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# GAS BALANCING PROBLEMS IN A DEREGULATED MARKET: CHANGES AND POSSIBLE SOLUTIONS UNDER OKLAHOMA LAW

Wade A. Hoefling\*

## I. INTRODUCTION

Gas balancing is becoming one of the most prominent issues in the natural gas industry. Because of a combination of recent events, owners of interest in wells producing natural gas have increasingly found themselves "out of balance" with other interest owners. This means that, in any particular well, some interest owners may have produced more than their respective shares of the total wellstream and thus are "overbalanced" or "overproduced," while others have produced less than their respective shares of the total wellstream and are thus "underbalanced" or "underproduced."

Production imbalances among working interest owners in gas wells have led to disruptions in anticipated cash flow, increased risk that each interest owner will not recover its rightful share of the reservoir, and increased administrative problems and expenses. Gas producers currently have little guidance in confronting gas imbalance problems absent agreements that specifically address gas imbalances. Such agreements (generally known as "balancing agreements"), however, are either (1) non-existent or (2) obsolete, and do not adequately address many of the problems that arise from gas imbalances.<sup>1</sup>

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1. For a useful guide to gas balancing agreements and practical advice for preparing them, see Lansdown, *The Use of Gas Balancing Agreements in Texas*, 7 CORP. COUN. REV., Nov. 1988, at 1. For a case in which a producer was seemingly penalized for having entered into a less-than-comprehensive gas balancing agreement, see *Chevron U.S.A., Inc. v. Belco Petroleum Corp.*, 755 F.2d 1151, 1154 (5th Cir.), *cert. denied*, 474 U.S. 847 (1985), which held that an agreement that provided for balancing in kind allocated the risk that the well would deplete before balancing had been achieved to the underproduced party. Thus, it denied the underproduced party's request for cash balancing

The focus of this Article is limited to the law governing gas imbalances in wells in which the parties have not entered into any gas balancing agreement. The inquiry is whether greater duties should be imposed upon well operators and overproduced parties in accounting to underproduced parties and in abating imbalances. This examination will involve, first, a review of the nature and history of gas imbalances and the resulting problems. Second, the current status of Oklahoma law governing imbalances absent a balancing agreement will be explained and criticized. Third, possible alternatives to the current law will be evaluated.

We shall discover that imbalances have become much more common in the gas industry because they are no longer limited to wells that have two or more physical connections to different pipelines. Instead, imbalances may potentially arise in any well that is connected to a single pipeline transporting on behalf of other purchasers. Deregulation of the natural gas pipeline industry has given rise to this multi-purchaser scenario throughout the gas-producing states, including Oklahoma.

Next, we shall find that Oklahoma's common law applicable to gas balancing problems developed when rigid pipeline regulation was still in place. As pipeline deregulation began spreading gas imbalances to wells with only one pipeline connection, the Oklahoma Legislature enacted statutes that mandated balancing solutions. This remedial legislation has been largely ignored in Oklahoma because the problem it was intended to address—the inability to get a gas purchase contract—has largely disappeared with the advent of an increasingly free trading market in gas.

Finally, we shall evaluate whether Oklahoma's balancing statutes, which have been left in the wake of deregulatory changes, should be repealed or judicially limited in their application. Alternatively, we shall evaluate whether such balancing statutes should be further extended to overtake the newly competitive gas market and more comprehensively address the problems it has bred.

## II. THE NATURE AND HISTORY OF GAS IMBALANCES

Imbalances arise among producers of gas because of the physical limitations of gas, multiple ownership of gas wells, and multiple markets

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upon depletion. This harsh result was based upon a severely limited construction of the applicable balancing agreement.

for gas. These elements combine to create imbalances. Primarily because of the deregulation of the natural gas industry, marked by the passage of the Natural Gas Policy Act of 1978 (the NGPA),<sup>2</sup> the composition of these elements has shifted to produce the more pervasive imbalances confronting the gas industry today.

