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Marketable Product: What Did Kuntz Say? What Did Merrill Say?

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MARKETABLE PRODUCT: WHAT DID KUNTZ SAY? WHAT DID MERRILL SAY?

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Introduction

I have written extensively about the marketable-product approach to royalty valuation, first articulated by the late Professor Maurice Merrill in his volume dealing with implied covenants and subsequently by the late Professor Eugene Kuntz in his seminal legal treatise on oil and gas law.[1]

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1. My articles dealing with royalty valuation include the following: *Self or Affiliate Gas Processing: Howell v. Texaco, Inc.*, 42 Rocky Mtn. Min. L Found. J. 331 (2006), a revision of portions of *Howell v. Texaco, Inc. and State ex rel. Oklahoma Tax Commission v. Texaco Exploration and Production, Inc*., Oklahoma City Mineral Lawyers Society (September 2005) and *Howell v. Texaco—Case Analysis*, Oklahoma Bar Association Mineral Law Newsletter (Feb. 2005); *Rogers, Wellman, and The New Implied Marketplace Covenant*, SPECIAL INST. ON PRIVATE OIL AND GAS ROYALTIES (Rocky Mtn Min. L. Found 2003); *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,* 35 LAND & WATER L. REV. 1 (2000), reprinted 37 PUBLIC LAND & RESOURCES L. DIG. 107 (2000), reprinted in LANDMAN (2001); *Royalty Valuation: Calculating Freight in a Marketable-Product Jurisdiction*, 20 E. MIN. L. INST. 10-1 (2000), reprinted 19(2) INST. OF PETROLEUM ACCOUNTING 12 (2000); *Royalty Valuation: Should Royalty Obligations Be Determined Intrinsically, Theoretically, Or Realistically? Part 1: Why All The Fuss? What Does History Reveal?*, 37 NAT. RES. L. J. 547 (1997) (actually published in 1998), revision reprinted in 17(2) Inst. of Petroleum Accounting 1 (1998); *Royalty Valuation: Should Royalty Obligations Be Determined Intrinsically, Theoretically, Or Realistically? Part 2: Should Courts Contemplate The Forest Or Dissect Each Tree?*, 37

Two companion articles[2] contained a thorough—some might say exhausting—discussion of royalty valuation commentary and case law, including a discussion of the views of Kuntz and Merrill. My limited purpose today is to focus on the views of Kuntz and Merrill without discussing the full myriad of case law on this divisive topic.

In my opinion, the Kuntz marketable-product approach represents the appropriate default rule for royalty valuation. Unfortunately, Kuntz's logical and sensible view has been rejected by lawyers for royalty owners and lawyers for lessees because neither group is happy with what would be the resulting outcome. Lawyers for lessees believe that Kuntz's and Merrill's views go too far in protecting the interests of royalty owners. Lawyers for royalty owners believe that Kuntz's and Merrill's views do not go far enough in protecting the interests of royalty owners. Thus, when making royalty valuation arguments, both groups of lawyers take an "all or nothing" approach.

As a result, and even more unfortunately, some courts have adopted this "all or nothing" approach to royalty valuation—some ruling in favor of royalty owners and some ruling in favor of lessees. At one extreme are the Alberta courts, where royalty valuation occurs at the mouth of the well. When calculating royalty in Alberta, lessees are allowed to deduct the costs of separating the oil and gas stream from associated saltwater as well as the costs associated with saltwater disposal.[3] Even Texas has not gone this far—at least not yet, holding, under a common bifurcated royalty clause providing from proceeds of sale at the well or market value at the well for sales off the premises, that royalty must be valued on the leased premises,

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NAT. RES. L. J. 611 (1997) (actually published in 1998), revision reprinted in 17(3) Inst. of Petroleum Accounting 1 (1998).

2. *Royalty Valuation: Should Royalty Obligations Be Determined Intrinsically, Theoretically, Or Realistically? Part 1: Why All The Fuss? What Does History Reveal?*, 37 NAT. RES. L. J. 547 (1997) (actually published in 1998), revision reprinted in 17(2) Inst. of Petroleum Accounting 1 (1998); *Royalty Valuation: Should Royalty Obligations Be Determined Intrinsically, Theoretically, Or Realistically? Part 2: Should Courts Contemplate The Forest Or Dissect Each Tree?*, 37 NAT. RES. L. J. 611 (1997) (actually published in 1998), revision reprinted in 17(3) Inst. of Petroleum Accounting 1 (1998).

3. Acanthus Resources Ltd. v. Cunningham and Sullivan, 57 Alta. L.R.(3d) 9, [1998] 5 W.W.R. 646, 213 A.R. 375, 37 B.L.R.(2d) 89 (Alberta Q.B.) (but reducing the lessee's cost calculations from $8.00 per cubic meter to $1.00, stating that the court's task was to determine costs, not set rates as though it were a ratemaking regulatory agency, and rejecting the lessee's evidence of treating rates charged by custom treating services on the grounds that such rates were unrelated to costs and unrelated to the particular oil in question). The Alberta view, at least in part, may be based on the non-recognition in Canada of implied covenants.

not strictly at the mouth of the well.[4] The Texas court is so attached to its view that it even held that language expressly disallowing post-lease deductions was "surplusage" where the basic royalty clause called for royalty valuation "at the well."[5]

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4. Exxon Corp. v. Middleton, 613 S.W.2d 240, 244 (Tex.1981). The court rejected in part Butler v. Exxon Corp., 559 S.W.2d 410 (Tex.Civ.App.1977), appeal after remand, 585 S.W.2d 881 (Tex.Civ.App.1979), which had held, based upon an argument by Exxon that a sale 100 feet off of the leased premises was a sale at the well.

