Oil & (and) Gas Law: Royalty Valuation: Rogers v. Westerman Farm Co.: Burdening Lessees with an Implied Duty to Deliver Gas to a Marketable Location

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Oil & Gas Law: Royalty Valuation: *Rogers v. Westerman Farm Co.*: Burdening Lessees with an Implied Duty to Deliver Gas to a Marketable Location

I. Introduction

In July 2001, the Colorado Supreme Court plowed new ground in the realm of oil and gas law. In *Rogers v. Westerman Farm Co.*, the court created new law regarding transportation costs in gas lease royalty valuation. The court invoked the implied covenant to market to impose upon the lessee a duty to deliver gas to a marketable location away from the vicinity of the well and to produce a first-marketable product. According to *Rogers*, both obligations are cost-free to the royalty owner. This novel marketable-location duty goes against the grain of both case law and commentary on gas lease royalty valuation, which generally holds that lessees may deduct transportation costs from the wellhead, or stated another way, holds that lessees do not owe royalty on value added by transportation.

A typical bifurcated royalty clause provides that “royalty is payable on 1/8 of the ‘market value’ of gas ‘at the well’ when gas is sold or used ‘off the premises,’ but on 1/8 of the ‘amount realized’ when gas is sold ‘at the well.’” Under such a clause, the lessee owes the lessor a proportion of the sale price of the gas when an arms-length transaction occurs in the vicinity of the well. If no arms-length sales occur in the vicinity of the well, the lessor receives a share of the “market value” of the gas. The typical basis for the “market value” is comparable sales of similar gas at the wellhead or the downstream price of the gas minus certain costs. Regardless, the “market value” should reflect the value of the gas in the vicinity of the well. This may require a

1. 29 P.3d 887 (Colo. 2001).
2. See id. at 902, 905.
3. See generally id. at 906.
5. See id. at 632.
7. See id. The basis for determining “market value” depends on a number of factors; however, the threshold factor typically relates to the lease jurisdiction’s approach to royalty valuation, discussed infra Part II.B.
work-back calculation to determine the "at the well" market value of the gas. Therefore, it is generally to the lessee's advantage to deduct off the top any costs incurred in preparing and transporting the gas for sale at a downstream market so as to minimize his royalty obligations.

Attempts on the part of the lessee to deduct such costs are often the flashpoint of gas-royalty litigation because the royalty owner wants to receive the highest possible royalty and the lessee wants to pay the lowest possible royalty. The case law on royalty valuation fuels this litigation because of the increasingly wide range of views expressed on royalty-valuation fundamentals. Even within single jurisdictions, case law tends to be very anecdotal and confusing. Nevertheless, in all jurisdictions, the lessee incurs post-wellhead costs that add value to the gas. The issue is whether the lessee can deduct these costs in calculating the royalty payable to the royalty owner. Until Rogers, the well-settled rule was that lessors and lessees appropriately shared transportation costs to a distant market.

The Rogers court ignored the traditional transportation rule by requiring lessees to absorb transportation costs and reached its marketable-location decision even though the leases in question expressly stated that royalty was payable "at the well." The court held that the phrase was silent regarding transportation costs. Contrary to the Rogers court's decision, "at the well" lease language is not silent regarding transportation costs to an off-lease market. "At the well" signals that royalty valuation should occur in the vicinity of the well and that transportation costs to a distant market are properly allocated between both the lessor and lessee. In addition, the implied covenant to market should not trump "at the well" lease language and impose upon the lessee an implied covenant to deliver gas to a market location. The implied covenant to market carries with it a duty on the part of the lessee to transform the gas into a marketable product if it is not in a marketable condition as the gas emerges from the wellhead. Therefore, because "at the well" means that royalty valuation occurs in the vicinity of the well, and

9. See Anderson, Calculating Freighi, supra note 6, at 338. A work-back calculation may include different cost components depending on the lease jurisdiction's approach as discussed infra Part II.B.


12. See id.

13. See discussion infra Part IV.C.
because the implied covenant to market only carries with it the duty to place gas in a marketable condition and not a marketable location, the lease should not require lessees to bear the costs of transportation to a distant market.

This note examines Rogers and analyzes the Colorado Supreme Court’s erroneous construction of “at the well” lease language and its treatment of transportation costs to a distant market.\(^{14}\) Part II explores, through case law and scholarly commentary, the two basic approaches to royalty valuation in the context of “at the well” lease provisions. It also explores how these approaches have traditionally treated distant-market transportation deductions. Part III takes an in-depth look at the Rogers decision. Part IV analyzes how Rogers departed from established case law and commentary on the construction of “at the well” provisions, the definition of “marketable,” and the traditional rule regarding transportation deductions. Finally, Part V focuses on the impact of Rogers on lease-royalty jurisprudence and specifically addresses Oklahoma law and the appropriate judicial response for Oklahoma courts.\(^{15}\)

II. The Law Prior to Rogers

A. Transportation Costs and the Two Basic Approaches to Royalty Valuation “At the Well”

Two basic approaches prevail in most jurisdictions regarding royalty valuation in an “at the well” lease: (1) the wellhead-valuation approach and (2) the marketable-product approach. The wellhead-valuation approach is essentially a property law approach to royalty valuation and generally requires the lessee to pay royalties on the value of the gas upon its severance from the wellhead.\(^{16}\) The marketable-product approach reflects contract law principles regarding royalty valuation and generally requires a lessee to transform gas

\(^{14}\) “Transportation costs,” for the purposes of this note, focus primarily on actual transportation/freight costs involved in physically moving gas to downstream markets. In some jurisdictions, transportation may include the gathering and compression necessary to deliver gas to a distant market; however, this note will not focus on any particular component of transportation.

\(^{15}\) This note uses terminology specific to the oil and gas industry. Although some jurisdictions use terminology inconsistently, this note looks to Norman J. Hyne, Dictiona

into a first-marketable product from which royalties are due on the value of the marketable gas. 17 This approach also recognizes that lessees do not owe royalty on value added by transporting the gas away from the vicinity of the well. 18

1. Wellhead-Value Approach

The wellhead-value approach stems from the property law notion that gas is real property in the ground and becomes personal property once severed at the wellhead. 19 In jurisdictions adopting this approach, especially regarding leases that expressly refer to "at the well," courts generally construe lease-royalty provisions to mean that when calculating royalty lessees may deduct a proportionate share of costs incurred after production ends. 20 In other words, "production" ends upon the severance of raw gas at the wellhead. 21 Therefore, wellhead-valuation jurisdictions imply the term "at the well" into leases that are silent as to location.

The marketable condition of gas is of little concern for royalty valuation under a wellhead-value approach. Lessees pay royalty on the value of the gas at the wellhead determined by actual or comparable sales of similar gas or by a work-back royalty calculation. 22 If the gas is water-saturated and sour 23 so that the purchaser can market it in that condition, the gas is valued using a work-back calculation based on the downstream value of dehydrated,
sweetened gas,\textsuperscript{24} less the costs of dehydration and treating (sweetening). Regardless of the condition of the gas, this approach seeks to value the gas upon severance from the wellhead.\textsuperscript{25} Therefore, under this approach, lessees traditionally deduct post-production costs, including transportation, except, of course, where gas is sold in its raw state at the wellhead.\textsuperscript{26}

