinsically, Theoretically, or Realistically? Part 2, Should Courts Contemplate the Forest or Dissect Each Tree?*, 37 NAT. RESOURCES J. 611 (1997) (published in August 1998) (hereafter Anderson III).

7. Owen L. Anderson, *Royalty Valuation: Calculating Freight in a Marketable-Product Jurisdiction*, 20 ENERGY & MIN. L. INST. 10-1 (1999) (formerly Eastern Mineral Law Institute, to be published in 2000) (hereafter Anderson IV).

8. I use the term lease royalty to describe the royalty reserved by the lessor in an oil and gas lease.

9. By overriding royalty, I mean a royalty carved from the working interest side of an oil and gas lease. An overriding royalty is often reserved upon assignment of the working interest but may also be granted by the working interest owner.

10. XAE Corp. v. SMR Property Management Co., 968 P.2d 1201 (Okla. 1998) (regarding an in-kind overriding royalty provision).

11. I have previously argued that a contracts-law approach is preferable to a property-law approach when considering lease royalty clauses. *See* Anderson II, *supra* note 6. *See also* Anderson III, *supra* note 6.

12. For purposes of this article, a nonparticipating royalty interest is a royalty carved from a fee mineral estate, not a lease.

II. OVERRIDING ROYALTY (AND NONPARTICIPATING) ROYALTY VALUATION.

Garman, Sternberger & XAE Compared.

Among the first-marketable product jurisdictions, there is disagreement over whether overriding royalty is payable on a first-marketable product basis—a contract approach—or on a severance basis—a property approach. In the Colorado case of *Garman*,[13] the only royalty at issue was an overriding royalty. In the Kansas case of *Sternberger*,[14] both lease royalty and overriding royalty owners were included in the certified class. Because these opinions discuss royalty generally and cite to lease royalty case law, the opinions in these cases imply, if not hold, that both overriding royalty and lease royalty should be valued on the same basis. These courts would probably reach this same conclusion if nonparticipating royalty interests were at issue. In contrast to *Garman* and *Sternberger*, the Oklahoma Supreme Court, in *XAE*[15] held that an "in-kind" overriding royalty interest allows the lessee to deliver the royalty gas to the overriding royalty owners in its natural condition at the wellhead.

There are, of course, some factual differences in these cases. *Garman* dealt with an overriding royalty interest that the majority opinion did not even bother to quote and that was carved from a federal oil and gas lease. In *Sternberger*, the plaintiffs consisted of a class of overriding royalty owners and lease royalty owners, but the court based its decision on a specific lease royalty provision that the parties stipulated to using as the representative clause. In *XAE*, the Oklahoma Supreme Court expressly recognized that it was dealing only with an overriding royalty provision that called for payment "in kind" and noted that its decision was based upon the express language of the clause. Thus, all three courts might reach similar decisions if squarely facing similar facts and similar overriding royalty provisions.

In *Garman*, the Colorado Supreme Court relied upon the implied covenant to market in reaching its decision that overriding royalty is owed on the value of a first-marketable product. In support of its view, the Colorado Court cited the late Professor Kuntz.[16] Rather than citing to Professor Kuntz, the *Garman* court should have cited the late Professor Merrill as supporting that view.[17] Professor Kuntz reached his first-marketable product view by contending that the express language of typical royalty provisions required a marketable-product valuation approach, not the implied covenant

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13. Garman v. Conoco, Inc., 886 P.2d 652, 653 (Colo. 1994).
14. Sternberger v. Marathon Oil Co., 894 P.2d 788, 793 (Kan. 1995).
15. XAE Corp. v. SMR Property Management Co., 968 P.2d 1201 (Okla. 1998).
16. *Garman*, 886 P.2d at 657 n.12, 659, and 661 n.27.
17. MAURICE MERRILL, COVENANTS IMPLIED IN OIL & GAS LEASES § 85 (2d ed. 1940).

to market.[18] Moreover, in the absence of special circumstances, Professor Kuntz generally rejected the notion of implying covenants in favor of holders of overriding royalty interests.[19] He reached this same general conclusion regarding nonparticipating royalty interests.[20] Although there is some case authority in support of recognizing implied lease covenants in favor of holders of overriding royalty interests,[21] the better reasoned cases are to the contrary.[22] Accordingly, if the *Garman* court had carefully construed the express language of the overriding royalty clause—a clause not even quoted in the majority opinion, citing Professor Kuntz's approach to the question of royalty valuation would have been appropriate. Of course, whether the court and Professor Kuntz would have reached the same conclusion in *Garman* is another matter. In any event, the approach taken in *Garman* is more consistent with the views of Professor Merrill.[23]

Although not quoted by the majority opinion in *Garman*, the concurring opinion did quote and construe the overriding royalty provision, which consisted of three paragraphs. The first paragraph provided that royalty was payable on "the market value, as hereafter determined, of all oil, gas, and casinghead gas produced, saved and marketed. . . ." The second paragraph provided that the "overriding royalty shall be computed . . . on the basis of the market price for oil, gas and casinghead gas prevailing in the field where produced for oil, gas or casinghead gas of like quality . . ." but that no royalty was owed on oil, gas or casinghead gas used in operations, unavoidably lost, or used for recycling or repressuring operations. The third paragraph provided that the operator could deduct the "full amount of any taxes required to be paid on such oil, gas and casinghead gas for or on account of the production or sale thereof, including the so-called gross production or severance taxes."[24] Noting that the clause expressly provided for only one deduction, the concurring justices concluded that other deductions were not permitted under the doctrine of *expressio unius est exlusio alterius*.[25]

A Closer Look at XAE.