#### A. *The Physical Limitations of Natural Gas*

Compared to oil, gas is difficult to store, transport, and measure.<sup>3</sup> The most economical means of storing gas is to leave it in the well's reservoir. Transportation of gas is generally limited to pipeline systems, which must be constructed, maintained, and operated at relatively high cost. Measurement of gas requires relatively expensive metering devices. Gas must be produced, gathered, and transported under pressure that in many instances requires steel containment. The inflammable and explosive characteristics of gas are well known. Because gas is relatively difficult to handle, pipelines and producers prefer to leave it in the reservoir until it is sold.<sup>4</sup>

#### B. *Multiple Ownership in Gas Wells*

No balancing problems arise if gas well ownership is unified because there are no disparate interests to become imbalanced. Oil and gas production rights, however, have commonly been subdivided because of the relatively high costs of financing drilling operations, desires to spread the risks associated with drilling,<sup>5</sup> and tax incentives that attract a substantial number of drilling participants from outside of the core oil and gas industry.<sup>6</sup> Generally, working interest owners in a successful gas well own their share of the gas contained in the reservoir made accessible by

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2. The NGPA was enacted on November 9, 1978, as part of the National Energy Act, Pub. L. No. 95-621, 92 Stat. 3351 (1978) (codified at 15 U.S.C. §§ 3301-3432 (1982)).

3. Hillyer, *Problems in Producing and Selling. By Split or Single Stream, Gas Allocable to Diverse Working Interest Ownerships*, 16 INST. ON OIL & GAS L. & TAX'N 243, 244 (1965). For an excellent introduction to the gas pipeline industry generally, see A. TUSSING & C. BARLOW, *THE NATURAL GAS INDUSTRY: EVOLUTION, STRUCTURE, AND ECONOMICS* (1984).

4. See Medina, McKenzie & Daniel, *Take or Litigate: Enforcing the Plain Meaning of the Take-or-Pay Clause in Natural Gas Contracts*, 40 ARK. L. REV. 185, 190 (1987) (noting value of storage in the reservoir).

5. Upchurch, *Split Stream Gas Sales and the Gas Storage and Balancing Agreement*, 24 ROCKY MTN. MIN. L. INST. 665, 665 (1978) (noting that because of soaring costs, deeper drilling, and more hostile environments, risks must be spread among a greater number of parties in larger units or exploration areas).

6. See Crichton & Griffin, *Securities Problems and Tax Implications of Oil and Gas Investments by Non-Industry Financiers*, 27 ROCKY MTN. MIN. L. INST. 1333 (1982).

the well.<sup>7</sup> According to the standard forms of operating agreements commonly used in the industry, each working interest owner in a gas well has the right to produce its share of the gas in the reservoir and take it in kind.<sup>8</sup>

The timing of when the various owners choose to exercise their respective rights to dispose of their respective shares of gas may lead to an imbalance. As long as all of the owners of the well produce their respective shares of the gas contemporaneously no imbalance arises; each owner's share of the production stream coincides with its share of the well and of gas in the reservoir. It is only when one or more of the well's owners is unable or refuses to produce its respective share of the gas that an imbalance arises.

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7. In states such as Oklahoma in which oil and gas exploration is governed by the so-called exclusive-right-to-take or nonownership theory, a more precise statement of a gas well owner's rights is that it may produce its fair share of the well's gas reserves. As among owners in a single well, that "fair share" is based upon each owner's working interest in the well. As among owners of wells overlying a field or other common source of supply, however, Oklahoma limits the rule of capture to allow each well a fair chance to produce its share of the gas contained in the field, or in the common source of supply. Regulatory limits upon the rule of capture include conservation (OKLA. STAT. tit. 52, § 87.1 (Supp. 1988)) and ratable take measures (OKLA. STAT. tit. 52, §§ 231-233, 240 (1981)).