2. *Marketable-Product Approach*

Under a marketable-product approach, a lessee’s production obligation is complete when the gas becomes marketable.\textsuperscript{27} This approach relies on a fact determination of when the gas first becomes a marketable product.\textsuperscript{28} “At the well” lease language speaks generally to location and suggests that valuation occurs in the vicinity of the well.\textsuperscript{29} Generally, lessees may not deduct costs incurred before the gas is marketable from royalty calculation, whereas both the lessor and lessee proportionately share those costs incurred after obtaining a first-marketable product.\textsuperscript{30} Case law from Oklahoma, Colorado, Kansas, and West Virginia share many common ties concerning such lease language and cost allocation.\textsuperscript{31} In most jurisdictions, including marketable-product jurisdictions, lessees may properly deduct from royalties transportation costs incurred in moving gas to a distant market.\textsuperscript{32}

\begin{itemize}
\item \textsuperscript{24} “Sweet gas” contains no significant amounts of hydrogen sulfide because it has been removed. See id. at 510.
\item \textsuperscript{25} See Anderson, *Royalty Valuation Part 1*, supra note 19, at 550-51.
\item \textsuperscript{26} Some gas may be sweet when severed at the wellhead and, thus, does not require dehydration. In this instance, the wellhead-value approach and the marketable-product approach would result in the same royalty valuation. See generally Anderson, *Calculating Freight*, supra note 6, 338-41 (comparing the basic differences between the wellhead-value approach and the marketable-product approach to calculating royalty).
\item \textsuperscript{27} See generally 3 EUGENE KUNTZ, LAW OF OIL & GAS § 40.5(b), at 348-57 (1989) (discussing the duty of the lessee to market royalty gas).
\item \textsuperscript{28} Although some courts and state statutes treat marketability as a question of law, this article adopts the view advocated by Professors Kuntz and Anderson that marketability is appropriately a question of fact. See 3 KUNTZ, supra note 27, § 40.5(b), at 351; Wood v. TXO Prod. Corp., *Discussion Notes*, 125 OIL & GAS REP. 155 (1995). See generally Anderson, *Royalty Valuation Part 2*, supra note 4, at 641-43.
\item \textsuperscript{29} See Anderson, *Royalty Valuation Part 2*, supra note 4, at 684.
\item \textsuperscript{30} See generally 3 KUNTZ, supra note 27, § 40.5(b), at 351.
\item \textsuperscript{32} See Haynes v. Southwest Natural Gas Co., 123 F.2d 1011, 1012 (5th Cir. 1941) (absent wellhead sales, downstream prices may be relevant in determining “market value at the well,” but royalties are due on value at the well); Kretni Dev. Co. v. Consol. Oil Corp., 74 F.2d 497, 500 (10th Cir. 1934) (“proceeds” royalty due on value of gas when it entered ninety-mile
\end{itemize}
Marketable-product jurisdictions seek to establish a valuation "point" when gas is fit to enter a market. This point refers not to a physical location, but to a point in the production process at which either market realities or state law dictate that the product is in a condition acceptable for sale. This conditional point demarcates between post-wellhead costs as deductible — nonroyalty-bearing — or not deductible — royalty bearing. Royalty disputes regarding post-wellhead cost allocation typically center on costs such as gathering, compression, dehydration, treating, and pipeline transportation.

pipeline, not on value at the market place at end of pipeline); Hemler v. Union Producing Co., 40 F. Supp. 824, 832 (W.D. La. 1941) ("market price" royalty payable at "the usual price paid at the nearest point where a market existed, less the additional costs of taking the gas or other product to that market"); Clear Creek Oil & Gas Co. v. Bushmiaer, 264 S.W. 830, 831-32 (Ark. 1924) (transportation costs properly deducted when paying royalty on "market price . . . at the well"); Sternberger, 894 P.2d at 795 (where royalty is due on "market price at the well," lessors were required to bear their proportionate share of reasonable expenses of transporting gas in gathering pipeline system constructed by lessee to move gas to distant market); Molter v. Lewis, 134 P.2d 404, 404-05 (Kan. 1943) (lessee may deduct reasonable trucking costs in paying oil royalty that was owed "free of cost, in the pipeline" where oil was trucked to a distant pipeline); Voshell v. Indian Territory Illuminating Co., 19 P.2d 456, 457-58 (Kan. 1913) (oil royalty owed "free of cost, in the pipeline" was payable at price received at distant market, less transportation costs); Scott v. Steinberger, 213 P. 646, 647 (Kan. 1923) (royalty owed "free of cost in pipelines" is payable on downstream price, less transportation costs); Warfield Natural Gas Co. v. Allen, 88 S.W.2d 989, 992 (Ky. 1935) ("proceeds" royalty was payable on value at the well, not on downstream price); Rains v. Ky. Oil Co., 255 S.W. 121, 122 (Ky. 1923) (construing a lease clause to mean gas royalty on value at well, not after delivery to town); Sartor v. United Gas Pub. Serv. Co., 173 So. 103, 108 (La. 1937) ("market value" royalties owed on prevailing field prices for gas rather than on values reflecting transportation downstream); Wall v. United Gas Pub. Serv. Co., 152 So. 561, 564 (La. 1934) (transportation costs to nearest market are properly deducted when royalty is paid on "market price" of gas at the well if no market exists in the field); Creson v. Amoco Prod. Co., 2000-NMCA-081, 10 P.3d 853, 856 (transportation costs are rightly deducted from lease providing royalties based on "net proceeds . . . of carbon dioxide gas at the well"); Johnson, ¶ 4, 475 P.2d at 397 (royalty owed on "gross proceeds at the prevailing market rate for all gas sold off premises" should be free of transportation costs off the lease where no market exists at the wellhead); Judice v. Mewbourne Oil Co., 939 S.W.2d 133, 136 (Tex. 1996) (construing value "at the well" to mean "the value of the gas before . . . transporting the gas to market").

33. See Anderson, Royalty Valuation Part 2, supra note 4, at 637.
34. Id.
35. Post-wellhead costs are also called post-production or processing costs.
36. "Gathering" refers to moving gas from the wellhead to a central accumulation point, often where many smaller pipelines from other wells on a lease connect for further processing, transmission, or consumption. See John C. Jacobs, Problems Incident to the Marketing of Gas, 5 INST. ON OIL & GAS L. & TAX'N 271, 273 (1954). See generally HYNE, supra note 15, at 217 (definitions of gathering-related terms). Gas from the wellhead may require "compression" if it lacks sufficient pressure to move through a pipeline. See generally id. at 97-98 (definitions of compression-related terms). Compression of gas may be required both at the wellhead for
Generally, once gas is first-marketable in fact, both the lessor and lessee share further post-production costs to the extent that these costs are relevant to determining a first-market value because any additional processing merely adds value to an already marketable product.37

a) Colorado Adopts the Implied Covenant to Market

Jurisdictions advocating the first-marketable product rule often invoke an implied duty on the part of the lessee to market the gas. Absent express lease provisions to the contrary, the implied covenant to market requires the lessee to absorb post-wellhead costs incurred in transforming gas into a marketable condition.38 Garman v. Conoco, Inc.,39 a recent influential decision, adopts this implied covenant.

In answering a certified question from the U.S. District Court for the District of Colorado,40 the Garman court held that when a lease is silent regarding the allocation of post-wellhead costs, the implied covenant to market creates an obligation for the lessee to bear those costs “required to movement through gathering lines and at the gathering point to move gas off the premises of the lease into the interstate pipeline. See Anderson, Royalty Valuation Part 2, supra note 4, at 691. “Dehydration” involves removing water from saturated gas to bring the gas to “pipeline or sales-quality specifications.” HYNE, supra note 15, at 126. “Transportation” costs may result from short-distance transportation of the gas on the lease premises, often related to gathering, or transportation off the premises of the lease to a distant market. See Anderson, Royalty Valuation Part 2, supra note 4, at 650-53.

37. See Garman v. Conoco, Inc., 886 P.2d 652, 661 (Colo. 1994) (“Upon obtaining a marketable product, any additional costs incurred to enhance the value of the marketable gas ... may be charged against nonworking interest owners.”); Sternberger, 894 P.2d at 799-800 (“[L]essee alone bears the expense in making the product [gas] marketable. . . . Once a marketable product is obtained, reasonable costs incurred to transport or enhance the value of the marketable gas may be charged against nonworking interest owners.”); see also Mittelstaedt v. Santa Fe Minerals, Inc., 1998 OK 7, 954 P.2d 1203.