In *XAE*, the Oklahoma Supreme Court construed a granted overriding royalty interest that was payable in kind. The court expressly considered

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18. 3 EUGENE KUNTZ, LAW OF OIL AND GAS § 40.5(b) (1989).
19. 5 EUGENE KUNTZ, LAW OF OIL AND GAS § 55.3(e) (1991).
20. *Id.* at § 55.3(c).
21. Cook v. El Paso Natural Gas Co., 560 F.2d 978 (10th Cir. 1977)(concerning drainage); Bolton v. Coats, 533 S.W.2d 914 (Tex. 1975) (concerning drainage). The problem with implying lease covenants in favor of overriding royalty owners is that the overriding royalty is actually carved from the burdened side of the implied covenant. In appropriate circumstances, however, it may be appropriate to imply separate covenants in favor of overriding royalty owners.
22. McNeill v. Peaker, 488 S.W.2d 706 (Ark. 1973); Cedar Creek Oil & Gas Co. v. Archer, 117 P.2d 265 (Mont. 1941); Kile v. Amerada Hess Petroleum Corp., 247 P. 681 (Okla. 1925).
23. Anderson III, *supra* note 6, at 670.
24. Garman v. Conoco, Inc., 886 P.2d 652, 664 (Colo. 1994).
25. *Id.* at 664-65 (holding that the expression of one thing implies the exclusion of another thing).

both the language of the provision and the nature of overriding royalty interests, although most of its opinion focused on the latter. The overriding royalty interest at issue granted an "overriding royalty interest in and to . . . [specified] leases . . . hereto attached in accordance with the terms and conditions thereof. . . ." The overriding royalty owners were entitled to an undivided 1/8 of the 7/8 of all gas "which may be *produced under the terms of . . . [the specified] oil and gas leases . . . the same to be delivered . . . free and clear of all costs and expenses whatsoever*, save and except gross production taxes or other government taxes properly chargeable thereto."[26]

The plaintiffs were successors in interest to the overriding royalty interest, and they had expressly authorized the lessee to market their share of the gas. Relying on lease royalty valuation case law,[27] and the express language of the overriding royalty provision, the plaintiffs brought suit contending that the operator wrongfully deducted from royalty payments a proportionate share of "gathering, processing and compressing" costs.[28] The "processing" deductions at issue did not involve the removal of natural gas liquids, an activity that is typically beyond the first market for gas.[29] Rather, the deductions reflected costs associated with a treating facility where hydrogen sulfide and carbon monoxide were removed from the gas prior to its sale at the outlet of the facility.[30]

As summarized by the court, the defendants contended that the deductions were valid because the overriding royalty was expressly "deliverable in-kind" and because the express cost-free language meant only that royalty was payable free of "exploration and production" costs.[31] Moreover, the defendants argued that "implied covenants of the oil and gas lease [such as the implied covenant to market] do not apply to overriding royalty owners."[32]

Adopting the defendants' framing of the issues, and citing prior Oklahoma authority[33] and the late Professor Kuntz,[34] the court held that the de-

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26. XAE Corp. v. SMR Property Management Co., 968 P.2d 1201,1202 (Okla. 1998)(emphasis added).

27. TXO Prod. Corp. v. State, 903 P.2d 259 (Okla. 1994) (regarding lessor-drafted state lease royalty provision on gas); Wood v. TXO Prod. Corp., 854 P.2d 880 (Okla. 1992) (regarding a lease royalty provision on gas); Clark v. Slick Oil Co., 211 P. 496 (Okla. 1922) (regarding a lease royalty provision on oil).

28. *XAE*, 968 P.2d at 1202-03.

29. *See generally* Anderson III , *supra* note 6, at 653-54.

30. *XAE* 968 P.2d at 1203. Defendants contended that they had sold the gas at the wellhead since December 1, 1995. *Id.* This contention was not further developed in the opinion. *Id.* If the gas had actually been sold at the well without requiring the seller to treat the gas, then the gas would have been in marketable condition at the wellhead.

31. *Id.*

32. *Id.*

33. Kile v. Amerada Petroleum Corp., 247 P. 681 (Okla. 1925).

34. 5 EUGENE KUNTZ, THE LAW OF OIL AND GAS § 55.3(e) (1991).

fendants did not owe the overriding royalty owners an implied obligation to deliver the gas free of any charge for gathering, processing (*i.e.*, treating), and compression costs.[35] In so holding, the court distinguished cases that recognized an implied obligation to protect an overriding royalty interest owner from drainage.[36] Then the court squarely rejected the rationale of *Garman*, which, in reliance on Oklahoma lease royalty case law, concluded that overriding royalty owners should be protected by the implied covenant to market like lessors are so protected under an oil and gas lease.[37] Citing precedent discussing the nature of in-kind overriding royalty interests, the *XAE* court adopted a property approach to overriding royalty valuation, specifically concluding that royalty in-kind is payable at the mouth of the well in its natural condition.[38]

In analyzing the case as reported, *XAE* is silent on whether there was also an overriding oil royalty provision. If there was, it was apparently a separate provision. If there was not, then no royalty was payable in kind or in value on oil. In either case, royalty was owed in-kind on "gas, gas condensate or other gaseous hydrocarbons which may be produced. . . ."[39] Regardless of the presence and type of oil royalty provision, if gas was produced along with oil and salt water, the operator is obliged to remit gas in-kind to the overriding royalty owners under the gas royalty provision. This in-kind delivery obligation would necessarily require that any mixture of oil, gas, and salt water be separated prior to the delivery of the gas. Because the lessee is obligated to deliver gas in kind, the lessee would presumably be obliged to absorb any separating cost.[40] Moreover, any disposal of salt water, which necessarily first requires its separation from the hydrocarbons, is generally regarded as production expense that the operator bears.[41] Thus,

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35. *XAE*, 968 P.2d at 1209. Justice Summers, argued that implied obligations could arise in the context of overriding royalties depending on the intent of the parties. *Id.* at 1209-11 (Summers, J., concurring in part and dissenting in part).

36. *XAE*, 968 P.2d at 1204-05, (distinguishing Continental Potash, Inc. v. Freeport-McMoran, Inc., 858 P.2d 66 (N.M. 1993); Cook v. El Paso Natural Gas Co., 560 F.2d 978 (10th Cir. 1977); Bolton v. Coats, 533 S.W.2d 914 (Tex. 1975); McNeill v. Peaker, 488 S.W.2d 706 (Ark. 1973); Cedar Creek Oil & Gas Co. v. Archer, 117 P.2d 265 (Mont. 1941)).

37. *Id.* at 1205-06.

38. *Id.* at 1207, (citing In re Martin, 321 P.2d 659 (Okla. 1956)).

39. *Id.* at 1202.