The statutory predicate of such regulatory limits is that "[a]ll natural gas under the surface of any land in this state is hereby declared to be and is the property of the owners, or gas lessees, of the surface under which gas is located in its original state." OKLA. STAT. tit. 52, § 231 (1981). The Oklahoma Legislature's apparent adoption of the "ownership-in-place" theory is in derogation of the common law and should be strictly construed to accomplish the objective of the legislation. *Republic Bank & Trust Co. v. Bohmar Minerals, Inc.*, 661 P.2d 521, 523 (Okla. 1983); *In re Adoption of Graves*, 481 P.2d 136, 138 (Okla. 1971); *Fenton v. Young Chevrolet Co.*, 191 Okla. 161, 163, 127 P.2d 813, 814 (1942). Therefore, the fundamental principle of gas ownership in Oklahoma is that absolute ownership is not established until the gas is reduced to possession and controlled. *Frost v. Ponca City*, 541 P.2d 1321, 1323 (Okla. 1975). The Oklahoma Legislature has merely regulated the gas owners' abstract rights to subsurface gas to ensure that each has a fair chance to produce its fair share consistent with the state's conservation interests. See Note, *Oil and Gas: H.B. 1221: Protection of Correlative Rights in the Absence of Waste*, 40 OKLA. L. REV. 127, 129-33 (1987); Note, *A New Dimension in the Ratable Taking of Natural Gas in Oklahoma: Enrolled House Bill 1221*, 20 TULSA L.J. 77, 78-83 (1984). See also 1 H. WILLIAMS & C. MEYERS, OIL AND GAS LAW §§ 203.1-203.4 (1988) (explaining various ownership theories with respect to oil and gas).

8. Smith, *Gas Marketing By Co-Owners: Problems of Disproportionate Sales, Gas Balancing and Accounting to Royalty Owners*, in NATURAL GAS MARKETING II, Paper No. 12, at 2-3 (1988), which is an updated version of Smith, *Gas-Marketing by Co-Owners: Disproportionate Sales, Gas Imbalances and Lessors' Claims to Royalty*, 39 BAYLOR L. REV. 365 (1987). There have been three versions of the A.A.P.L. Form 610 Model Form Operating Agreement, in 1956, 1977, and 1982. A 1988 version was proposed but has not been adopted. All versions to date provide that each party has the right to "take in kind or separately dispose of its proportionate share" of gas produced from the contract area. This is consistent with Oklahoma common law, which represents the majority rule, that any cotenant in the right to explore and produce oil and gas may do so without the consent of the other cotenants, subject to an obligation to account to those cotenants for their share of net profits. *Earp v. Mid-Continent Petroleum Corp.*, 167 Okla. 86, 27 P.2d 855 (1933); see 1 E. KUNTZ, A TREATISE ON THE LAW OF OIL AND GAS §§ 5.2-5.6 (1987 & Supp. 1989).

### C. Multiple Markets for Gas

Generally, when there is only one purchaser for the well's gas, all of the working interest owners choose to sell their respective shares of gas. All other things being equal, the single purchaser of gas at the wellhead is indifferent as to which owner's gas is purchased, and thus all owners should receive the same price. The producers in such a case have little economic incentive to withhold their respective shares of gas from the purchaser unless they believe the price will rise.

In the past some pipelines chose to discriminate among owners in a well or other common source of supply by choosing to buy the gas of some owners while eschewing that of others. This arose in situations in which the pipeline had no market for additional gas,<sup>9</sup> there was common ownership between the pipeline and the wells involved,<sup>10</sup> or other business factors unrelated to the microeconomics of a single pipeline purchaser connected to a well were present. Several of the producing states, however, enacted so-called "common purchaser" legislation to prevent this practice. Such legislation requires that the pipeline purchase gas from all owners in a well or other common source of supply ratably and without discrimination.<sup>11</sup>

Thus in states such as Oklahoma, which enacted common purchaser legislation as early as 1913,<sup>12</sup> the various owners in a well have little incentive to withhold their gas from a purchaser that is required by law

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9. See, e.g., *Republic Natural Gas Co. v. Oklahoma*, 334 U.S. 62 (1948), which upheld an Oklahoma Corporation Commission order requiring a pipeline to take gas from different producers in a field ratably. The order was issued upon complaint of a producer whose gas from a newly drilled well had been refused because supply exceeded market demand.