5. Heritage Resources, Inc. v. NationsBank, 939 S.W.2d 118 (Tex. 1996). In this case, the royalty clause required payment on the basis of the market value of gas at the well. Although the court never provides a definition, the court states that the phrase "market value at the well" has a commonly accepted meaning in the oil and gas industry. The court did define "market value" as "the price a willing seller obtains from a willing buyer," but the concluded that "market value at the well" could be calculated by "subtracting reasonable post-production marketing costs from the market value at the point of sale" and that "[p]ost-production marketing costs include transporting the gas to the market and processing the gas to make it marketable." The court seemed totally unaware of the inherent inconsistency in its reasoning. For there to be a willing seller and willing buyer, a marketable product and a market are needed. When all of these elements are present, market value may be determined and nothing needs to be deducted except perhaps freight.

The court reached its conclusion notwithstanding express lease language providing that "there shall be no deductions from the value of Lessor's royalty by reason of any required processing, cost of dehydration, compression, transportation, or other matter to market such gas." The court ruled that this language was "surplusage as a matter of law." Apart from the express reference to transportation, which does seem inconsistent with the phrase "at the well," the no-deduction clause may be "belt and suspenders," but the entire royalty clause certainly cannot mean what the court concluded—that the non-deduction clause is surplusage. Read as a whole, the royalty clause provides that the lessee may not take any deductions from the market value of the gas. The additional "no-deduction" clause underscores that the lessee must pay royalty on the full market value of production. And the words "market value" necessarily require the existence of a marketable product. Thus, just as with other "market price," "market value," "proceeds," and "amount realized" clauses, at a minimum under the *NationsBank* clause, royalty is payable on a *marketable product*. The further clause denying deductions is not surplusage. It can be easily harmonized, which is what courts are supposed to do when construing instruments that contain seemingly inconsistent terms. One means of harmonizing this language would be to construe the entire royalty clause in light of how the phrase "at the well" was defined in *Exxon Corp. v. Middleton*, 613 S.W.2d. 240, 244 (Tex. 1981), wherein the Texas Supreme Court stated that "at the well" was anywhere on the leased premises. This would mean that the lessor could not be charged through royalty accounting for any transportation of oil or gas to the boundary of the leased premises. Another alternative would be to construe "at the well" as anywhere in the vicinity of the field, as defined in *Butler v. Exxon Corp.*, 559 S.W.2d. 410 (Tex. Civ. App. El Paso 1977, writ ref'd n.r.e.) (but later rejected in *Middleton*). Still another means of harmonizing would be to construe the clause as a whole applying a plain-meaning

The fact that some courts, including Texas, have rejected the Kuntz and Merrill approaches outright is puzzling since none of Kuntz's contemporary scholars, including A. W. Walker, Jr., Howard Williams, or Charles Meyers, ever expressly disagreed with them about royalty-valuation. Kuntz's immediate successor at the University of Oklahoma, Richard Hemingway, supported the marketable-product approach as the better one.[6]

At the other extreme is West Virginia, where the court essentially held that royalty is payable at the ultimate point of an actual arm's-length sale, no matter how far downstream of the well that such a sale might occur—apparently even if the actual sale occurs at a location beyond an established market that is closer to the well.[7] Not even Colorado has gone this far, but Colorado does require the lessee to pay royalty on gas that is in both a first-marketable condition and at a first-market location.[8] Clearly, the courts of Colorado and West Virginia have gone well beyond both Kuntz and

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construction: that the lessee was obliged to pay royalty based upon the gross price received by the lessee, but never less than on the basis of market value at the well.

Although *Nationsbank* is reported and continues to be cited, the case should have little precedential value. On motion for rehearing, one of the justices who had joined in the majority opinion recused himself, two justices on the majority opinion, together with two dissenting justices, would have granted rehearing, another justice who had previously joined in the majority opinion sided with the concurring justices. This left only the author of what had been the majority opinion continuing to support that opinion, along with three concurring justices refusing to grant rehearing. Four justices favored rehearing. Thus, the result in the case stands based upon a 1 - 3 - 4 deadlock. *See* Case. No. 95-0515 (Tex. March 21, 1997) (denial of rehearing) (Gonzales, J., dissenting).

Earlier Texas precedent seemed to support a marketable-product approach. *See, e.g.*, Winterman v. McDonald, 102 S.W.2d 167, 173 (Tex. 1937) (stating that the "term 'free royalty' . . . must mean that the interest . . . must not bear any part of the expense of the production, sale, or delivery thereof"); Pan American Petroleum Corp. v. Southland Royalty Co., 396 S.W.2d 519, 524—25 (Tex. Civ. App. El Paso 1965, writ dism'd) (citing the *Merrill* view that the lessee bears the sole costs of preparing oil and gas for market if it is unmerchantable in its natural form and noting the "well-adjudicated and accepted legal principle that royalty interests are not chargeable with the expenses of production, preparation, marketing, etc." but recognizing the deductibility of transportation costs); and Miller v. Speed, 248 S.W.2d 250, 256 (Tex. Civ. App. Eastland 1952, no writ) (noting that royalty is "free of cost of producing, saving, and preparing for market").