40. Anderson II, *supra* note 6, at 604 n.251.

41. *Cf.*, Kingwood Oil Co. v. Bell, 136 F.Supp. 229 (E.D. Ill. 1955), *aff'd*, 244 F.2d 115 (7th Cir. 1957) (holding owner of overriding royalty not responsible for proportionate share of waterflooding secondary recovery costs); Lege v. Lea Exploration Co., Inc., 631 So.2d 716 (La. Ct. App. 1994) (holding that salt water disposal system was a capital cost of production for purposes of determining paying quantities); CCH, Inc. v. Heard, 410 So.2d 1283 (La. Ct. App. 1982) (holding that the lease had terminated for lack of paying production where lessee had spent large sums of money dealing with large volumes of salt water). One trial court decision in Canada has allowed a lessee to recover overpayments of lease royalty arising from its failure to charge lessors for a proportionate share of "treating" costs. The treating costs at issue were incurred to remove water from oil and to reinject it into the producing formation. The court said that royalty valuation was "a matter of agreement," thereby implicitly rejecting a property approach. The royalty agreement expressly provided that royalty was payable on "the current market value at the wellhead. . . [of oil] produced, saved and marketed." Acanthus Resources Ltd. v.

a pure property-law approach, based upon severance of gas at the wellhead and its conversion to personal property, is not convincing. As I have previously stated, any departure from the strict wellhead-severance lynchpin of the property approach causes it to "fall[] down like a house of cards. . . ."[42]

The court in *XAE* grounds its decision, in part, on the fact that the overriding royalty was payable in-kind.[43] As discussed in my second article, historically, royalty was commonly payable in kind and yet commonly remitted to the royalty owner (the Crown) downstream of a mine or quarry in the form of a marketable product.[44] Thus, the fact that nonparticipating royalty interests and overriding royalty interests are commonly payable in-kind should not automatically subject such interests to a property approach. Admittedly, some in-kind royalty provisions lack language specifically describing the quality of production that is to be remitted in-kind. In contrast, most lease royalty clauses require payment of gas royalty in value based upon the proceeds, amount realized, market value, or market price. These words more plainly state that royalty is due on the value of a product that can be actually marketed.[45] Nevertheless, oil and gas royalty, whether payable in-kind or in value, is owed, explicitly or implicitly, on production. The words "production" and its derivatives, such as "produced," used in the overriding royalty provision in *XAE*, necessarily refer to a product. A "product" is something that can be used or marketed. Thus, on balance, in-kind royalty interests should be construed as entitling the royalty owner to a marketable product.

An illustrative Oklahoma in-kind royalty case that avoids a property approach to royalty valuation is *Clark v. Slick Oil Co.*,[46] a case cited, but otherwise ignored, by the court in *XAE*.[47] In *Clark*, a lessor reserved 1/8th of all oil produced and saved, which the lessee was "to deliver to the credit of

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Cunningham & Sullivan, [1998] 5 W.W.R. 646, 648 ¶ 2 (Alberta Q.B.). Based on this language, the court held that the treating costs could be deducted; however, due to the lessee's inadequate proof of costs, the court, without discussing the methodology, reduced the amount of the deduction from $8 to $1 Canadian per cubic meter. *Id.* at 654 ¶ 27 & 655 ¶ 37. This case never directly addresses the issue of whether water removal and disposal is a cost of production. It is also noteworthy that Canada has not generally recognized implied lease covenants. Nevertheless, if *Acanthus* stands for the proposition that water removal is a post-production cost, then, as a practical matter, royalty would seldom be a cost-free interest because most wells produce some salt water or other impurities. Note, however, that it is by no means clear that *Acanthus* represents the general view in Canada. *Cf.* Amerada Minerals Corp. of Canada Ltd. v. Mesa Petroleum (N.A.) Co., [1985] 4 W.W.R. 607 (Alberta Q.B.), *app. and cross-app. denied*, [1987] 1 W.W.R. 107 (Alberta C.A.) (holding, under the language of an overriding royalty agreement calling for royalty on substances "produced, saved and marketed," that production occurs at the point where the gas becomes first marketable, but allowing the lessee to deduct costs incurred in enhancing an already marketable product).

42. Anderson III, *supra* note 6, at 642, n.127.
43. *XAE*, 968 P.2d at 1207-08.
44. *See* Anderson II, *supra* note 6, at 573-84.
45. Anderson III, *supra* note 6, at 636-48.
46. 211 P. 496 (Okla. 1922).
47. XAE Corp. v. SMR Property Management Co., 968 P.2d 1201, 1203 (Okla. 1998).

the [lessor] . . . free of cost, in the pipeline to which [lessee] . . . may connect the well or well. . . ."[48] The oil in question contained "cut oil," which the court described as being contaminated with mud and water.[49] This cut oil had to be removed before a pipeline would take the oil. The court held that the lessee was obliged to remove cut oil without charge to the lessor to "make it marketable."[50] Thus, the in-kind nature of the royalty clause did not require the lessor to take the oil in its wellhead condition. Rather, the lessee was obliged to deliver the oil to the lessor in a marketable condition.

The language of the lease royalty provision in *Clark* is similar to the language of the overriding royalty interest in *XAE*. The only possible relevant distinction[51] is that the overriding royalty interest in XAE provided that royalty was to be remitted "free and clear of all costs and expenses whatsoever,"[52] not "free of cost, in the pipeline, . . ." as in *Clark*.[53] This latter phrase has been construed as requiring the operator to absorb all costs of delivering oil or gas into a pipeline near the well, but not to a distant pipeline.[54] As a result, at least in a marketable-product jurisdiction, the phrase "free of cost, in the pipeline" probably means nothing more than a royalty provision that is silent as to the delivery point or that provides for delivery at the well. If it does mean more, it might require the operator to deliver pipeline quality gas to the credit of the lessor into a pipeline near the immediate vicinity of the well even if the gas was marketable in fact in less than pipeline-quality condition.[55] Thus, there appears to be little, if any practical differences, between "free of cost, in the pipeline" and "free and clear of all costs and expenses whatsoever." In any event, even in the absence of these "free-of-cost" phrases, because royalty is owed on "production," a royalty owner should share, whether in kind or in value, in a marketable product in the immediate vicinity of the well. As I have previously stated, royalty valuation should logically take place where the exploration and production segment of the oil and gas industry ends. For this segment of the industry to separately exist in the marketplace, it must necessarily produce a product that can be marketed.[56]

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48. *Clark*, 211 P. at 497.
49. *Id.* at 499.
50. *Id.* at 497.
51. I do not regard the fact that *Clark* concerned an oil royalty clause and *XAE* concerned a gas royalty clause as a relevant distinction. Both the oil royalty and the gas royalty were due in kind.
52. *XAE*, 968 P.2d at 1202.
53. 211 P. at 497.
54. *See, e.g.*, Rains v. Kentucky Oil Co., 255 S.W. 121 (Ky. Ct. App. 1923).
55. Anderson II, *supra* note 6, at 650-51 n.147, 684 n.307.
56. Anderson III, *supra* note 6, at 689-90.