38. See MAURICE MERRILL, COVENANTS IMPLIED IN OIL AND GAS LEASES § 85, at 214-15 (2d ed. 1940). Requiring a lessee to produce a marketable product can also result from reasonably construing a typical lease-royalty clause that commonly requires royalties to be paid on the basis of “proceeds” or “market value.” Logically, for there to be “proceeds” or “market value,” a marketable product must exist.


40. The certified question read:

Under Colorado law, is the owner of an overriding royalty interest in gas production required to bear a proportionate share of post-production costs, such as processing, transportation, and compression, when the assignment creating the overriding royalty interest is silent as to how post-production costs are to be borne?

Id. at 653.
transform raw gas into a marketable product.”\textsuperscript{41} Although the court declined to address specific types of post-wellhead costs, Garman provides that the lessee has met its cost obligations once gas is marketable. At that point, the lessor and lessee proportionately share subsequent costs if these costs are reasonable and if they proportionately increase the royalty revenue.\textsuperscript{42} Garman failed to answer, however, whether an “at the well” lease diminishes the lessee’s burden to bear all post-wellhead transformation costs required to place the gas in a marketable condition in the vicinity of the well.

\textbf{b) Kansas and Oklahoma Follow Colorado}

Courts in Kansas and Oklahoma have expressly adopted the Garman rule. In \textit{Sternberger v. Marathon Oil Co.},\textsuperscript{43} the Kansas Supreme Court found that an “at the well” lease did not provide for the deduction of costs incurred to transform gas into a marketable product.\textsuperscript{44} The Sternberger court held that the lessee has a duty to make the gas marketable and to bear all expenses to that end.\textsuperscript{45} Likewise, in \textit{Mittelstaedt v. Santa Fe Minerals, Inc.},\textsuperscript{46} the Oklahoma Supreme Court answered a certified question from the Tenth Circuit Court of Appeals concerning the deduction of specific post-wellhead costs.\textsuperscript{47} Although the question did not deal directly with “at the well” language, one of the lease clauses at issue providing for royalties to be paid on “gross proceeds, at the mouth of the well,” caused the Mittelstaedt court to discuss the implied covenant to market.\textsuperscript{48} The court concluded that, in the absence of express lease provisions for cost allocation, the implied covenant to market obligates the lessee to bear those costs incurred in making the gas marketable.\textsuperscript{49} Mittelstaedt followed the Garman decision regarding post-marketable deductions, holding that the lessee must show that such costs are reasonable and that they enhance the value of an already marketable product.\textsuperscript{50}

\begin{footnotesize}
\textsuperscript{41} \textit{Id.} at 659-62.
\textsuperscript{42} \textit{Id.} at 661.
\textsuperscript{43} 894 P.2d 788 (Kan. 1995).
\textsuperscript{44} \textit{Id.} at 794, 800.
\textsuperscript{45} \textit{Id.} at 799.
\textsuperscript{46} 1998 OK 7, 954 P.2d 1203.
\textsuperscript{47} \textit{Id.} ¶ 1, 954 P.2d at 1204-05. The certified question asked whether the lease provision at issue entitled the lessee to “deduct a proportional share of transportation, compression, dehydration, and blending costs from the royalty interest paid to the lessor.” \textit{Id.}

\textsuperscript{48} \textit{Id.} ¶ 12, 954 P.2d at 1206.
\textsuperscript{49} \textit{Id.} ¶¶ 26, 28, 954 P.2d at 1209-10.
\textsuperscript{50} \textit{Id.} ¶ 27, 954 P.2d at 1210.
\end{footnotesize}
B. Transportation to a Distant Market

Although jurisdictions differ on whether lessees must produce a first-marketable product, they widely agree regarding the allocation of costs incurred when transporting gas off the lease premises to a distant market.51 Although there may be some divergence of opinion regarding short-distance transportation — i.e., gathering and related compression — prior to Rogers, courts seemed to agree unanimously regarding distant-market transportation costs.52 Sternberger dealt with transportation costs extensively.53 The Sternberger court looked to long-standing Kansas precedent,54 as well as Oklahoma55 and Texas case law.56 The Sternberger court specifically concluded that a lessor in an “at the well” lease must bear a proportionate share of transportation costs when the actual sale of gas occurs off the lease premises.57 The case law relied on in Sternberger reveals an entrenchment of

51. See Clear Creek Oil & Gas Co. v. Bushmiaer, 264 S.W. 830, 831-32 (Ark. 1924) (holding that transportation costs were properly deducted when paying royalty on “market price . . . at the well”); Rains v. Ky. Oil Co., 255 S.W. 121, 122 (Ky. 1923) (construing a lease clause to mean gas royalty on value at well, not after delivery to town); Wall v. United Gas Pub. Serv. Co., 152 So. 561, 564 (La. 1934) (transportation costs to nearest market are properly deducted when royalty is paid on “market price” of gas at the well if no market exists in the field); Creson v. Amoco Prod. Co., 2000-NMCA-081, 10 P.3d 853, 856 (transportation costs are rightly deducted from lease providing royalties based on “net proceeds . . . of carbon dioxide gas at the well”); Judice v. Mewbourne Oil Co., 939 S.W.2d 133, 136 (Tex. 1996) (construing value “at the well” to mean the “value of the gas before . . . transporting the gas to market”).

52. See infra notes 53 & 54.

53. Sternberger v. Marathon Oil Co., 894 P.2d 788, 792-806 (Kan. 1995). The “transportation cost” at issue in Sternberger was the construction cost of building a pipeline to transport the gas to a distant market. The Sternberger court, however, spent much of its time discussing the deductibility of distant-market transportation costs.

54. See, e.g., Molter v. Lewis, 134 P.2d 404, 404-05 (Kan. 1943) (lessee may deduct trucking costs to a distant pipeline when such costs are necessary to obtain a market); Voshell v. Indian Territory Illuminating Co., 19 P.2d 456, 457-58 (Kan. 1933) (oil royalty owed “free of cost, in the pipe line” was payable at price received at distant market, less transportation costs); Scott v. Steinberger, 213 P. 646, 647 (Kan. 1923) (transportation costs appropriately deducted from downstream market price under a “free of cost in the pipelines” royalty provision).

55. See, e.g., Johnson v. Jemigan, 1970 OK 180, 475 P.2d 396 (lessee may deduct transportation costs when point of sale is off lease premises and no market exists at the lease).

56. In looking to Texas, Sternberger cited Parker v. TXO Production Corp., 716 S.W.2d 644 (Tex. Ct. App. 1986), and Martin v. Glass, 571 F. Supp. 1406 (5th Cir. 1984) (holding that under Texas law gas is produced upon severance from the wellhead, and post-production costs are shared proportionately between lessor and lessee). Although these cases did not consider transportation costs, the Sternberger court found that the lessee may deduct transportation costs under Texas law because it is a post-production cost. Sternberger, 894 P.2d at 805.