10. See, e.g., *Cities Service Gas Co. v. Peerless Oil & Gas Co.*, 340 U.S. 179 (1950), in which the interstate pipeline operator also owned a substantial number of the wells in the field, which was subject to the plaintiff producer's complaint that the pipeline should be required to take gas ratably from all wells in the field without discrimination. The Court upheld orders issued by the Oklahoma Corporation Commission requiring such ratable takes and at a "fair" price as not violating either the due process or equal protection clauses of the fourteenth amendment.

11. Act of Mar. 26, 1913, ch. 99, § 3, 1913 Okla. Sess. Laws 167 (codified at OKLA. STAT. tit. 52, § 23 (1981)) provides in part that:

Every corporation . . . or other person . . . exercising the right to carry or transport natural gas . . . engage[d] in the business of purchasing natural gas shall be a common purchaser thereof, and shall purchase all the natural gas in the vicinity of, or which may be reasonably reached by its pipelines, or gathering branches, without discrimination in favor of one producer or one person as against another . . . .

*Id.*

12. *Id.* Other states that enacted common purchaser legislation followed Oklahoma: Louisiana in 1918 (LA. REV. STAT. ANN. § 30:41-46 (West 1989)), Texas in 1930-1931 (TEX. NAT. RES. CODE ANN. § 111.082 (Vernon 1978)), Kansas in 1935 (KAN. STAT. ANN. §§ 55-701, 55-703 (1983)), New Mexico in 1941 for oil and 1949 for gas (N.M. STAT. ANN. § 70-2-19 (1978)), and Colorado in 1953 (COLO. REV. STAT. § 34-60-117 (1984)).

to purchase it at the same price and on the same terms from every owner in the well. This situation changes when two or more pipelines are available to gather gas from any particular well, or other common source of supply. In that case, the different pipelines can pay different prices and purchase gas on different terms without violating common purchaser requirements. In many such instances, producers will contract to sell their gas to different pipeline purchasers and a "split-stream" connection results. Some of the wellstream is produced by some owners to their pipeline purchaser and the remainder is produced by the remaining owners to their pipeline purchaser.

Split-stream connections involve economic waste to the extent that additional gathering line is laid to accommodate more than one pipeline. They also increase administrative difficulties in operating the well and accounting for production and sales.<sup>13</sup> As a result, split-stream connections are generally limited to prolific gas producing areas, which exhibit sufficient reserves and pressure to justify the added gathering and administrative expense.<sup>14</sup> Another factor, however, has played a much greater role in creating the multiple market scenario—the deregulation of the gas industry.

#### D. *Deregulation Leading to Multiple Markets and Imbalances*

Before enactment of the NGPA, the price that interstate pipelines could pay for gas at the wellhead was set by federal regulation.<sup>15</sup> The Federal Energy Regulatory Commission (the FERC) and its predecessor, the Federal Power Commission (the FPC), determined the price that should be paid a producer based upon its cost of making that gas available to the interstate system.<sup>16</sup> Conceptually, the producer's cost of making the gas available at the wellhead was just another element in determining the pipeline's total cost of providing gas service to the pipeline's ultimate customers.<sup>17</sup> The commodity character of gas was not

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13. See Hillyer, *supra* note 3, at 259-69 (outlining various practical and administrative problems encountered with split-stream sales); Upchurch, *supra* note 5, at 665 (describing problems created by split-stream gas sales as "nightmarish").

14. See Note, *Oil and Gas: Production Imbalance in Split Stream Gas Wells Getting Your Fair Share*, 30 OKLA. L. REV. 955, 957 n.15 (1977) (noting incidence of split stream connections in Oklahoma fields in which there is enhanced competition among purchasers seeking additional reserves).