Instead of discussing and relying on *Clark*, the court relies on *In re Martin*.[57] In *Martin*, the initial lessees assigned the lease, reserving "5/16ths of the 8/8ths gross production."[58] This reservation further provided that:

> all of the oil, gas and other minerals produced, saved, and sold from said premises and creditable to the interest reserved shall be delivered . . . free and clear of all costs of developing, equipping and operating said properties . . . but there shall be deducted from the sale of production to said reserved interest all gross production taxes and other taxes assessed or assessable by proper governing authorities except as hereafter provided.
>
> Assignee shall have the right to deliver Assignor's share of said products to the pipeline or lines to which it may connect the wells located upon said leasehold tracts. Assignors shall be entitled to receive direct payment for their share of the products sold, and joint division orders or contracts of sale shall be executed by each of the parties. Provided that upon reasonable notice (not less than thirty days) to Assignee, Assignor shall have the right to receive in kind or to separately dispose of their share of such production and receive the proceeds therefor, if proper facilities are provided by the Assignors in which to receive such production.[59]

Subsequently, oil and gas was discovered in the area, and the property burdened by this royalty was included in a unitization approved by the Corporation Commission. The unit wells produced oil and wet gas. The wet gas was separated from the oil and sent to a processing facility, operated by the unit operating committee, where liquid hydrocarbons were extracted. The remaining dry gas was returned to the reservoir for pressure maintenance. Initially, all royalty owners were paid their pro rata share of the proceeds received for the sale of liquids without deduction for plant costs. The suit arose when the assignee of the property at issue convinced the unit operator to start deducting plant costs from the overriding royalty owners' shares. Although this action was commenced in court, the matter was first adjudicated by the Corporation Commission, which found in favor of the overriding royalty owners.[60] On appeal, the Oklahoma Supreme Court vacated the order of the Commission.[61]

Martin is easily distinguishable from *XAE*. *XAE* concerned sour gas that was treated at a treating facility (although the court called it a "processing" facility) apparently to make it marketable in fact. *Martin* concerned

57. 321 P.2d 659 (Okla. 1956).
58. *Id.* at 661.
59. *Id.*
60. *Id.*
61. *Id.* at 659.

casinghead gas that was saturated with valuable natural gas liquids (NGLs) that were extracted at a true processing facility. Gas that is saturated with valuable NGLs is usually marketable in fact prior to processing.[62] Accordingly, a gasoline plant has been consistently viewed as a refining facility that is downstream from the exploration and production segment of the industry.[63] The court in *Martin* emphasized that there was no evidence that the overriding royalty share of production could not be measured at the wellhead and no evidence that the wet gas was not marketable in its natural state at the wellhead.[64] Regarding valuation, the court recognized that, "if convenience or other considerations dictates," the royalty payable could be determined via a work-back computation provided that the royalty owners received nothing less than their proportionate share of the market value of the gross casinghead gas production.[65]

As precedent, the *Martin* court cites *Danciger Oil & Refineries, Inc. v. Hamill Drilling Co.*,[66] and *Armstrong v. Skelly Oil Co.*[67] Like *Martin*, both *Danciger* and *Armstrong* deal with wet gas (*i.e.*, gas saturated with NGLs), and their reasoning supports the proposition that royalty is payable on the value of a first-marketable product. I have discussed *Armstrong* in detail in a prior article.[68] *Danciger*, which I cited in a prior article,[69] specifically involved overriding royalty due for known reserves of wet, "sweet" gas.[70] The royalty was payable in value on gas "produced, saved and marketed."[71] There was, however, "no market in the vicinity at that time."[72] The operator processed the gas for liquids extraction in a plant owned by its subsidiary. In a dispute over royalty valuation, the court properly reasoned that royalty was expressly owed on "gas," not on refined products.[73] The court noted that the words "produced, saved and marketed" would have only obligated the operator to "put the gas in condition for marketing as 'gas' of the kind contemplated by the parties."[74] *Danciger* concerned wet, sweet gas for which there was no available market at that particular *location*; however, the sweet gas was most likely in a marketable *condition*, and the fact that

62. Anderson III, *supra* note 6, at 653-54.

63. *Id.* at 654. Because NGLs are sometimes extracted by the lessee or its affiliate, it may be necessary to deduct these processing costs to arrive at a proper royalty value where the pre-processing value is unknown or cannot be reliably determined.

64. In Re Martin, 321 P.2d 659, 664 (Okla. 1956).

65. *Id.* at 665.

66. 171 S.W. 2d 321 (Tex. 1943) (holding that overriding royalty is payable on the market value of wet gas, not on the gross value of extracted liquids and residue gas).

67. 55 F.2d 1066 (5th Cir. 1932) (holding that royalty was properly paid on the value of marketable wet gas).

68. *See* Anderson II, *supra* note 6, at 597-98. In essence, the *Armstrong* court found that there was an established market for wet gas. *Id.*

69. *See* Anderson III, *supra* note 6, at 653 n. 156.

70. Danciger Oil & Refineries, Inc. v. Hamill Drilling Co., 171 S.W.2d 321, 323 (Tex. 1943).

71. *Id.*

72. *Id.*

73. *Id.*

74. *Id.*

the gas was wet (*i.e.*, saturated with NGLs) most likely made it more valuable. The court remanded the case for a determination of the fair and reasonable value of the unrefined wet, sweet gas in the vicinity of the well, which would necessarily include an adjustment for freight.[75] In this regard, the court noted that the royalty provision expressly provided that the royalty gas was to be valued at the "prevailing market prices paid by major companies in the Gulf Coast area."[76] In other words, royalty is to be paid on the basis of comparable sales of *marketable* sweet gas. If the gas in question was not marketable in fact, there could be no comparable sales. Without comparable sales, there could be no known "market price."

The court in *XAE* also justified its decision by noting that the obligation to market is an implied lease covenant which does not extend to overriding royalty interests carved from the working interest.[77] In rejecting the recognition of such an implied covenant "in this case,"[78] however, the court implicitly leaves open the possibility of recognizing an implied duty to market in good faith in a future case involving different circumstances. For example, in the case of an overriding royalty payable in value, the court would probably protect an overriding royalty owner from the operator's sweetheart sale of production for less than the best available arm's-length equivalent price and terms.[79]

To avoid having to distinguish this case in the future (*e.g.*, respecting an operator's possible implied duty to pay an in-value royalty based upon an arm's length equivalent price), the court could have decided this case solely on the language of the overriding royalty interest. This was the approach taken in the concurring opinion in *Garman*.[80] Of course, had it done so, the result may have been different—at least with regard to the treating costs.