57. Sternberger, 894 P.2d at 803, 806. The Kansas Supreme Court supported this assertion
this traditional transportation rule in royalty-valuation jurisprudence prior to the Colorado Supreme Court’s decision in Rogers v. Westerman Farm Co.58

III. Rogers v. Westerman Farm Co.

A. Facts and Procedural History of the Case

In the mid-1970s, the parties executed gas leases pertaining to some 200 wells. The leases provided for the lessee to pay royalties based on gas “at the well.”59 The gas emerging from the wells was sweet,60 and the parties agreed that the gas required gathering, compression, and dehydration to enter the interstate pipeline.61 Nevertheless, the lessees sold some gas at the well, some away from the well, and delivered some “in kind”62 to the lessors in lieu of cash royalties.63 The lessors claimed that royalties paid on gas sold at the well were much lower because the gas was not “marketable” at the well.64 For gas sold away from the well, the lessors claimed that the lessees improperly deducted the costs for gathering, compressing, and dehydrating from royalty calculations.65 The lessees argued that the “at the well” language trumped any duty to absorb post-wellhead marketing costs; however, they also asserted that the gas was marketable at the well and that costs deducted for gathering, compressing, and dehydrating were “reasonable transportation related costs” necessary to sell an already marketable product at the interstate pipeline.66

The trial court concluded that the “at the well” language of leases was silent regarding cost allocation.67 Further, the trial court held that the implied covenant to market trumped this language for the purposes of determining cost

with a line of Kansas cases holding that the lessor and lessee share transportation costs when a lease provides for royalties “free of cost in the pipe line.” See generally id. at 795-96 (citing Molter v. Lewis, 134 P.2d 404 (Kan. 1943); Voshell v. Indian Territory Illuminating Co., 19 P.2d 456 (Kan. 1933); Scott v. Steinberger, 213 P. 646 (Kan. 1923)).

58. 29 P.3d 887 (Colo. 2001).

59. The leases at issue all used the term “at the well” and “at the mouth of the well.” For the purposes of this discussion, the term “at the well” refers to both “at the well” leases and “at the mouth of the well” leases.

60. See supra note 24 and accompanying text.

61. See Rogers, 29 P.3d at 892.

62. The term “in kind” refers to gas physically delivered to the lessor instead of paying the lessor monetary royalties on the gas pursuant to the lease. See 8 HOWARD R. WILLIAMS & CHARLES J. MEYERS, OIL AND GAS LAW 952 (2001).

63. See Rogers, 29 P.3d at 892-93.

64. See id. at 893.

65. See id. at 893-94.

66. See id. at 894.

67. See id.
allocation. The jury found that gas sold away from the well was not marketable and that the lessee improperly deducted costs associated with gathering, compression, dehydration, and transportation. The jury, however, found that the gas sold at the well was marketable. The appeal focused on these seemingly inconsistent findings.

The Colorado Court of Appeals reversed the judgment of the trial court, determining that the language of the lease was not silent with regard to post-production cost allocation. The court held that the traditional rule addressing transportation-related costs for gas sold away from the lease premises applied. Further, the court of appeals determined that the parties correctly shared these costs because gas actually sold at the well and used in kind meant that the gas was marketable at the well.

B. Issues Presented

Of the issues presented in the petition to the Colorado Supreme Court, two carried predominant significance in the Rogers decision: (1) whether the lease phrase “at the well” was silent regarding cost allocation, including transportation costs; and (2) whether the implied covenant to market, as adopted in Garman v. Conoco, Inc., obligated the lessee to make the gas marketable regarding both its “quality” and “location.”

C. The Court’s Decision and Reasoning

The Colorado Supreme Court found that “at the well” lease language is silent as to all costs, including transportation — whether to a near or distant market. The court asserted that the threshold determination for cost allocation rests only upon the fact question of marketability of the gas. The court stated that when a lease is silent the implied covenant to market obligates the lessee to make the gas marketable with respect to both “condition” and “location.” Further, the court held that transportation costs to a distant market are not deductible as a matter of law. Presumably,

68. See id.
69. See id.
70. See id.
71. See id. at 895.
72. See id.
73. See id.
74. 886 P.2d 652 (Colo. 1994).
75. See Rogers, 29 P.3d at 898, 899, 902.
76. See id. at 905.
77. See id. at 902, 905
78. See id.
however, they may be deductible as a matter of fact if there is a market location at the well or closer to the well than the lessee’s chosen market location and if the Garman requirements of “reasonableness” and proportionate increase in value are met.\textsuperscript{79}

In Rogers, the court first examined the “at the well” language in the leases and determined that such lease language is silent with respect to cost allocation.\textsuperscript{80} The court dissected the lease clauses in the four types of leases at issue.\textsuperscript{81} Each clause used either “gross proceeds,” “proceeds,” “market value,” “at the well,” or a combination of these terms as the basis for royalty valuation for gas sold in the vicinity of the well and for gas sold or used off the premises.\textsuperscript{82} The court concluded that none of the clauses at issue explicitly address costs or allowable deductions and are, therefore, silent regarding all deductions.\textsuperscript{83}

To support this conclusion, the court looked to conflicting interpretations of both “proceeds” and “market value” clauses.\textsuperscript{84} In light of these differing interpretations, the Rogers court found the lease language to be inherently unclear. With respect to Type I leases,\textsuperscript{85} the court held that the language failed to address costs or deductions when calculating “market value.”\textsuperscript{86} For Types II and III,\textsuperscript{87} the court concluded that the lease language did not contemplate the sale of gas away from the well.\textsuperscript{88} For Type IV leases,\textsuperscript{89} the

\begin{itemize}
  \item \textsuperscript{79} See Garman, 886 P.2d at 661.
  \item \textsuperscript{80} See Rogers, 29 P.3d at 896-97.
  \item \textsuperscript{81} Type I provides royalties paid on “gross proceeds . . . at the mouth of the well or, if not sold at the mouth of the well, . . . market value . . . at the mouth of the well.” Id. at 891 n.1. Type II provides for royalties paid on “proceeds from the sale of gas . . . at the mouth of the well.” Id. Type III provides for royalties paid on “market price at the well for gas sold, used off the premises, or in the manufacture of products therefrom.” Id. Type IV provides for royalties paid on “proceeds . . . from each well . . . or the market value at the well of such gas used off the premises.” Id.
  \item \textsuperscript{82} See id. at 897-98.
  \item \textsuperscript{83} See id.
  \item \textsuperscript{84} See id. at 897 n.10 (noting that Schroeder v. Terra Energy, Ltd., 565 N.W.2d 887 (Mich. Ct. App. 1997) and 3 WILLIAMS & MEYERS, supra note 62, § 645.2, at 597-98, both support an interpretation that the term “gross proceeds” suggests that costs are shared); see also Hanna Oil & Gas Co. v. Taylor, 759 S.W.2d 563, 564-65 (Ark. 1988) (holding that “proceeds at the well” means gross proceeds when the lease does not refer to costs or use the term “net proceeds”); Rogers, 29 P.3d at 897 (citing 3 WILLIAMS & MEYERS, supra note 62, § 646.1, at 608.4-608.6) (suggesting that a proceeds clause must either specify the place where proceeds are to be calculated, or the expenses that can be deducted).
  \item \textsuperscript{85} See supra note 81.
  \item \textsuperscript{86} See Rogers, 29 P.3d at 897.
  \item \textsuperscript{87} See supra note 81.
  \item \textsuperscript{88} See Rogers, 29 P.3d at 897-98.
  \item \textsuperscript{89} See supra note 81.
\end{itemize}
court held that the language spoke neither to the allocation of costs nor to sales off the premises. Therefore, the court concluded that each lease was silent with respect to cost allocation.

After reaching the conclusion that "at the well" lease language is silent regarding cost allocation in general, the Rogers court next turned specifically to the issue of transportation costs. The court treated transportation costs no differently than other costs, holding that the "at the well" language was also silent with regard to transportation costs, including long-distance transportation. It reasoned that "at the well" language cannot sufficiently address only transportation costs without looking to other costs typically associated with transporting gas. Because costs like gathering, compression, and dehydration may be necessary to transport gas, the court reasoned that a separate rule for transportation would be inconsistent. Additionally, the court refused to distinguish between transportation to near or distant markets, holding that the distance to market is irrelevant and that the determining factor for transportation cost allocation is the marketability of the gas.