15. Breyer & MacAvoy, *The Natural Gas Shortage and the Regulation of Natural Gas Producer*, 86 HARV. L. REV. 941 (1973).

16. *Id.* at 952-58.

17. *Id.*

considered separately.<sup>18</sup> There was no reason for such a distinction because the pipeline served both as exclusive transporter and as exclusive purchaser of gas.<sup>19</sup> It did not matter to the ultimate customer because all of a pipeline's various costs incurred in delivering "gas service" were rolled into one price.<sup>20</sup>

This structure changed with the advent of the NGPA.<sup>21</sup> First, the NGPA ended the distinction between the interstate and intrastate gas markets. Second, it deregulated the price that could be paid for gas, limited only by specified ceilings that phased out over a term of years. Because the NGPA was enacted during a period of supply shortage, the pipelines, freed of direct regulatory restraints, quickly bid the price of so-called new gas (*i.e.*, generally that drilled after the NGPA) up to the newly promulgated maximum lawful ceilings. In the case of some so-called high-cost gas (*viz.*, gas deeper than 15,000 feet and from various "tight" formations) no ceilings were imposed and the price escalated above its equivalent heating value in fuel oil.

The increasingly free market then began to operate. As pipelines began including these skyrocketing producer prices in their cost of providing service, gas began pricing itself out of the heating fuel market. Industrial users and other customers that had the ability to switch to alternative fuels, such as oil or coal, did so and the demand for gas dropped as supplies increased, spurred by higher wellhead prices. The results were the well-documented curtailment and take-or-pay problems that have plagued the industry since 1983.<sup>22</sup>

At the time such problems were first noticed, the FERC began experimenting with special marketing programs that allowed certain customers to purchase gas subject to take-or-pay obligations at market-

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18. See Order No. 436, *Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol*, [1982-1985 Regs. Preambles] F.E.R.C. Stats. & Regs. ¶ 30,665, at 31,472-75 (1985).

19. *Id.* See also *Associated Gas Distribs. v. FERC*, 824 F.2d 981, 993-97 (D.C. Cir. 1987), *cert. denied*, 108 S. Ct. 1468 (1988) (a good summary of Order No. 436 and its role within the context of natural gas regulation in general).

20. See *Wisconsin Gas. Co. v. FERC*, 770 F.2d 1144, 1149-52 (D.C. Cir. 1985), *cert. denied*, 476 U.S. 1114 (1986) (a good overview of interstate ratemaking based upon commodity and demand charges). For a detailed description of regulation of the gas industry, see R. PIERCE, *NATURAL GAS REGULATION HANDBOOK* (1980).

21. The following overview of the NGPA relies upon Pierce, *Reconsidering the Roles of Regulation and Competition in the Natural Gas Industry*, 97 HARV. L. REV. 345, 348-50 (1983).

22. See *Seal v. Corporation Comm'n*, 725 P.2d 278, 285 (Okla. 1986), *appeal dismissed sub nom. Amerada Hess Corp. v. Corporation Comm'n*, 479 U.S. 1073 (1987). For a factually based description of how pipelines were able to pay rapidly increasing prices for "new" gas by rolling such purchase costs into their overall rate base, see Order No. 436, *supra* note 18, at 31,475-86.



competitive prices.<sup>23</sup> The goal of these experiments was to provide pipelines with take-or-pay relief and to allow gas to be sold at a price determined by the market. These experiments blossomed into the FERC's open-access initiatives in Order Nos. 436 and 500,<sup>24</sup> which were designed to allow gas to be sold as a commodity and to compensate pipelines for transporting it on a volumetric basis. These Orders implied that pipelines would no longer serve as the exclusive wholesaler of gas, buying it at the wellhead, gathering it, transporting it, storing it downstream if necessary, and then delivering it to their customers. Instead, these different services would be "unbundled" and the pipelines would charge for each component service separately.