The court's detailed discussion of the implied covenant to market in *XAE* is a classic example of being trapped by one party's framing of the issues. By falling for this trap the court gets hung up on the question of

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75. *Id.*

76. *Id.*

77. XAE Corp. v. SMR Property Management Co., 968 P.2d 1201, 1204 (Okla. 1998) (citing Kile v. Amerada Petroleum Corp., 247 P. 681(Okla. 1925)) (refusing to protect an overriding royalty owner under the implied lease covenant to protect against drainage).

78. *XAE*, 968 P.2d at 1207.

79. *Cf.*, Barby v. Cabot Corp., 550 F.Supp. 188, 190 (W.D. Okla. 1981); Harding v. Cameron, 220 F.Supp. 466, 470 (W.D. Okla. 1963); Diamond Shamrock Corp. v. Harris, 681 S.W.2d 317, 321 (Ark. 1984); Amoco Prod. Co. v. First Baptist Church of Pyote, 579 S.W.2d 280 (Tex. App.–El Paso 1979) (recognizing lessee's duty to market for the best available price and terms). *See also* U.C.C. § 1-203 (providing that "every contract or duty imposes an obligation of good faith in its performance and enforcement) and RESTATEMENT (SECOND) OF CONTRACTS § 205 (1979)(recognizing that every contract imposes a duty of good faith and fair dealing).

80. Noting that the royalty clause at issue expressly provided for only one deduction, taxes, the concurring justices concluded that other deductions were not permitted under the doctrine of *expressio unius est exlusio alterius*. *Garman*, 886 P.2d at 664-65. Likewise, in *XAE*, the only deduction expressly permitted was taxes. *XAE*, 968 P.2d at 1202.

whether covenants should be implied in overriding royalty interests. In justifying its decision in *XAE*, the court relies on Professor Kuntz for the general proposition that implied lease covenants, presumably including the implied covenant to market, should not ordinarily be implied in the case of an overriding royalty interest.[81] The problem with this reliance is that Professor Kuntz did not base his first-marketable product approach to royalty valuation on the implied covenant to market. Rather, he based it on the proper construction of the typical gas royalty clause,[82] as I have previously emphasized.[83] On the other hand, Professor Merrill did base his view that the lessee had a duty to produce a marketable product in terms of an implied lease covenant.[84] Thus, unlike Professor Merrill, Professor Kuntz would not have considered whether an operator owes an overriding royalty owner an implied covenant to produce a marketable product.

Specifically regarding overriding royalties, Professor Kuntz does state that overriding royalty is ordinarily due free and clear of costs.[85] He further recognizes that, under an in-kind provision, the overriding royalty owner is "entitled to have the specified share delivered to such owner or *to the pipeline free of all costs* including secondary recovery operations."[86] Because pipelines have historically accepted only marketable gas, his express reference to delivery to a pipeline free of all costs necessarily implies that royalty production must be in a marketable condition. Professor Kuntz then states that the operator should "account for production or its proceeds if sold at the mouth of the well. If any costs are incurred beyond that point, they should be shared."[87] If production is sold at the mouth of the well, it is obviously in marketable condition at that location. In the next sentence, he states that "if overriding royalty . . . is to be delivered in kind, the owner of that interest may make arrangements for sale of the oil or gas or join in any gas purchase contract made by the lessee."[88] Again, since the overriding royalty owner is permitted to join in the lessee's gas contract, the referenced gas has to be marketable in fact. Otherwise, there could be no gas purchase contract. Moreover, his reference to the overriding royalty owner making

81 5 EUGENE KUNTZ, THE LAW OF OIL AND GAS § 55.3(c) (1991).

82. 3 EUGENE KUNTZ, THE LAW OF OIL AND GAS § 40.5(b) at 351 and § 42.2 at 389-90(1989).

83. *See supra* section 1; *See also* Anderson II *supra* note 6, at 604-05; *See also* Anderson III *supra* note 6, at 670, 683-87.

84. MAURICE H. MERRILL, COVENANTS IMPLIED IN OIL AND GAS LEASES § 85 (2d ed.1940).

85. 5 EUGENE KUNTZ, THE LAW OF OIL AND GAS § 63.2 at 218, 223.

86. Kuntz, *supra* note 81, at § 63.2 at 223 (emphasis added), citing Brenimer v. Cockburn, 254 F 2d 821, 823 (10th Cir. 1958) (concerning an overriding royalty of "one percent (1%) of all the oil and gas hereafter developed or discovered . . . .") and Thornburgh v. Cole, 207 P.2d 1096 (Okla. 1949) (concerning an overriding royalty on coal payable in value).

87. *Id.*

88. *Id.*

arrangements for sale does not suggest that such owner is to do anything more, such as having to make unmarketable gas marketable.[89]

In his next paragraph, Professor Kuntz mentions the deductibility of compression costs "required to market the gas. . . . "[90] This is an obvious reference to transportation-related compression.[91]

On the next page, Professor Kuntz addresses the issue of whether overriding royalty is owed on casinghead gas. He notes that, where overriding royalty is due on "all oil, gas and other minerals produced, saved and sold," that it "has been held to include casinghead gas."[92] He then states that an overriding royalty owner "is not entitled to a share of the products refined, but is entitled to a share of production in its natural state."[93] His specific reference to casinghead gas, together with his reference to refining, indicates that Professor Kuntz is writing about wet gas, not unmarketable gas. His use of the word "refined" is significant because that is the word that he uses when he discusses his marketable-product view in his chapter on the lease gas royalty clause.[94]

In discussing the gas royalty provision typically found in an oil and gas lease, Professor Kuntz states:

> Much of the difficulty can be avoided if it is recognized that there is a distinction between acts which constitute production and acts which constitute processing or refining of the substance extracted by production. Unquestionably, under most leases, the lessee must bear all costs of production. There is, however, no reason to impose on the lessee the costs of refining or processing the product, unless an intention to do so is revealed by the lease. It is submitted that the acts which constitute production have not ceased until a marketable product has been obtained. After a marketable product has been obtained, then further costs in improving or transporting such product should be shared by the lessor and lessee if royalty gas is delivered in kind, or such costs should be taken into account in determining market value if royalty is paid in money.

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89. *See also* 3 EUGENE KUNTZ, THE LAW OF OIL AND GAS § 40.3(c) page 321 (1989) (in discussing a lessor's possible waiver of the right to take gas in kind, he makes reference only to a lessor failing to make arrangements for a pipeline connection).

90. *Id.*

91. Professor Kuntz did recognize a lessee's right to charge the lessor through royalty accounting for a proportionate share of transportation costs incurred to deliver gas beyond the immediate vicinity of the well. 3 EUGENE KUNTZ, THE LAW OF OIL AND GAS § 40.5 at 351 (1989). *See also* 3 EUGENE KUNTZ, THE LAW OF OIL AND GAS § 40.3(d) page 321-22 (1989) (in concluding that the volume of gas due the lessor should be determined at the well, he also notes that this would establish the point where price would be determined in the event of sale, again recognizing that royalty is now owed on transportation).