The Rogers court ultimately based its decision on the implied covenant to market and its previous decision in Garman v. Conoco, Inc. The Rogers court concluded that the implied covenant to market controls the allocation of costs, including transportation costs, in an "at the well" lease. The court further rejected the rule that transportation costs are deductible as a matter of law because the rule "assumes that gas is marketable as it emerges from the wellhead." In looking to other jurisdictions that support the transportation rule, the Rogers court concluded that other jurisdictions "fail to recognize that the implied covenant to market controls the lessee's duty to make the gas marketable." The court noted that these jurisdictions adopt an approach

90. See Rogers, 29 P.3d at 898.
91. See id.
92. See id. at 899. Interestingly, the Rogers case did not initially concern long-distance transportation; however, upon petition for rehearing, amicus curiae urged the court to clarify this point, and the court modified the decision on denial of rehearing and "clarified" this point in the opposite direction indicating the court's indifference to short- or distant-market transportation. See id. at 900; Amicus Brief of Atlantic Richfield Co. et al. in Support of Petition for Rehearing at 1-3, Rogers v. Westerman Farm Co., 29 P.3d 887 (Colo. 2001) (No. 97CA0293).
93. See id. at 899.
94. See id.
95. See id.
96. 886 P.2d 652 (Colo. 1994).
97. See Rogers, 29 P.3d at 900.
98. See id.
99. See id. at 901.
contrary to the marketable-product rule by holding that gas is marketable upon severance from the wellhead. The court acknowledged that it may be adopting a minority view, but explained that its analysis was consistent with its prior holding in Garman.

IV. Analysis

A. Rogers' Divergent Interpretation of "At the Well" Lease Language

The first thing that takes the Rogers court in a novel direction is its holding that the phrase "at the well" is silent regarding the allocation of all costs. Prior to Rogers, no court had ever held that "at the well" lease language is completely silent regarding that allocation. Although this phrase has come under fire for being ambiguous, and case law differs on its exact meaning, the phrase generally means that royalty valuation occurs in the vicinity of the well, either at the wellhead or at some point on or near the lease where marketable gas is ready to enter a purchaser's pipeline.

To support the view that the phrase "at the well" is silent, Rogers cited Wood v. TXO Production Corp. In Wood, the Oklahoma Supreme Court

100. See id.
101. See id.
102. See Anderson, Royalty Valuation Part 2, supra note 4, at 633-35 (discussing the historical reasons for use of the phrase "at the well" and the inherent ambiguity of this phrase). Professor Anderson suggests that lessors adopted "at the well" to avoid directly stating their objectives regarding cost sharing. Id. at 635. Anderson notes, however, that although courts differ on the exact meaning of the phrase "at the well," it nonetheless provides that royalty valuation should occur in the vicinity of the well and would seem to state expressly what has always been implicit — that royalty should not be owed on value added by transportation costs. Id. at 650-69. See also Schroeder v. Terra Energy Ltd., 565 N.W.2d 887, 892 (Mich. Ct. App. 1997) (comparing the price of gas in an "at the wellhead" lease to the price of other goods sold "f.o.b. the seller's place of production") (emphasis added). F.O.B. stands for "free on board" and typically means that a seller of goods fulfills his obligation to deliver when the goods are available to the buyer at the named location of shipment. See INTERNATIONAL CHAMBER OF COMMERCE, INCOTERMS 38 (1990). From the F.O.B. point, a buyer must pay freight and accept the risk of loss during transportation. Although the Schroeder court ultimately mischaracterizes F.O.B. as speaking to both location and condition, in the court's view, "at the well" plainly means "F.O.B. the well."
103. See Heritage Res., Inc. v. NationsBank, 939 S.W.2d 118, 129 (Tex. 1996) ("The words 'at the well' should be given their straightforward meaning. Market value 'at the well' means the value of gas at the well, before it is transported, treated, compressed or otherwise prepared for market."); see also Cresent v. Amoco Prod. Co., 2000-NMCA-081, 10 P.3d 853, 857 ("net proceeds . . . at the well" in a Unit Agreement with a working interest ownership (WIO) was unambiguous and entitles WIO to royalties based on value as it emerges at the wellhead). See generally Martin v. Glass, 571 F. Supp. 1406, 1411-15 (N.D. Tex. 1983).
104. 1992 OK 100, 854 P.2d 880.
specifically addressed the allocation of compression costs in an “at the well” lease.105 The Rogers court’s reliance on Wood, however, is misplaced because Wood did not hold that the lease was silent regarding cost allocation. Rather, the Wood court concluded that it was not “prepared to require the lessor to bear compression costs as a matter of law where there is no agreement . . . to share those costs.”106 The Wood court limited its decision to compression costs occurring on the leased premises, but did not hold that the phrase “at the well” is silent regarding all post-wellhead transportation deductions.107 Moreover, the Oklahoma Supreme Court clarified this holding in Mittelstaedt v. Sante Fe Minerals, Inc.,108 indicating that a distinct analysis applies to costs incurred when moving gas to a distant market.109 Under the Wood analysis, and contrary to the Rogers court’s conclusion, courts should give the phrase “at the well” a plain meaning construction that lessees do not owe royalty on value added by transporting the gas to a distant market.

The Rogers court also looked to Sternberger v. Marathon Oil Co.,110 which held that a “market price at the well” lease provision was silent regarding post-production deductions, but not ambiguous regarding the point of royalty valuation.111 The Sternberger court gave a plain meaning construction to “at the well” and allowed the parties proportionately to share costs incurred in delivering gas to a distant market where no market was available at the well.112 Although the Sternberger court’s differentiation between silence and ambiguity is somewhat confusing, it reveals that “at the well” language is not meaningless, as the Rogers court suggested.

The Rogers court failed to give appropriate meaning to the phrase “at the well.” This is the fatal flaw of the decision because it fails to recognize that “at the well” language creates an express covenant in a gas lease that royalty valuation occurs in the vicinity of the well. The phrase may not carry significant meaning with regard to transformational production costs — costs incurred to transform gas into a marketable condition — however, it should mean that the lessee does not owe royalty on value added to gas through long-distance transportation because such costs are nontransformational. They instead serve to increase the value of the gas away from the vicinity of the well when royalty valuation occurs in an “at the well” lease.

105. Id. ¶ 1, 854 P.2d at 880.
106. Id. ¶ 5, 854 P.2d at 881 (emphasis added).
107. See id. ¶ 6, 854 P.2d at 881.
108. 1998 OK 7, 954 P.2d 1203; see also supra Part II.A.2.b.
110. 894 P.2d 788 (Kan. 1995); see also supra Part II.A.2.b.
111. Sternberger, 894 P.2d at 794.
112. Id. at 806.
B. Misapplying Garman to a Nontransformational Cost

To the extent that the Rogers court reiterated the first-marketable product rule, requiring the lessee to transform unmarketable gas into a marketable condition, the court started in the right direction. However, from convention by stretching the implied covenant to market to trump the express covenant created by the “at the well” language of the lease, thereby imposing upon the lessee the burden of delivering gas to a market. The court’s previous decision in Garman v. Conoco, Inc. did not imply this result. The Garman court limited its holding to “those post-production costs undertaken to convert raw gas into a marketable product.” The court was not speaking to transportation costs away from the vicinity of the well. Indeed, even absent “at the well” language in the royalty provision, courts have always recognized that royalty was payable for location purposes in the vicinity of the well.

The Garman court declined to define the nebulous term “post-production costs.” Although the court mentioned examples of post-production expenses, like compression and transportation, it acknowledged at the outset of its opinion that anticipating “every conceivable type of post-production cost” was an impossible task. The court stated that it was considering the certified question “as if it were posed without examples.” In any event, it correctly recognized that marketability is necessarily a question of fact.