6. RICHARD W. HEMINGWAY, THE LAW OF OIL AND GAS § 7.4 (3d ed. 1991)

7. Tawney v. Columbia Natural Resources, L.L.C., 633 S.E.2d 22 (W. Va. 2006).

8. Rogers v. Westerman Farm Co., 29 P.3d 887 (Colo.2001). The court of appeals' opinion in the case was consistent with the Kuntz and Merrill marketable-product views. Rogers v. Westerman Farm Co., 986 P.2d 967 (Colo. App. 1998).

Merrill. Indeed, in the leading West Virginia case, the court cited neither Kuntz nor Merrill.[9]

Oklahoma[10] and Kansas[11] are somewhere between the Texas and West Virginia extremes, so far closer to the Merrill and Kuntz approach. Because Professors Kuntz and Merrill are revered in Oklahoma and because existing royalty-valuation case law in both Kansas and Oklahoma are similar, one or both courts may end up where Kuntz or Merrill have argued. Kansas case law and perhaps Oklahoma case law are closest to the Kuntz and Merrill views. Neither the Kansas nor Oklahoma Supreme Court has expressly rejected what either Kuntz or Merrill have said about royalty valuation. Neither court has intentionally adopted either a rule of law or a rule of construction radically different from what Kuntz and Merrill have said in their respective treatises about royalty valuation.

A careful reading of Kuntz and Merrill illustrates that neither scholar was out to make a radical change in royalty-valuation as practiced in the industry at the time of their writings—Merrill in the 1930s and Kuntz in the 1950s. Cases cited favorably by both scholars supported their measured approaches as explained in their respective treatises. Nevertheless, Professor Kuntz did take a somewhat different approach to royalty valuation than Merrill—a difference that is apparent when one compares what Kuntz said and where he said it in his treatise on oil and gas law with what Merrill says in his treatise on implied covenants. Notwithstanding the fact that Professors Kuntz and Merrill agree on the destination—that the marketable-product approach is the appropriate default rule—they reach

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9. Tawney v. Columbia Natural Resources, L.L.C., 633 S.E.2d 22 (W. Va. 2006).

10. Mittelstaedt v. Santa Fe Minerals, Inc., 954 P.2d 1203 (Okla.1998) (holding that lessee must bear costs of making gas initially marketable); TXO Prod. Corp. v. State ex rel. Com'rs of the Land Office, 903 P.2d 259 (Okla.1994) (holding that dehydration and gathering costs are not deductible); Wood v. TXO Prod. Co., 854 P.2d 880 (Okla.1992) (holding that compression costs are not deductible); Johnson v. Jernigan, 475 P.2d 396 (Okla.1970); (holding that transportation costs to move product away from the leased premises are deductible).

11. Sternberger v. Marathon Oil Co., 894 P.2d 788 (Kan.1995) (holding that costs of an extensive gathering system are deductible where royalty was due on market price at the well); Sterling v. Marathon Oil Co., 576 P.2d 635 (Kan.1978) (holding that certain administrative, management, and legal expenses incurred to obtain an increased price were not deductible); Schupbach v. Continental Oil Co., 394 P.2d 1 (Kan.1964) (holding that compression costs are not deductible); Gilmore v. Superior Oil Co., 388 P.3d 602 (Kan.1964) (holding that compression costs are not deductible). In Smith v. Amoco Prod. Co., 31 P.3d 255 (Kan. 2001), the court held that Amoco had a duty to market gas as an experienced operator of ordinary prudence under the circumstances, having due regard for the interests of the itself and its lessor, whether royalty was due on proceeds or market value.

their destination by different paths. Kuntz's path follows the tracks of typical royalty clauses found in oil and gas leases. Merrill's path does not track royalty clauses. Merrill chooses his own path—mapped out by his view of the implied covenant to market. Some courts have failed to recognize these different paths. For example, although the Colorado Supreme Court has cited Kuntz,[12] the court's own analysis is much closer to Merrill's view.

What did Merrill say about royalty valuation?

Professor Merrill's first edition of his one-volume treatise, published in 1926, addresses covenants implied in oil and gas leases. He did not discuss his marketable-product views in this initial volume.[13] His second edition, published in 1940, did discuss the marketable-product approach to royalty valuation. The second edition was last supplemented in 1964.

To fully understand the Merrill view, one must first read the introductory sections to his treatise. These sections explain how the lessor and lessee have divergent views on exploration, development, marketing, and royalty, and how scholars and courts have generally classified implied covenants.[14] Merrill acknowledges that an implied covenant is a "fiction, used like other fictions by the law in order to achieve a *desirable result*."[15] Implicitly, therefore, an implied covenant should not be used to achieve an "undesirable result." Merrill discusses his view of each implied lease covenant in detail. Thus, one can glean his ideas on what would be too restrictive or too expansive in construing an implied covenant, which, in either case, would lead to an "undesirable result."