A primary impetus for such regulatory changes was that pipelines had stopped buying gas when their weighted average cost of gas (WACOG) exceeded what the heating fuel market would bear.<sup>25</sup> A great number of producers were left without contracts to sell their gas. Many had been selling their gas without written contracts but on the same terms as the operator or another major owner in the well. The pipelines were willing to follow this industry practice and honor common purchaser requirements as long as the supply shortage continued. When the oversupply problem developed, the pipelines honored only their written contracts, leaving the uncontracted producers without a market.<sup>26</sup>

In response, the FERC encouraged a new breed of non-pipeline purchaser to fill the merchant void left by the large interstate pipelines. Hundreds of gas brokers and marketers rushed into this void. Many additional separate companies have been established by the pipelines themselves, known as affiliated marketers.<sup>27</sup> The primary purpose of all gas marketing companies (affiliated and non-affiliated alike) is to purchase gas, which is then transported on a pipeline, or pipelines, for delivery to

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23. For a good overview of special marketing programs, limited-term abandonments, off-system, and discounted sales, see Griggs, *Restructuring the Natural Gas Industry: Order No. 436 and Other Regulatory Initiatives*, 7 ENERGY L.J. 71, 81-89 (1986).

24. Order No. 436, *Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol*, [1982-1985 Regs. Preambles] F.E.R.C. Stats. & Regs. ¶ 30,665 (1985), 18 C.F.R. § 284 (1989), as amended by Order No. 500, *Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol*, III F.E.R.C. Stats. & Regs. ¶ 30,761 (1987), 18 C.F.R. § 284 (1989).

25. See Order No. 436, *supra* note 18, at 31,482-83 (comparing the non-regulated flexibility of an independent marketer with the regulated inflexibility burdening an interstate pipeline under the Natural Gas Act of 1938).

26. Taylor, *The Excess Gas Market—Recent Legal Problems Precipitated by Excess Gas Deliverability, and Applicable Regulatory Provisions*, 35 INST. ON OIL & GAS LAW & TAX'N 87, 90-94 (1984).

27. See Order No. 497, *Inquiry into Alleged Anticompetitive Practices Related to Marketing Affiliates of Interstate Pipelines*, III F.E.R.C. Stats. & Regs. ¶ 30,820 (1988).

the customers of the marketing company (which in many instances are also sales customers, or former sales customers, of the transporting pipelines).<sup>28</sup>

As a result of this new marketing structure the producer is confronted at the wellhead with multiple market opportunities. Depending upon the location of its well a producer may be able to choose from a variety of purchase contracts with terms ranging anywhere from one month to several years, and prices varying depending upon the term to which the producer commits its gas.<sup>29</sup> For producers whose gas is dedicated under a long term contract (*i.e.*, longer than five years, but generally fifteen or twenty years), these alternative marketing opportunities are available to the extent that the producer has obtained the pipeline's release from that obligation.

Greater imbalances have arisen under this new marketing structure for several reasons. First, producers with above-market price contracts prefer to deliver their share of gas under such contracts. In many instances, pipelines have refused to take such high-price gas or have reduced the amount of their takes.<sup>30</sup> The remaining share of the wellstream is hence available for sale by other producers in the well, who may choose to sell it under a lower-price contract, thus creating an imbalance between the high-price producer and the low-price producer.<sup>31</sup>

Second, many smaller producers with relatively small staffs have been slow to adjust to the new marketing environment and have not made appropriate sales arrangements as quickly as some other larger, better-staffed or more opportunistic producers. Again, the result is that

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28. See *Maryland People's Counsel v. FERC*, 761 F.2d 768, 771, 780 (D.C. Cir.), *mandate stayed*, 768 F.2d 1354 (D.C. Cir. 1985) (considering consumer challenges to transportation programs that allow customers with fuel switching capability to buy low-priced gas while distributors, without such switching capacity, remain obligated to purchase higher priced system supply).