92. 5 EUGENE KUNTZ, THE LAW OF OIL AND GAS § 63.2, at 224 (1989).

93. *Id.*

94. 3 EUGENE KUNTZ, THE LAW OF OIL AND GAS § 40.5, at 351)(1989).

It is not always easy to determine, however, when the first marketable product has been obtained. Marketability of the product may be affected because the quality of the raw gas is impaired by the presence of impurities. In this instance, it should be necessary to determine if there is a commercial market for the raw gas. If there is a commercial market, then a marketable product has been produced and further processing to improve the product should be treated as refining to increase the value of the marketable product. If there is no commercial market for the raw gas, the lessee's responsibilities theoretically have not ended, and the lessee should bear the costs of making the gas marketable. The decisions are not all consistent with this analysis.

Consistent with this analysis is the conclusion that the lessee should deduct the allocable costs of processing wet gas when royalty is paid on the basis of the proceeds from sales of the products derived from processing.[95] Also consistent is a decision in which reference is made in the opinion to this treatise regarding the lessee's duty to produce a marketable product and to bear all expenses of doing so, but the court found it unnecessary to determine if the removal of hydrogen sulfide is a production expense or a processing expense. Instead, the court held that a proceeds type royalty clause that does not specify either net or gross proceeds nor refer to the situs of the sale is ambiguous and construed it against the lessee to require the payment of royalty on the basis of gross proceeds without deduction of any lessee's processing costs to remove hydrogen sulfide.[96] Inconsistent with the analysis suggested is a case in which the sour gas produced has little marketability and no demonstrated market value. The court held that the costs of removing hydrogen sulfide were not production costs but were costs to be proportionately deducted from royalty payments.[97]

Marketability of gas may also be affected because the gas in its natural state is low pressure gas that requires compression to enter an available pipeline. Marketability in this instance is not affected by the chemical quality of the gas that can be corrected by processing. Marketability is impaired by the absence of marketing facilities for low pressure gas. The analysis suggested herein of identifying the first marketable product would be helpful only in the unusual event where the well could be served by either a low pressure pipeline or a high pressure pipeline and the gas is compressed to obtain a higher price available at the high pressure pipeline. Absent

95. *See* Axis Petroleum Co. v Taylor, 108 P.2d 978 (Cal. Ct. App. 1941).
96. *See* West v. Alpar Resources, Inc., 298 N.W.2d 484 (N. D. 1980).
97. *See* Piney Woods Country Life Sch. v. Shell Oil Co., 539 F.Supp. 957 (S.D. Miss. 1982).

> such a situation, compression is more easily identified as an element of transport or as a marketing cost of a marketable product rather than as a production or refining process.[98]

Nothing in Professor Kuntz's discussion of overriding royalty[99] or in his discussion of in-kind lease gas royalty provisions[100] contradicts this detailed analysis of the typical lease gas royalty clause.

I believe the court in *XAE* quotes his treatise out of context and misinterprets his meaning.[101] In quoting Professor Kuntz's conclusion that implied covenants should not be implied in the grant of an overriding royalty,[102] the court fails to recognize that he did not view the obligation to produce a marketable product as in implied covenant. In quoting Professor Kuntz's discussion of overriding royalty,[103] the court overlooks the fact that gas delivered to a pipeline free of all costs must be gas that is marketable in fact. In quoting from his discussion regarding the payment of royalty on other substances,[104] the court ignores the fact that this entire section deals with royalty on other substances and that the quoted paragraph consists entirely of cross references to other parts of the treatise, including a specific reference to the section where he advances his view that production does not cease until a marketable product is obtained.[105] Further, Professor Kuntz' discussion of in-kind royalty on oil[106] and gas,[107] does not contradict his view that royalty is due on the basis of a marketable product.

Most importantly, in quoting all of these excerpts from Professor Kuntz's treatise, the court ignores the language of the overriding royalty provision at issue, which expressly provided that the royalty gas was to be remitted "free and clear of all costs and expenses whatsoever, save and except gross production taxes or other governmental taxes properly chargeable thereto."[108] If this does not require the delivery of a marketable product, what language would be necessary to accomplish that end?[109]

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98. 3 EUGENE KUNTZ, THE LAW OF OIL AND GAS § 40.5(b) at 351-52 (1989).
99. 5 EUGENE KUNTZ, THE LAW OF OIL AND GAS § 63.2 (1991).
100. 3 EUGENE KUNTZ, THE LAW OF OIL AND GAS §§ 40.3(a)-(c) and 40.5(a) (1989).
101. XAE Corp. v. SMR Property Management Co., 968 P.2d 1201, 1208 (Okla. 1998).
102. *Id.* at 1205 (citing 5 EUGENE KUNTZ, THE LAW OF OIL AND GAS § 55.3(c) (1991)).
103. *XAE*, 968 P.2d at 1208 (quoting 5 EUGENE KUNTZ, THE LAW OF OIL AND GAS § 63.2 at 223 (1991)).
104. *XAE*, 968 P.2d at 1208 (quoting 5 EUGENE KUNTZ, THE LAW OF OIL AND GAS § 41.3(c), at 379 (1989)).
105. 3 EUGENE KUNTZ, THE LAW OF OIL AND GAS § 40.5 (1989).
106. *Id.* at § 39.4(a).
107. *Id.* at § 40.5(a).
108. XAE, 968 P.2d at 1202.
109. *See also* Heritage Resources, Inc. v. Nations Bank, 939 S.W.2d 118 (Tex. 1996) (holding that a clause expressly prohibiting the lessee from deducting any processing, dehydration, compression or transportation costs was surplusage.) *But see e.g.*, Anderson III, *supra* note 6, at 641 n. 125 (explaining that *Heritage* has little, if any, precedential value.)