Merrill discusses the implied duty to market in sections 84 through 92 of his treatise. In section 84, Merrill states: "Whatever the [royalty] provision, the result of the customary conduct above referred to is that in most cases the lessor thinks of his [royalty] return solely in the sense of a fixed portion of the money realized from the operations of the lessee and the lessee in effect so treats it."[16] Merrill concludes that the lessee owes an implied duty "'to [diligently] market the production' within … a reasonable time … [for]

12. Rogers v. Westerman Farm Co., 29 P.3d 887, 900, 905, 911 (Colo.2001).

13. He does discuss a duty to market—that is a general duty to produce an economic discovery. MAURICE H. MERRILL, COVENANTS IMPLIED IN OIL AND GAS LEASES § 54 (Thomas 1926).

14. MAURICE H. MERRILL, THE LAW RELATING TO COVENANTS IMPLIED IN OIL AND GAS LEASES, §§ 1-7 (Thomas 1940) (hereafter Merrill).

15. *Id*. § 7, at 27 (emphasis added).

16. *Id*., § 84 at 212.

the highest price obtainable by the exercise of reasonable effort."[17] Merrill reasons: "If it is the lessee's obligation to market the production, it seems necessarily to follow that his is the task also to prepare it for market, if it is unmerchantable in its natural form. No part of the costs of marketing or of preparation for sale is chargeable to the lessor."[18] This reasoning is entirely logical as a matter of simple contract law. If one party has a duty, the risk and cost of performing that duty should be borne by that party, unless the contract expressly says otherwise. This is certainly not a radical line of reasoning.

Merrill then criticizes California case law that subjects lessors to industry customs,[19] and Louisiana case law that distinguishes "in kind" and "in value" royalty clauses regarding the duty to market cost free.[20] Regarding the latter, he states:

> Too much dependence is placed upon the language of a printed form, in the preparation of which at least one party has had no part and to the selection of which the other frequently has given no consideration, if upon a variance in that language a difference is established in a duty not specifically referred to. The lessor in the normal lease wants no oil or gas. He would not be prepared to deal with it or handle it if it were tendered him. The sole thought associated with royalties in his mind is monetary return, and it is erroneous to read into the royalty clauses stipulations

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17. *Id*. at 212-13. This is very similar to what the Kansas Supreme Court said in Smith v. Amoco Prod. Co., 31 P.3d at 273.

18. *Id*. § 85 at 214. In his last supplement to this volume, published in 1964, Merrill added additional sentences: "Neither are ordinary costs of operation thus chargeable. The case obviously is different where the lessor has stipulated for a share of profits or if there is an express provision allowing the deduction of costs." Merrill Supplement § 85 at 72. Later in this supplement he criticizes a California case that allowed the lessee to charge for dehydration, including an overhead charge. Id. at 73.

Commentators have pointed out that the cases cited by Merrill for this proposition (see Merrill § 85, n. 23) do not squarely support it. Richard B. Altman & Charles S. Lindberg, *Oil and Gas: Non-Operating Oil and Gas Interests' Liability for Post-Production Costs and Expenses*, 25 OKLA. L. REV. 363 (1972). Admittedly, Merrill was advocating his view of what a "desirable result" should be, not reporting on actual holdings, but his views are still not radical and general support for his view can be found in many of the cases that he cites and in others that he does not.

19. Merrill § 85 at 215-216.

20. *Id*.

> concerning the cost of marketing and preparation which are not specifically expressed.[21]

It is somewhat surprising that Merrill fails to state that a lessor who was tendered royalty in kind would necessarily either need to receive a marketable product or would have to replicate wasteful expenditures in duplicating the lessee's facilities that were necessarily established to market the lessee's share. Such duplication (waste) would lead to an "undesirable result." Since in-kind royalties tended to predate in-value royalties, the logical question would be: Should the lessee be allowed to charge the lessor when paying in value but not when paying in kind? Presumably, without some additional change in the royalty language from in kind to in value, the answer is that the lessee should not be able to so charge.

Thereafter, Merrill comments on the practice of purchasers of crude oil "in some regions" that deduct 3% from the amount of oil taken as an allowance for impurities. Merrill deduces that the lessor should suffer this reduction in royalty only if the impurities could not have been removed by the lessee "at a reasonable cost."[22] On the other hand, if the lessee "could not dispose of the impurities at a reasonable cost, the loss should fall on both lessor and lessee in proportion to their interest in the inferior oil."[23] Thus, Merrill's view of the duty to market is subject to a "reasonable cost" limitation.[24]

Merrill's comments on this practice seem to ignore that the deduction is taken on the production volumes, which if accurately reflecting condition of the oil, involve a deduction for waste products that the purchaser should not have to pay for. If the impurities in a volume equal to 3% actually have been removed, the production volume would be 3% less. Thus, the lessor would realize no apparent net gain in royalty. Moreover, the lessee presumably suffered this same 3% volume reduction from its working-

21. *Id*. § 85 at 216.

22. *Id*. at 217.

23. *Id*. at 217-18.