The Garman court, however, tacitly made one key distinction with regard to transportation. It stated that transportation occurs for two purposes. The court stated that “[t]ransportation is required when gas is moved from the wellhead to a central location to prepare it for transmission and consumption, commonly referred to as gathering. If no market for the gas exists near the wellhead, transportation may be required to move the gas to a distant market.” Here, the court specifically noted the traditional rule that “the costs to transport gas to a distant market are shared by all benefitted parties.” In the remainder of the opinion, the Garman court gave no

114. Id. at 906.
115. 886 P.2d 652 (Colo. 1994); see also supra Part II.A.2.a.
116. See Garman, 886 P.2d at 654.
117. Among the earliest cases so holding are Rains v. Kentucky Oil Co., 255 S.W. 121 (Ky. 1923), and Scott v. Steinberger, 213 P. 646 (Kan. 1923). See also cases cited supra note 32.
118. Garman, 886 P.2d at 654.
119. Id.
120. Id.
121. Id. (citation omitted).
indication that it planned to retreat from the traditional transportation rule. In declining to conceive of every post-production cost, the court consistently emphasized the point that its holding only applies to those “post-production costs required to transform raw gas into a marketable product.”

The Rogers court missed the mark by applying Garman to a nontransformational cost. Although transporting gas to a distant market may add value to gas, it does nothing to physically transform the gas from an unmarketable product to a marketable one. For example, if there is no actual, arms-length equivalent market for water-saturated, sour gas at the wellhead, the lessee must dehydrate the gas to remove the water and “sweeten” the gas to remove impurities. If the gas lacks sufficient pressure as it emanates from the wellhead, it must be compressed to enter wellhead gathering lines to move to a central accumulation point on the lease premises. These processes physically transform the gas into a salable or marketable product, with a sufficient pressure and gathered quantity to enter a purchaser’s pipeline. If no market exists at this point, the transportation required to move the gas to a distant point of sale off the lease premises does not change the physical quality of the product. Therefore, transportation costs clearly fall outside the realm of “post-production costs required to transform raw gas into a marketable product.”

Transportation is simply “freight.” The Rogers court ultimately sidestepped the task of clarifying this difference between transformational and nontransformational costs by redefining “marketability.”

C. Scholarly Rejection of Rogers’ Definition of Marketability

Claiming to use Garman as a guide, the court set out to shape a “workable definition of marketability.” Marketability is ultimately a question of fact. The Rogers court’s determination that gas must be marketable with respect not only to “condition” but also “location,” however, adds a new dimension for the trier of fact to consider to determine marketability. In arriving at this conclusion, the Rogers court mischaracterized the views of preeminent scholars and failed to recognize the difference between a marketable product and the costs of transporting such a product to a buyer or point of sale.

123. Id. at 660.
124. See Anderson, Calculating Freight, supra note 6, at 341.
127. See Anderson, Calculating Freight, supra note 6, at 341.
129. See Anderson, Royalty Valuation Part 2, supra note 4, at 642, 665, 668, 672.
130. Rogers, 29 P.3d at 905.
The Rogers court claimed that Professor Anderson\textsuperscript{131} alludes to the possibility that obtaining a first-marketable product may require gas to be in a marketable location as well as a marketable condition.\textsuperscript{132} Anderson’s brief discussion of market location, however, is in the context of a typical “at the well” or similar lease.\textsuperscript{133} Unless the lease speaks to a specific location, Anderson argues that lessees do not owe royalty on value added by transportation beyond the immediate vicinity of the well.\textsuperscript{134} When calculating royalty, Anderson would allow lessees to deduct transportation costs reasonably and necessarily incurred to move gas beyond the vicinity of the well, including transportation-related compression, whether such transportation is classified as gathering or pipeline transmission.\textsuperscript{135} Moreover, unlike the Rogers court, Professor Anderson bases his view on the plain meaning of typical oil and gas royalty clauses, not on the implied covenant to market.\textsuperscript{136}

Likewise, the late Professor Kuntz\textsuperscript{137} based his view of marketability on the express language of typical leases and not on the implied covenant to market, excluding location from the definition.\textsuperscript{138} Kuntz noted that the presence of impurities and the natural pressure of the gas might affect its marketability, whereupon the lessee has the duty to remedy these effects through treating and compression.\textsuperscript{139} This language of production implies that making gas marketable involves transformational processes for which the lessee must bear all associated costs. When Kuntz did reference location, in the context of the presence of an actual market for gas not requiring treating or compressing, he specifically noted that the price for gas at a distant market may be used to compute the market value of the gas after a deduction for transportation costs.\textsuperscript{140} Although Professor Kuntz recognized that the location of gas at an actual market may aid in determining the market value of gas, he advocated a view that location is not a criteria in determining whether gas is marketable.

Not only have scholars arrived at a conditional view of marketability based on typical lease language, they have also consistently and clearly stated that the implied covenant to market should render the same result. The late

\textsuperscript{131} Eugene Kuntz Professor of Oil, Gas, & Natural Resources, University of Oklahoma College of Law.
\textsuperscript{132} Rogers, 29 P.3d at 905 n.20.
\textsuperscript{133} See Anderson, Royalty Valuation Part 2, supra note 4, at 664-65.
\textsuperscript{134} See id. at 634.
\textsuperscript{135} See id. at 634-35.
\textsuperscript{136} See id. at 650.
\textsuperscript{137} The late Professor and Dean Emeritus of the University of Oklahoma College of Law.
\textsuperscript{138} See 3 KUNTZ, supra note 27, § 40.5(b), at 351, § 42.2, at 389-90.
\textsuperscript{139} See id. § 40.5(b), at 352.
\textsuperscript{140} See id. § 40.5(b), at 351.
Professor Merrill,\textsuperscript{141} who based his view on the implied covenant to market rather than on typical lease language, supported a view of marketability based on condition, not location. In his work on implied covenants in oil and gas leases, Merrill argued that a lessee is under an obligation to “prepare [gas] for market, if it is unmerchantable in its natural form.”\textsuperscript{142} “Preparation” is the language of production, speaking to quality and not location. Preparation for delivery to a market, rather than actual delivery, makes gas marketable. Merrill further explained that “there is no authority, and it seems impossible to conceive of any arguments in . . . favor” of an obligation on the part of a lessee to absorb all costs of delivery to a marketable location.\textsuperscript{143}

Other leading scholars share this view. Professors Williams and Meyers\textsuperscript{144} refer to marketable gas in terms of condition.\textsuperscript{145} For them, marketable gas is gas that is “sufficiently free from impurities” and “will be taken by a purchaser.”\textsuperscript{146} The Rogers court incorrectly used the language “will be taken by a purchaser” to support its conclusion that purchasers are “willing to take” at the location of a commercial market.\textsuperscript{147} This locational construction is inappropriate because the Rogers court also used the language “fit for sale in a commercial market.”\textsuperscript{148} The proper construction of the word “fit” is as language of condition, not location.\textsuperscript{149} Williams and Meyers do not advocate a location component to the determination of marketability.

All of these scholars support the view that marketability is determined in the vicinity of the well under typical lease provisions. Looking collectively at this body of work, it is apparent that both an interpretation of typical lease language and the implied covenant to market support only a conditional view of marketability. The Rogers court ultimately mischaracterized this work and created a novel definition of marketability. This novel definition, coupled with the refusal to recognize the traditional meaning of “at the well,” led it to create a new burden on the lessee to deliver gas to a distant market if no market exists in the vicinity of the well.