Of course, no one can be certain of what Professor Kuntz's view would have been regarding the dispute in *XAE*, but based upon the court's statement of the facts, he probably would have sided with the overriding royalty owners on the issue of treating costs. The court's statement of facts indicated that the extracted gas in XAE was sour and in need of treating.[110] Yet, the court also notes that the defendants contended that the sour gas had been marketed at the wellhead since December 1, 1995.[111] Whether the gas was marketed or marketable in an untreated condition is a question of fact. Thus, given the defendants' contention, perhaps this issue should not have been decided on summary judgment. In any event, however, if the sour gas was not marketable in fact, the overriding royalty owners should not have been charged with a proportionate share of the treating cost.[112] On the other hand, unless the gathering and transportation-related compression costs were *de minimus*,[113] the overriding royalty owners should have been charged through royalty accounting for a proportionate share of those costs.[114] Lessees and operators should not pay royalty on value added by transportation costs incurred to move gas to a market that is beyond the immediate vicinity of the well.[115]

Distinguishing Lease, Overriding, and Nonparticipating Royalty Interests

Of course, an overriding royalty is distinguishable from a lease royalty on several grounds. These distinctions may serve as a basis for differentiating among them for various purposes, including royalty valuation. I will first examine the general distinctions, and then I will consider whether these distinctions justify a different approach to royalty valuation.

1. Distinctions in General

Lessees most often draft the lease royalty clause, and a lease royalty is always reserved in or retained by the lessor, not granted. In contrast, either party to an overriding royalty transaction may draft the pertinent language, which is often shorter and less detailed than the typical lease royalty provision but sometimes longer and more detailed as in *Garman*. In addition, an overriding royalty interest may be either reserved upon assignment of the working interest or simply granted by the owner of the working interest to a third party. Moreover, lease royalty, especially in the case of gas, is typi-

110. *XAE*, 968 P.2d at 1203.
111. *Id.*
112. 3 EUGENE KUNTZ, THE LAW OF OIL AND GAS § 40.5(a), at 348 and § 40.5(b), at 351 (1989). *See also* Anderson III, *supra* note 6, at 683.
113. By transportation-related compression, I mean compression, regardless of location, that is primarily required to move the gas to a market beyond the immediate vicinity of the well. This is in contrast to production-related compression, which acts as a vacuum to suck the gas out of the ground. *See* Parker v. TXO Prod. Corp., 716 S.W.2d 644 (Tex. App.1986).
114. 3 EUGENE KUNTZ, THE LAW OF OIL AND GAS § 40.5(b), at 351-52 (1989).
115. *See* Anderson III *supra* note 6, at 691-92.

cally payable in value, while an overriding royalty is often phrased as being payable in-kind, although in practice, it most often is actually paid in value. And unlike the typical lease situation, both parties to a transaction involving the creation of an overriding royalty interest are often sophisticated parties with oil and gas experience and thus aware of industry custom and practice. Because of these differences, credible arguments can be made for treating overriding royalty differently from lease royalty.

Likewise, nonparticipating royalty interests, which are carved from the fee title, are distinguishable from both overriding royalty interests and lease royalty interests. Like the overriding royalty interest, the typical nonparticipating royalty interest may be either granted or reserved, might be drafted by either party to the transaction, and is often phrased as payable in kind. When reserved, the nonparticipating royalty interest is usually created in the context of a sale of a fee interest in the mineral estate and oftentimes a sale of the surface estate as well. Accordingly, while both parties to an overriding royalty transaction often have oil and gas transactional experience and while the lessee of an oil and gas lease is often the only party having oil and gas transactional experience, one or both parties to a nonparticipating royalty interest may have no oil and gas transactional experience. Parties with little or no oil and gas experience are less likely to be familiar with industry custom and practice.

In addition, under prevailing case law, an underlying mineral interest owner owes a nonparticipating royalty interest owner a higher duty of good faith to perpetuate and protect the value of the nonparticipating interest where it is defeasible,[116] than a working interest owner of a lease owes an overriding royalty owner.[117] This higher duty includes a duty to lease for exploration and development,[118] and to obtain as high a royalty rate as possible where the nonparticipating royalty interest is phrased as an undivided share of the lease royalty.[119] Unlike both the lease royalty and overriding royalty interest, the duration of which is commonly tied to production, the nonparticipating royalty may be for a perpetual duration or for a shorter duration, such as a term of years and so long thereafter as oil and gas are produced. Also, unlike the lease royalty and overriding royalty, the parties to a nonparticipating royalty transaction do not necessarily contemplate that the underlying interest owner will conduct any actual exploration and production activities. Again, because of these differences, credible arguments can be made for treating the nonparticipating royalty differently from both the lease royalty and the overriding royalty.

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116. *See, e.g.*, Kimsey v. Fore, 593 S.W.2d 107 (Tex. Civ. App. 1979).

117. *See, e.g.*, Brannan v. Sohio Petroleum Co., 260 F.2d 621 (10th Cir. 1958).

118. *See* Manges v. Guerra, 673 S.W.2d 180 (Tex. 1984) (dealing with a nonexecutive mineral interest).

119. *See, e.g.*, Mims v. Beall, 810 S.W.2d 876 (Tex. App.1991) (involving the reservation of an undivided 1/4 interest in the lease royalty).

2. Distinctions for Royalty Valuation Purposes

Query whether overriding and nonparticipating royalty interests should be governed by the same general principles applicable to lease royalty valuation?[120] I submit that the answer is yes. Accordingly, all types of royalty interests should be construed in light of their express language. In the absence of express language to the contrary, the language of all types of royalty interests should be construed in light of the following factors, common to all three types. In general, for valuation purposes, all types of royalty interests should be construed as a forest of provisions that express similar obligations, not as individual trees in a diverse forest. The language of these interests should be construed as a whole and as providing for a sharing arrangement in the exploration and production segment of the oil and gas industry. They should be construed as anticipatory in nature in contemplation of what may be decades of production and in light of the fact that it provides the royalty owner with contractual consideration for productive reserves. Royalty provisions should be construed in light of the fact that the underlying operating or working interest, which is burdened by the royalty interest, may be freely assigned. Moreover, they should be construed in light of the fact that the holder of the underlying operating interest cannot easily honor the terms of thousands of royalty interests burdening its lease portfolio if the language of each interest is narrowly and strictly construed or if different types of royalty interests are subject to formalistic legal distinctions affecting valuation.[121]

Accordingly, royalty should be payable, whether in-kind or in value, on production, and absent express language to the contrary,[122] production should not be complete until a marketable product has been obtained in fact.[123] If the first sale occurs beyond the first real market, an operator who pays cash royalty should pay only on the value of production as a first-marketable product. In other words, the operator should not have to share downstream profits with a royalty owner. If a sale occurs at a first market that is not within the immediate vicinity of the well, the operator should be allowed to deduct reasonable transportation costs, including the costs of gathering and of transportation-related compression.[124]

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120. The focus of my prior articles, Anderson I through IV, was on commonly encountered gas royalty clauses found in leases drafted by lessees, not on other royalty interests.