24. This limitation could be used to explain the decision in *Piney Woods Country Life School v. Shell Oil Co*., 726 F.2d 225 (5th Cir. 1984), where the court allowed the lessee to deduct treating costs because the gas was extremely sour. Based upon the amount at issue in the case, the treating costs were apparently substantial. For critical commentary about *Piney Woods*, see 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. RES. L. J. 611, 620-631 (1997) (actually published in 1998), revision reprinted in 17(3) Inst. of Petroleum Accounting 1 (1998).

interest share of production. He then speculates that this 3% reduction may simply be arbitrary on the part of the purchaser and further speculates that lessees may be powerless to do anything about this reduction without greater competition among purchasers.[25]

In § 86, Merrill addresses the proper location for royalty valuation. This section begins: "Ordinarily, the product is marketed from the lease, and the lessee's duty is merely to arrange for sale there. [footnote omitted] But suppose the lessee carries the product to a distant point of sale, either for his own convenience or because there is no market at the field?"[26] He then posits three possible solutions:

> 1. He must account for the price received with no allowance for the transportation to the market; 2. He must account for the price received, less the reasonable cost of transportation from the lease to the market; 3. He may purchase the product for his own account at the lease, or treat it as though it were so purchased, at a price representing its fair value there, and may keep for himself whatever profits results from the enhanced price at the outlet in excess of transportation cost.[27]

Merrill then states: "For the first, there is no authority, and it seems impossible to conceive of any arguments in its favor. The transportation to the distant point is not part of the legitimate operating expense of the lease."[28] He concludes: "Upon principle, the second seems preferable" especially "[i]f there is no market value in the field."[29]

Note Merrill's careful language in these passages. Royalty is owed at the lease, which is a bit more broad than "at the well" or "wellhead." His later references to "a distant point of sale" and "no market value in the field" can be reconciled as follows: The location for royalty valuation is at the lease (within the leased premises), but known market value in the field may be used as a surrogate for lease value. A market value established beyond the field is at "distant point of sale." Accordingly, transportation costs incurred beyond the field are proportionally chargeable to the lessor through royalty accounting.[30]

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25. Merrill § 85 at 218.
26. *Id*. at 219.
27. *Id*.
28. *Id*.
29. *Id*. at 220.
30. This is consistent with result in Johnson v. Jernigan, 475 P.2d 396 (Okla.1970).

In his last pocket supplement, published in 1964, Merrill mentions the problem of apportioning the costs of transporting a product for treating, stating: "On principle, so much of the transportation as is reasonably incurred in getting the product to the place of treatment should be borne by the lessee, as a part of the cost of preparation for market."[31] The words "so much of" indicate that Merrill would apparently apportion such expense, making some portion of the transportation expense not proportionally chargeable to the lessor through royalty accounting and some portion chargeable. He offers no details about how to accomplish this apportionment.

In Section 87, Merrill discusses whether the lessee must "construct facilities" to use or provide an outlet for production. Although Merrill's discussion is very brief, and his personal view is not expressly stated, he does imply agreement with A.W. Walker, Jr., that such a duty may exist if "there is reasonable ground for anticipating profit from the adventure."[32] The lessee may have a duty to construct facilities if investment would be profitable, but, by analogy to what he says about transportation, the lessee would account for royalty at the price received, less the reasonable cost of constructing and operating the facilities. He concludes: "Of course, there is no duty to go into a completely different business…."[33] Merrill does not suggest that the lessee has to account for royalties without a consideration of costs. Having to remove sediment from crude oil is one thing.[34] Building and operating a processing plant to extract natural gas liquids (NGLs)—a midstream sector activity more akin to refining than to production—is quite another thing.

In a new section, § 89A, added to his supplement, he discusses the lessee's "use" of wet gas for extracting liquid hydrocarbons.[35] In the case of a sale of wet gas to the lessee's processing affiliate, the implied obligation to "obtain the best price reasonably possible [footnote omitted] affords the safeguard against collusive depression of prices which might arise from such relationship."[36] He then suggests a consideration of comparable sales of wet gas in other fields "where competitive conditions prevail" as an

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31. Merrill Supplement § 86 at 77 (1964).

32. Merrill § 87 at 221, citing A.W. Walker, Jr., *The Nature of Property Interests Created by and Oil and Gas Lease in Texas*, 11 TEX. L. REV. 399, 438 (1933).

33. *Id*. at 221-22.

34. See, e.g., Clark v. Slick, 211 P. 496 (Okla. 1922).

35. Merrill Supplement § 89A at 84-87.

36. *Id*. at 84.

appropriate means of testing whether the affiliate sales price represents a "proper basis" for the value of the wet gas.[37]

If the liquid hydrocarbons are extracted prior to the sale of the residue gas [perhaps including gas that is sold to an affiliate but which cannot be valued by looking to comparable sales in a competitive environment], he states: "If this extraction takes place prior to the sale of the residue gas, the price received for the latter cannot reasonably be considered the entire 'net proceeds' of the gas taken from the premises."[38] He concludes that "the correct solution appears to be … to require the lessee to account for the lessor's share of the gasoline extracted from the gas at the lessee's plant, at its fair value there, determined by all relevant data, with allowance for the costs of transportation to the plant and separation."[39] Thus, by adding this new section, § 89A, he makes a clear distinction between (1) treating costs incurred to remove impurities, and (2) processing costs incurred to remove NGLs. The former costs are not proportionally chargeable to the lessor through royalty valuation and accounting, but the latter are.

In Section 91, Merrill states: "The burden of proving a failure to employ reasonable diligence in operation is on the lessor…. He does not satisfy his burden by showing a failure to market an unmarketable product…."[40]

In summary, what does Merrill teach?