\textsuperscript{141} The late Alfred P. Murrah Professor and Dean Emeritus of the University of Oklahoma College of Law.
\textsuperscript{142} MERRILL, supra note 38, § 85, at 214.
\textsuperscript{143} \textit{Id.} § 86, at 219.
\textsuperscript{144} Howard R. Williams, Robert E. Paradise Professor of Natural Resources Law, Emeritus, Stanford University; Charles J. Meyers, the late Richard E. Lang Professor and Dean Emeritus of the School of Law, Stanford University.
\textsuperscript{145} See 8 WILLIAMS & MEYERS, supra note 62, at 601.
\textsuperscript{146} \textit{Id.}
\textsuperscript{147} Rogers v. Westerman Farm Co., 29 P.3d 887, 904 (Colo. 2001).
\textsuperscript{148} \textit{Id.}
\textsuperscript{149} “Fit” means “in a suitable condition, ready.” OXFORD MODERN ENGLISH DICTIONARY 369 (2d ed. 1996).
D. Ignoring Tradition and Imposing a Duty to Deliver on Lessees

The Rogers court concluded that it is "inconsistent to carve out a rule for transportation costs alone" when a lease contains "at the well" language because other costs may be necessary to physically transport the gas.\(^\text{150}\) The court further noted that whether transportation occurs to a near or distant market is irrelevant in determining cost allocation.\(^\text{151}\) This conclusion blatantly ignores the traditional rule, which recognizes that lessees do not owe royalty on freight, whether or not the lease contains “at the well” language. Indeed, “at the well” merely expresses what has always been implicit. The Rogers court noted that "the general rule regarding transportation costs assumes that gas is marketable as it emerges from the wellhead."\(^\text{152}\) Most jurisdictions, however, apply this transportation rule as a matter of law regardless of the marketable condition of the gas.\(^\text{153}\) In this regard, differentiating between near- and distant-market transportation is extremely relevant because the duty to deliver gas to a distant market could potentially exact a heavy financial burden on the lessee.

The Rogers court ignored tradition because of its failure to recognize that transportation costs are different in nature from costs of care and preparation for delivery.\(^\text{154}\) As previously stated, the Rogers court opted to redefine marketability rather than differentiate transportation costs from transformational costs. Professor Anderson instructively notes that transportation costs incurred in moving the gas beyond the immediate vicinity of the well are essentially freight.\(^\text{155}\) Regarding the appropriate allocation of freight costs, Anderson makes compelling analogies to other royalty-bearing commercial transactions.\(^\text{156}\) For instance, Anderson compares book royalties to oil and gas royalties, noting that a publisher "implicitly promises to transform the manuscript into a marketable product."\(^\text{157}\) Royalties are typically paid on the downstream price, usually to a wholesaler, minus transportation costs.\(^\text{158}\) Although the selling price at a distant market may add

\(^{150}\) Rogers, 29 P.3d at 900.

\(^{151}\) Id.

\(^{152}\) Id.

\(^{153}\) See cases cited supra note 51.

\(^{154}\) See Johnson v. Jernigan, 1970 OK 180, 475 P.2d 396. The Johnson court distinguished between "costs of care and preparation of the gas before delivery" and "transportation costs away from the leased property" and held that a lessor is required to pay a proportionate share of transportation costs when the sale occurs off the lease premises. Id. ¶ 17, 475 P.2d at 400.

\(^{155}\) See Anderson, Royalty Valuation Part 2, supra note 4, at 640.

\(^{156}\) See id. at 643-45, 650.

\(^{157}\) Id. at 644 n.132.

\(^{158}\) See id. at 643-45.
freight costs, that price does not reflect the value of the product at that point. The appropriate value is the selling price minus freight. Paying royalties on the freight-included price for gas — or any other royalty-bearing product, for that matter — benefits the lessor with an artificially high product value, and forces the lessee to pay royalties on freight as well as on the product.

V. Impact

A. Complications and New Incentives for Lessees

Forcing lessees to bear all transportation costs under an implied duty to deliver creates a host of complications. *Rogers* creates a new, unnecessary, and illogical element of gas lease interpretation that will make traditional gas leases fodder for future litigation. Instead of simplifying royalty valuation, *Rogers* needlessly complicates it by forcing lessees to concern themselves more with transportation costs than with finding the best market for gas when no actual market exists in the vicinity of the well.

Moreover, forcing lessees to bear freight costs accomplishes none of the policy concerns inherent in construing “at the well” lease language against the lessee. The most notable concern is rewarding lessees for vague lease language. Courts may justify construing ambiguous lease language against lessees only in as far as it removes the lessee’s incentive to charge the lessor, through royalty accounting, for costs necessary to achieve a marketable product. Making lessees solely responsible for moving gas, however, punishes them for a cost component that is not transformational as it does nothing to affect the physical marketability of the gas.

Forcing lessees to bear transportation expenses also chills their incentive to construct and operate their own transportation networks, in turn chilling the exploration and production of gas products. Such networks are common under modern gas market scenarios, and they enable lessees to move gas downstream to the “best” market or perhaps a distant one. The potentially huge burden of constructing and operating a transportation network necessary to move gas to a distant market free of cost to the royalty owner will create an incentive to move gas markets further upstream — perhaps to an inefficient market.

The Tenth Circuit decision in *Atlantic Richfield Co. v. Farm Credit Bank of Wichita,*159 exemplifies the potential problems of the *Rogers* court’s transportation rule in a similar context. In this case, the lessee, Atlantic Richfield Co. (ARCO), constructed a 500-mile pipeline to transport carbon dioxide (CO₂) gas produced under an “at the mouth of the well” lease from

159. 226 F.3d 1138 (10th Cir. 2000).
Colorado\textsuperscript{160} to southwest Texas for use in enhanced oil recovery\textsuperscript{161} operations. Because CO\textsubscript{2} is only useful in enhanced recovery of oil in southwest Texas, there is no market "at the well," or perhaps elsewhere.\textsuperscript{162} Therefore, lessees have no choice but to transport the gas to the only market for this product — southwest Texas. Under Rogers, Texas may be the market location. If so, ARCO would have to bear all expenses incurred in transporting the CO\textsubscript{2} over the 500-mile distance. Having to bear such a burden may be enough to make the market inefficient and thus unavailable to the lessee and, hence, the lessor as well.

Perhaps the greatest potential impact of a duty to deliver is that it creates an incentive contrary to the implied covenant to market.\textsuperscript{163} Lessees will have an incentive to seek a market most economical to their cost structure and not the market with the best purchase price. The lessee will focus on avoiding transportation costs, thereby confining their marketing efforts to nearby markets where prices may be significantly lower. This scenario will certainly come to fruition under the Rogers approach, and courts will have a heavy task to determine if, in fact, lessees are acting in good faith in seeking the first market for gas.

\textbf{B. Oklahoma Case Law}

Oklahoma case law concerning lease royalties historically closely tracks surrounding jurisdictions, with the apparent exception of Texas. The necessity for uniformity in gas lease jurisprudence stems from the fact that most pipelines run interstate. Indeed, in Mittelstaedt \textit{v.} Santa Fe Minerals, \textit{Inc.},\textsuperscript{164} the Oklahoma Supreme Court adopted the Garman holding with respect to lease royalties.\textsuperscript{165} Rogers, however, represents a point where Oklahoma will likely diverge from Colorado jurisprudence. In 1970, the Supreme Court of Oklahoma decided Johnson \textit{v.} Jernigan,\textsuperscript{166} holding that lessees are not solely liable for transportation costs of gas where a market does not exist in the vicinity of the well. The court has never overruled this case.