121. These points are made in the context of lease royalty clauses in Anderson III, *supra* note 6, at 612, 683-89.

122. For an example of express language to the contrary see Maddox v. Texas Co., 150 F.Supp. 175, 179 (E.D. Tex. 1956) (construing a gas royalty clause expressly providing that royalties were to be paid on "the current market price at the wells . . ., [but] Lessor's interest shall bear its proportion of any compression, treating, or other expenses necessary to render the gas merchantable").

123. 3 EUGENE KUNTZ, THE LAW OF OIL AND GAS §§ 40.5(b) and 42.2 (1989).

124. Anderson III, *supra* note 6, at 683-92.

Determining the overriding royalty obligation at the wellhead regardless of its marketable condition at that point is based upon the same property-law approach that I criticized in my second and third articles.[125] There is no need to repeat that analysis here. Suffice it say that courts should consider the language of the overriding gas royalty interest in light of the factors previously stated. In *XAE*, by taking a property approach, the court narrowly construes the express language of the interest, "*free and clear of all costs and expenses whatsoever*, save and except gross production taxes or other government taxes properly chargeable thereto."[126] This, of course, results in a construction that is inconsistent with how the court construes similar lease gas royalty clauses under a contracts approach.[127] I submit that a more uniform standard of royalty valuation is desirable.

III. CONCLUSION

Perhaps the most compelling reason for a single royalty valuation approach is to establish, to the extent possible, a uniform regime for royalty remittance and valuation. The oil and gas industry is facing an ever-growing problem of fractionalization and subdivision of mineral interests.[128] This proliferation of small fractional mineral interests and various resulting types of royalty interests is already requiring companies to maintain and administer, at great expense, extensive and complex division order records, something the industry does not face in overseas operations. Achieving a uniform regime of royalty valuation law, preferably nation-wide, for all royalty interests would lower lease and division order maintenance and administration costs for the entire oil and gas industry.

Beyond that, however, world royalty history[129] and older United States royalty case law[130] provide ample support for a more uniform approach to royalty valuation—an approach that construes royalty provisions as contractual in nature, but which nevertheless recognizes that typical royalty provisions express similar obligations.[131] Regarding the typical in-kind royalty provision, which is commonly phrased as a cost-free interest through "production," common sense dictates that the royalty owner should not be forced to accept an unmarketable product. If the *XAE* court is correct in

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125. Anderson II, *supra* note 6, at 571-604. *See also* Anderson III, *supra* note 6, at 649-64.

126. XAE Corp. v. SMR Property Management Co., 968 P.2d 1201, 1202 (Okla. 1998) (emphasis added).

127. *See, e.g.*, Mittelstaedt v. Santa Fe Minerals, 954 P.2d 1203 (Okla. 1998) (construing a lease royalty provision); TXO Prod. Corp. v. State, 903 P.2d 259 (Okla. 1994) (construing lessor-drafted lease royalty provision in a state lease); Wood v. TXO Prod. Corp., 854 P.2d 880 (Okla. 1992) (construing a lease royalty provision).

128. *See generally*, Owen L. Anderson and Ernest E. Smith, *The Use of Law to Promote Domestic Exploration and Production*, 50 INST. ON OIL & GAS LAW & TAX'N, 2-1 (1999).

129. Anderson II, *supra* note 6, at 573-84.

130. Anderson II, *supra* note 6, at 584-603.

131. Anderson III, *supra* note 6, at 612, 635-48.

holding that the operator could complete its obligation to the overriding royalty owner by delivering wellhead sour gas instead of marketable gas, the operator could force the overriding royalty owner to take its share of the sour gas in kind at the wellhead. Forcing a royalty owner to accept an unmarketable product would convert the royalty owner's interest into a cost-bearing interest in that the royalty owner would have to do something tangible to the product to make it marketable and, in so doing, duplicate the similar facilities of the operator. In such a situation, the operator, having completed its duty to the royalty owner, could then offer to buy the sour gas at a very low price (far below what it would cost the operator to sweeten the gas). In so doing, the operator would create a captive, not a real, market.

Accordingly, based on royalty history and the benefits to be derived from a uniform royalty valuation standard, the oil and gas industry and royalty owners would all be better served in the long run by a single valuation standard for all commonly encountered royalty provisions, whether found in leases, lease assignments, or deeds. That standard should require royalties to be remitted, whether in kind or in value, on the basis of a first-marketable product, an approach that avoids the difficulties of calculating an intrinsic value for unmarketable products or of forcing royalty owners to accept unmarketable products. Operators should not be required to share downstream profits with royalty owners where oil or gas is marketed beyond the first real and substantial market.[132] This approach eliminates the need for controversial work-back calculations except for costs necessarily incurred to move the gas to a first market beyond the immediate vicinity of the well, the royalty owner's proportionate share of production taxes, and in some circumstances, processing costs incurred to extract natural gas liquids from wet gas. In calculating transportation costs, lessees should be allowed to deduct all reasonable, not to exceed actual expenses, but should not be allowed to treat their own transportation facilities, or those of a closely held affiliate, as a profit center.[133] This general approach should apply whether royalty is payable in kind or in value and whether the royalty is a lease royalty, a non-participating royalty or an overriding royalty. In other words, royalty provisions of whatever type should be construed as a forest of very similar trees, not as individual trees in a diverse forest.[134]

Unfortunately, given the mix of views encountered in the various states concerning royalty valuation standards, we may have arrived at the worst possible result, which is that royalty valuation must be determined on a state-by-state, interest-by-interest, and clause-by-clause basis. The prospect

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132. Anderson III, *supra* note 6, at 687-89.

133. For guidance in the calculation of reasonable gathering, transportation, and transportation-related costs, see generally Anderson IV, *supra* note 7 (relating to first-marketable product jurisdictions) and Anderson I, *supra* note 1 (addressing the inappropriateness of deducting rates of return after income taxes).

134. Anderson II, *supra* note 6, at 553. *See also* Anderson III, *supra* note 6, at 612.

of having various royalty valuation approaches (that vary state-to-state, that depend upon the type of royalty interest at issue, that charge trial courts with the task of narrowly and strictly construing discreet words and phrases in royalty provisions often resulting in strained definitions, and that, in turn, lead to varied results from case to case) will only serve to further complicate an already complex and expensive royalty maintenance and administrative system. Moreover, these various approaches will fuel litigation in states whose courts have not considered the various royalty valuation issues. The result will be large bodies of case law that offer little guidance to parties facing a royalty valuation dispute. The end result will serve only to make domestic exploration and production even less competitive in the world marketplace.