- In his treatise, as supplemented through 1964, Merrill teaches that, absent express lease provisions to the contrary, the lessee is implicitly obliged to incur reasonable costs necessary to secure a marketable product. Recall that he states the duty in the negative—the duty arises "if [the oil or gas] is unmerchantable in its natural form."[41] Thus, he recognizes that oil and gas may be merchantable[42] in its natural form. In today's (and yesterday's) marketplace, this obligation would surely include reasonable costs incurred to remove impurities, such as

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37. *Id*. at 84-85.
38. *Id*.
39. *Id*.
40. Merrill § 91 at 228.
41. *Id*. at §85 at 214.
42. His use of the term "unmerchantable" is not significant. Black's Law Dictionary cites "merchantable" as a synonym for "marketable." Black's Law Dictionary 1115 (10th ed. Thomson Reuters 2009, Garner edit.). "Marketable" is defined as "[o]f commercial quality; fit for sale and in demand by buyers." Id. "Merchantable" is defined as "[f]it for sale in the usual course of trade at the usual selling prices." Id. at 1137.

hydrogen sulfide and excess water, because one is unlikely to have "gas" until that is accomplished, and royalty is due on marketable gas.

- On the other hand, in today's (and yesterday's) marketplace, wet gas—gas saturated with NGLs—is marketable. Wet gas can and is sold to third-party processing plants for the extraction of valuable liquids, similar to how a barrel of crude oil is processed for gasoline, diesel, aviation fuel, asphalt, etc. Although large operators may sell wet gas to an affiliate processing facility or transfer custody to an affiliate for processing, these possibilities should not fundamentally change the lessee's royalty obligation. Recall that Merrill argues that "[o]f course there is no duty to go into a completely different business…."[43] He also places a "reasonable cost" limitation on the lessee's duty to market free of cost to the lessor.[44] Thus, requiring the lessee to absorb all costs of extracting NGLs without somehow allocating a proportionate share to the royalty owner would be unreasonable—that is, it would lead to an "undesirable result." NGL processing facilities are more akin to mini-refineries and are regarded as part of the midstream gas sector, not part of exploration and well operations. Thus, the unreasonable costs of processing wet gas for the extraction of NGLs, including related transportation, should be somehow proportionately shared, through royalty accounting, by the lessor and the lessee.

- As to the proper method of royalty accounting for NGL extraction Merrill discusses this in the new treatise section, § 89A, found in his final 1964 supplement.[45] "[T]he correct solution appears to be … to require the lessee to account for the lessor's share of the gasoline extracted from the gas at the lessee's plant, at its fair value there, determined by all relevant available data, with allowance for the costs of transportation to the plant and separation."[46] Thus, in the case of so-called POP (percentage of proceeds) or similar processing arrangements, the test for royalty accounting should be whether the

43. *Id*. at § 87 at 221-222.

44. *Id*. § 85 at 217-218. He speaks here of removing and disposing of "impurities," but surely he would not limit this statement just to impurities.

45. Merrill Supplement §89A at 84-87. In the case of unitization, Merrill states that the appropriate accounting method is by "deducting only such costs of manufacture as are not properly attributable to the employment of the gas in the unitized program." Id. at 86.

46. *Id*. at 85.

particular POP formula fairly represents comparable values of pre-processed gas or of post-processed gas and NGLs less the costs of NGL extraction. If the formula is a fair representation, then using the formula would seem to be a fair means of determining the royalty payable to the lessor. If the formula is not a fair representation, then the court can make the necessary adjustments so that the royalty owner is properly compensated.

- Finally, transportation costs incurred to move gas beyond the field to a distant point of sale away from the field should be borne proportionately, through royalty accounting, by the lessor and the lessee, preferably by deducting a share of the transportation costs.

What does Kuntz say about royalty valuation?

Professor Kuntz's multi-volume treatise on oil and gas law was published in the early 1950s and occasionally republished with replacement volumes through 1991. Although the treatise indicates that it is a revision of Thornton, Kuntz rewrote the entire treatise, using very little of Thornton's prior language.

As a basic default rule, Kuntz agrees with Merrill that royalty should be paid on a marketable product. He also agrees with Merrill on many of the details, but he begins his analysis from a different starting point. Unlike Merrill, Kuntz does not rely on the implied covenant to market. Rather, Kuntz relies upon the typical language of common oil and gas royalty clauses. Essentially, he takes a "plain meaning" contract interpretation approach to royalty valuation. His difference with Merrill is clear because Kuntz's discussion of royalty valuation issues does not occur in his treatise chapters on implied covenants,[47] but in his discussion of the royalty clause.

Kuntz discusses the oil and gas lease royalty clause in several chapters in Volume 3, chapters 38, 39, 40, 41, 42, 43, 44, and 45. For purposes of this essay, the key chapters are chapters 39 (addressing royalty on oil) and 40 (addressing royalty on gas). In chapter 40, Kuntz sets forth his marketable-product theory as follows: "It is submitted that the acts which constitute

47. Kuntz's discussion of implied covenants occurs in Volume 5 of his treatise, 5 EUGENE KUNTZ, OIL AND GAS, ch. 60, "Duty to Market the Product" (Anderson 1991) (hereafter Kuntz). In Volume 5, chapter 60, he identifies the royalty valuation issue and then in footnotes he refers the reader to §§ 39.4(b) (oil royalty clause) and 40.5(b) (gas royalty clause) for further discussion. These two sections are in Volume 3, where he discusses express, not implied, lease provisions.

production have not ceased until a marketable product has been obtained."[48] To understand the full meaning of this sentence, one must consider this statement in full context as it is the penultimate sentence of a six-sentence paragraph, which states in full:

> 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.[49]

Note that Kuntz expressly references "processing," which in the stated context of "processing or refining," can only reasonably mean processing wet natural gas for valuable natural gas liquids (NGLs). Moreover, his stated view regarding processing, which treats NGL extraction as downstream of production and part of the midstream sector, is consistent with reported case law as of the date of his commentary. Indeed, no reported case up to the present has ever squarely held that royalty should be paid on the value of NGLs without adjustment, either directly or indirectly, for the costs of processing the wet gas to remove NGLs. Numerous cases, including many cited by Kuntz, have either held or stated in dicta the opposite—that these processing costs may be deducted or otherwise factored into the calculation of the net royalty due a lessor.[50]

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48. Kuntz, § 40.5(b), page 351. Kuntz says the same regarding oil. Kuntz, § 39.4(b), page 299.

49. *Id*. § 40.5(b), at 351.

50. *See*, *e.g.*, Armstrong v. Skelly Oil Co. (No. 6406), 55 F.2d 1066, 1068 (5th Cir. 1932) (applying Texas law and holding that lessee properly accounted to lessor for royalty based upon a percentage of the revenues derived from the extraction of gasoline); Crichton v. Standard Oil Co., 150 So. 668, 669 (La. 1933) (holding that the cost of extracting gasoline is deductible when calculating royalty); Coyle v. Louisiana Gas & Fuel Co., 144 So. 737 (La. 1932) (holding that the cost of extracting gasoline is deductible when calculating royalty); O'Neal v. Union Prod. Co., 153 F.2d 157 (5th Cir. 1946) (applying Louisiana law

Note further that Kuntz expressly references "transporting." Kuntz never distinguishes "gathering" from "pipeline" transportation. To Kuntz, after gas becomes marketable, both gathering and pipeline transport, including related compression, are "transporting." Specifically, Kuntz states:

> A further distinction to be considered involves the determination of marketability of the product that has been extracted. Such distinction requires a consideration of the significance of situs in determining marketability. The situation is more likely to occur with gas than it is with oil, but it is possible for the lessee to extract gas which is otherwise valuable and marketable except for the fact that there is no market at the well because of the

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and holding that, under royalty based upon "net proceeds at prevailing market price at well," lessor was entitled to market value of wet gas at the well, not to royalty on the extracted gasoline); Phillips Petroleum v. Record, 146 F.2d 485, 486 (5th Cir. 1944) (applying Texas law and holding that where royalty is due at the "prevailing market rate," royalty is measured by market value of gas at the well, not on the value of products manufactured from gas); Danciger Oil & Refineries, Inc. v. Hamill Drilling Co., 171 S.W.2d 321 (Tex. 1943) (holding that overriding royalty is payable on the market value of the crude gas at the well and not on the gross value of extracted gasoline); Katschor v. Eason Oil Co., 63 P.2d 977 (Okla. 1936) (holding that where the lessee operates a gasoline plant used exclusively for the manufacture of gasoline from casinghead gas produced from the lease, "market value" royalty is synonymous with "actual value royalty, which may be established by subtracting the sum of the costs of manufacturing, depletion of the plant, and marketing costs from the total sales prices of the gasoline and residue gas); McCoy v. United Gas Pipeline Serv. Co., 57 F. Supp. 444 (W.D. La. 1932); Martin v. Amis, 288 S.W. 431 (Tex. Comm'n App. 1926) (holding that lessor is entitled to a 1/8 royalty on the 25% portion of the value of the extracted gasoline remitted to lessee after processing by a third party and not on the 75% portion retained by the processor).

The only case that is arguably contrary is *Wemple v. Producer's Oil Co*., 83 So. 232 (La. 1919), but this case is readily distinguishable because it involved extracting natural gasoline at the well through the use of a vacuum pump—a wellhead operation, not a downstream processing plant. Moreover, the court acknowledged that the outcome might be different if a greater expense had been involved:

> If the treatment of the casing-head gas were shown, in this case, to involve an expense greater in proportion to the value of the product than that incurred in the production and handling of the oil, it would perhaps be proper to increase the allowance to the operator in a like proportion; but no such showing has been made. To the contrary, the main expense which has been testified to that which is necessarily incurred in the production and saving of the oil, and in the treatment of the gasoline off the premises, at the blending plant; the additional expense of precipitating the gasoline, by merely passing the casing-head gas through water cooled coils, being apparently trifling, and more than compensated by the greater value of the product.

Id. at 1048.

> absence of pipeline facilities. In such instance, the fact of marketability of the gas should be determined on the basis of its quality rather than on the basis of its marketability as affected by the situs of the well.[51]

In other words, quality, not location, is the determining issue regarding whether gas is marketable. Kuntz concludes in the next paragraph: "…unless the lease reveals a contrary intention, the expenses incident to marketing [such as transporting] the product should be shared by the lessor and lessee."[52]

Regarding Kuntz's view of "quality," he teaches:

> 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.[53]

In the next paragraph, Kuntz states: "…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."[54] In other words, treating costs to remove impurities, such as hydrogen sulfide, and dehydration costs to remove water ordinarily should be borne solely by the lessee. These activities are a necessary part of production because the wellhead stream is not truly "gas" until such substances have been removed. But once treating and dehydration have occurred, then only valuable gaseous substances are left. Although that gas might sometimes be infused with valuable natural gas liquids (NGLs), Kuntz would regard gas sent to a processing plant for NGL extraction as marketable. Processing plants are generally owned and operated independent of well operations. While leasing land, drilling wells, operating wells, and operating separators, treaters, and dehydrators, and disposing of saltwater are part of the

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51. Kuntz at § 39.4(b), page 299.
52. *Id*.
53. *Id*. § at 40.5 (b), page 351.
54. *Id*.