\textsuperscript{160} CO\textsubscript{2} resides in large concentrations in the subsurface layer in Colorado.
\textsuperscript{161} "Enhanced recovery" refers to the process in which oil producers use CO\textsubscript{2} to increase recovery from certain types of oil reservoirs. \textit{See} Farm Credit Bank, 226 F.3d at 1146.
\textsuperscript{162} See id.
\textsuperscript{163} \textit{See generally} MERRILL, supra note 38, § 85, at 214-18, § 86, at 219-20 (explaining the role of the implied covenant to market in oil and gas leases regarding preparation for market and place of sale).
\textsuperscript{164} 1998 OK 7, 954 P.2d 1203.
\textsuperscript{165} \textit{id.} ¶¶ 18, 29-30, 954 P.2d at 1208, 1210; \textit{see also id.} ¶ 1, 954 P.2d at 1210 (Opala, J., dissenting in part).
\textsuperscript{166} 1970 OK 180, 475 P.2d 396.
Since Johnson, the court has repeatedly affirmed that the implied covenant to market does not require a lessee to bear transportation costs to a distant market.\textsuperscript{167} The Johnson court recognized that the cost of transporting gas away from the lease is distinct from "costs of care and preparation of the gas before delivery."\textsuperscript{168}

To steer Oklahoma clear of the quagmire created by Rogers, the Oklahoma Supreme Court should adopt the position advocated by Justice Opala's dissent in Mittelstaedt.\textsuperscript{169} In his dissent, Justice Opala dealt with the issue of transportation directly, falling in line with the traditional rule while simultaneously advocating a marketable-product approach that addresses many of the cost-allocation concerns of recent litigation.\textsuperscript{170} In fact, the Rogers court misstated Justice Opala's dissent where it concerned transportation costs. The Rogers court claimed that Justice Opala championed the first-marketable-product rule without suggesting that certain costs are deductible as a matter of law.\textsuperscript{171} On the contrary, Justice Opala's dissent clearly stated that "no work-back calculations should be necessary other than a possible deduction of transportation costs if the point of first-markability is not in the vicinity of the well."\textsuperscript{172} This statement reveals that a deduction for transportation cost is appropriate in a marketable-product jurisdiction and will continue to be so in Oklahoma.

\textbf{B. Uncertainty Over Downstream Profits}

The Rogers court's decision has one peripheral effect worth noting; however, an in-depth discussion is outside the scope of this note. At the heart of the Rogers case is a royalty owner who realized that the lessee was getting a higher price for gas at a downstream market and desired a piece of that good fortune, free of the transportation costs required to move gas to this market. This scenario brings to light a largely unresolved area in the realm of royalty valuation involving the sharing of downstream profits and how lessees should account to royalty owners for downstream sales in second or third markets.\textsuperscript{173}

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\textsuperscript{168} Johnson, ¶ 17, 475 P.2d at 400.

\textsuperscript{169} See Mittelstaedt, ¶ 2, 954 P.2d at 1211 (Opala, J., dissenting in part) (citing Anderson, Royalty Valuation Part 2, supra note 4, at 643-45, 650). Justice Opala's dissent in Mittelstaedt can be fairly read as a concurring opinion, merely calling for some technical adjustments to the majority's application of the first-marketable product rule.

\textsuperscript{170} See supra note 10 and accompanying text.

\textsuperscript{171} Rogers v. Westerman Farm Co., 29 P.3d 887, 907-08 (Colo. 2001).

\textsuperscript{172} Mittelstaedt, ¶ 2, 954 P.2d at 1211 (Opala, J., dissenting in part).

\textsuperscript{173} "Second or third markets" is used here to describe off-lease markets past the first "at
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The Rogers court’s decision offers, perhaps inadvertently, an approach to downstream profit sharing that could potentially give lessees an upper hand in reducing their royalty obligations.

To illustrate, assume that an arms-length market exists at the well with a price of $2.00/Mcf (per thousand cubic feet). This represents the first-market price of the gas. If the lessee transports the gas to a market away from the vicinity of the well where the price is $4.00/Mcf, but the lessee’s cost of transportation is $1.00/Mcf, should the lessee pay royalties on the $2.00/Mcf, first-market price or the second-market net value of $3.00/Mcf ($4.00 — $1.00)? Consider the converse. If the second-market transportation costs are $3.00/Mcf, does the lessee pay royalties on the $2.00/Mcf first-market value or the $1.00/Mcf second-market net value? Jurisdictions and commentators remain unsettled on how the lessee must account to the royalty owner and whether or not the lessee can choose to pay on the first- or second-market price.

Professor Merrill suggests three possible approaches: (1) the lessee must account for royalty on the value received at the second market without transportation deductions; (2) the lessee must account for royalty on the value received at the second market with transportation deductions; or (3) the lessee must account for royalty on the value received at the first market.¹⁷⁴ Merrill states that no logical basis exists for the first approach.¹⁷⁵ As between the second and third, Merrill prefers the second.¹⁷⁶ In other words, Merrill would require the lessee to pay royalty on the second-market price because he argues that sharing in downstream proceeds is a “presumption of the lease . . . and should continue until the final disposition of the product.”¹⁷⁷ Unfortunately, this approach seems to assume that the downstream proceeds will generally be higher than the proceeds “at the well,” and it fails to address the situation when the downstream value is less than that of the first market.

Professor Anderson advocates an approach similar to Merrill’s third approach, requiring lessees to pay royalties on the first-market price.¹⁷⁸ Under this approach, the downstream price and the transportation costs would be irrelevant.¹⁷⁹ Anderson reasons that the risk of sharing downstream losses should offset the potential to share downstream profits.¹⁸⁰ Therefore, the

¹⁷⁴. See Merrill, supra note 38, § 86, at 219.
¹⁷⁵. See id.
¹⁷⁶. See id.
¹⁷⁷. Id.
¹⁷⁸. See Anderson, Royalty Valuation Part 2, supra note 4, at 687-88.
¹⁷⁹. See id.
¹⁸⁰. See id. at 688.
lessor should share neither.\textsuperscript{181} Anderson roots his reasoning in the notion that leases are freely assignable to any type of operator.\textsuperscript{182} The potential disparity in operator size and vertical integration makes the notion of requiring a share in downstream profits a gamble for any lessor because the amount of his royalties may directly relate to the size and sophistication of the operator who actually develops the property.\textsuperscript{183} Confining the royalty valuation to the first legitimate market in the vicinity of the well better serves a marketable-product jurisdiction because this price depends less on the differences among potential lease operators.\textsuperscript{184} Simply put, royalty payment on $2.00/Mcf is consistently better than a fluctuating and uncertain royalty payment based on $4.00/Mcf one day and, possibly, $0/Mcf the next.

In \textit{Atlantic Richfield Co. v. State},\textsuperscript{185} the California Court of Appeals required the lessor to share the risk of downstream net losses, as well as the potential benefit of higher downstream net profits.\textsuperscript{186} In comparison, the \textit{Garman}\textsuperscript{187} and \textit{Mittelstaedt}\textsuperscript{188} courts take a more pro-lessee approach. Under these cases, if the second-market price results in a higher net value, the lessee may proportionately deduct transportation costs, provided such costs are reasonable.\textsuperscript{189} If the net value at the second-market is lower than the first, however, the lessee must pay royalty on the value received at the first market. It is not clear under \textit{Garman, Mittelstaedt,} and \textit{Rogers} whether the lessee may elect to pay on the first-market value, even though its net downstream profits are greater. Future litigation will likely force clarification of this in Colorado and Oklahoma courts.

\textit{VI. Conclusion}

While claiming to advance a marketable-product approach to royalty valuation, the \textit{Rogers} court illogically diverged from conventional application of the implied covenant to market. The \textit{Rogers} court stretched this covenant to impose upon lessees a duty to deliver gas to a distant marketable location if one does not exist in the vicinity of the well. In doing so, the court not only ignored settled case law and commentary, it also created incentives for lessees

\textsuperscript{181} See id.
\textsuperscript{182} See id.
\textsuperscript{183} See id. at 688-89.
\textsuperscript{184} See id. at 690-91.
\textsuperscript{185} 262 Cal. Rptr. 683 (Cal. Ct. App. 1989).
\textsuperscript{186} Id. at 687-88.
\textsuperscript{189} See Garman, 886 P.2d at 661; Mittelstaedt, ¶ 30, 954 P.2d at 1210.
to focus more on minimizing their freight costs than on seeking the best first market.

"At the well" lease language, while short on details, is not completely silent. Regardless of the location of the first market, royalty valuation under an "at the well" lease, or under a lease that is truly silent, appropriately occurs in the vicinity of the well. If the first market is beyond the immediate vicinity of the well, a decisive weight of authority indicates that lessors and lessees should proportionately share transportation costs incurred under typical leases, including "at the well" leases. This approach helps to ensure that lessees will seek the best first market to the mutual benefit of the parties.

Adam Marshall