"upstream," processing is part of the "midstream" oil and gas sector. Royalty valuation should not go beyond the upstream unless the royalty clause expressly so provides.

In the next paragraph, Kuntz states:

> 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 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.[55]

In Kuntz's view, apart from wellhead compression, which in part may be used to suck gas up the wellbore, and perhaps compression associated with removing impurities or water, compression is an element of transport—a cost that Kuntz believes should be deductible for royalty-valuation purposes. In other words, compression beyond the wellhead, but certainly beyond treating and dehydration, is a "midstream" activity. In his mentioned example, low pressure gas is compressed to feed the gas into a high pressure pipeline to obtain a higher price. The low pressure gas was marketable but the gas was compressed to secure a higher price—an example of taking a marketable product and enhancing its value. In such a circumstance the lessor would share proportionally in such costs (here compression) through royalty accounting.

Further regarding transport, Kuntz states:

> If the lease contains the unusual type of royalty clause which provides for the delivery of royalty gas to the lessor's credit free of cost in the pipeline to which the well is connected, the question which may be raised is whether or not the lessee is required to construct feeder lines at the lessee's own expense in order to deliver the lessor's royalty gas to a distant market. If the

55. *Id*. at page 352.

> problem is not solved by a specific provision in the lease, it is not difficult to conclude that the parties contemplated a delivery of royalty gas at the well and that the lessee should not be required to stand the entire expense of constructing a pipeline to carry the gas to a distant market. [footnote omitted] Similar to the situation involving oil, [footnote omitted] such conclusion is not inconsistent with the recognition of a duty to market the product. The lessee may be under a duty to seek a market for gas which it cannot deliver at the well as contemplated, but the existence of such duty should not require that the lessee carry the entire expense of delivering gas at a point other than at the well as contemplated.[56]

Note that Kuntz makes this statement in the context of a royalty clause expressly providing that the lessee is to deliver gas free of cost in the pipeline. The royalty clause does not contain the now common "at the well" phrase. In Kuntz's view, it is simply unreasonable to assume that the lessee has to absorb transport costs beyond the lease.

Comparing Kuntz and Merrill

Although Merrill and Kuntz reach similar conclusions—that royalty is due on a marketable product, they get there by different paths. Although Merrill is somewhat more willing to overlook minor differences in royalty-clause language, Kuntz is not. Kuntz would begin royalty valuation by reading the particular royalty clause carefully to see if each clause spoke to a particular issue in a way that might vary from his marketable-product approach. Nevertheless, Kuntz would probably conclude that many short-form, garden-variety royalty clauses found in leases such as the clause found in A.A.P.L. Form 675 lease would not vary from his marketable-product approach.[57] After all, Kuntz's marketable-product view is based upon his reading of such clauses. Kuntz's marketable-product approach is essentially a rule of construction. Merrill's marketable-product approach is

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56. *Id*. at 355-56.

57. *A.A.P.L. Form 675 Oil and Gas Lease Texas Form—Shut-in Clause, Pooling Clause*. This form is instructive of many royalty clauses because it contains both an "amount realized" (proceeds) and "market-value" provision. Likewise, Kuntz would undoubtedly regard short-form gas-royalty clauses calling for royalty on "market price," "net proceeds," or even "gross proceeds" as not negating his marketable-product approach, whether or not such leases were further modified by phrases such as "at the well," "at the mouth of the well," or "free of cost into the pipeline."

closer to a quasi-rule of law—he regards implied covenants as implied in law, not in fact—but even Merrill recognizes that express royalty provisions would control.

Some royalty clauses might allow the deduction of treating and dehydration costs. In contrast, other clauses might prohibit the deduction for processing NGLs. To illustrate the importance of reading the lease royalty clause when taking the Kuntz approach, Kuntz states: "The different types of royalty clauses are easily described and classified in the abstract, but it is frequently very difficult to make a proper classification of a specific clause. [footnote omitted] Because the royalty provisions vary as to type, a class action is not appropriate to recover deficiencies in payment of royalty under separate leases and units in separate fields."[58]

Conclusion: Which is the better approach, Kuntz or Merrill?

Although either approach reaches the same destination, on balance, I think the Kuntz approach is the better one and the one that seems to come closest to the current Kansas and Oklahoma views. One problem with the Merrill approach is that he views implied covenants to be implied in law. Most courts, including the Kansas[59] and Oklahoma[60] Supreme Courts, have held that they are implied in fact. This difference may make it more likely that Kansas and Oklahoma courts, when faced with a direct inquiry, may choose to follow Kuntz over Merrill, but both scholars have been cited numerous times by both courts. Of course, the real issue is whether the Kansas and Oklahoma courts will ultimately arrive at an altogether different destination.

58. Kuntz 40.4(a) at 323.
59. Smith v. Amoco Prod. Co., 31 P.3d at 264-65.
60. Indian Territory Illuminating Co. v. Rosamond, 120 P.2d 349, 354 (Okla. 1941).