29. See Piccone & Reimer, *Natural Gas Wellhead Agreements*, in *NATURAL GAS MARKETING II*, Paper No. 6 (1988).

30. See Medina, McKenzie & Daniel, *supra* note 4.

31. See, *e.g.*, *Kaiser-Francis Oil Co. v. Producer's Gas Co.*, 870 F.2d 563 (10th Cir. 1989), a take-or-pay case in which the court rejected the pipeline's argument that it had accepted delivery of gas only under reduced-price contracts to the exclusion of plaintiff's high-price gas. The court reasoned that an imbalance between high-price and low-price contracts would inexorably continue until depletion, at which time the low-price owners would cash balance at their low price, thus defeating the plaintiff's contract right to the higher price. In addition, plaintiff's payment would be delayed until depletion unless the price and quantity provisions of the contract were enforced. *Id.* at 569-70. The court in *HBOP, Ltd. v. Delhi Gas Pipeline Corp.*, 645 P.2d 1042, 1047-48 (Okla. Ct. App. 1982), also held that the pipeline purchaser's take obligations are governed by the appropriate clauses in its contract with the producer, reasoning that balancing issues are relevant only among co-owners in a well, and only incidentally affect obligations between those co-owners and their respective purchasers.

some of the producers have sold more than their reservoir share of the wellstream and an imbalance arises.

Third, some producers have chosen to curtail delivery of their share of gas based upon their belief that the current market price of gas is historically low and that they can maximize the value of their share of the gas reserves by selling a greater share of the wellstream in the future. They have thus chosen to store their gas in the reservoir.

Having addressed the nature and history of imbalances and how deregulation has increased them, we now turn to the current Oklahoma law that applies to them.

### III. THE CURRENT LAW: "EQUITABLE BALANCING"

Oklahoma's law governing gas balancing issues comprises a limited number of reported cases, which provide only general guidance, and a recently enacted statutory scheme, commonly known as House Bill 1221, which provides very specific obligations and remedies. Together, Oklahoma's published cases and House Bill 1221 provide for a law of "equitable balancing."

#### A. Oklahoma's Common Law

Commentators note that Oklahoma law provides guidance in dealing with balancing problems,<sup>32</sup> citing *Beren v. Harper Oil Co.*<sup>33</sup> and *United Petroleum Exploration, Inc. v. Premier Resources, Ltd.*<sup>34</sup> These cases are two of the few published cases that address balancing in the absence of an agreement;<sup>35</sup> the two deciding courts, however, employ very different reasoning. Although *United Petroleum* was decided by a federal court in a diversity case and purportedly followed *Beren*, it reached a result different from that seemingly dictated by *Beren*. Reading both *Beren* and *United Petroleum* together leaves a confused confluence of principles, stirred in the stew of equity. *Beren* is more consistent with Oklahoma oil and gas law and should be read alone as the clearest statement of Oklahoma's law on balancing problems; *United Petroleum* should be largely ignored.

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32. 6 H. WILLIAMS & C. MYERS, *supra* note 7, at § 951; 5 E. KUNTZ, *supra* note 8, at § 77.3(f); Fell, *Marketing of Production from Properties Subject to Operating Agreements*, 33 INST. ON OIL & GAS LAW & TAX'N 115, 132 (1982) (noting that *Beren v. Harper Oil Co.*, 546 P.2d 1356 (Okla. Ct. App. 1975), was the first appellate court to use the term "balancing").

33. 546 P.2d 1356 (Okla. Ct. App. 1975), *as corrected on limited grant of cert.*

34. 511 F. Supp. 127 (W.D. Okla. 1980).

35. *See Smith, supra* note 8, at 17-24.

*Beren* involved a multiple-owner well with a split connection. The owner, which was connected to a high-pressure line (ONG), experienced delivery problems and became underbalanced in relation to the other owners, who were connected to a lower pressure line (Arkla). After the ONG contract was terminated, the split-connection removed, and all owners were selling to Arkla, the underproduced owners became concerned that the reservoir would deplete before they could make up the underbalance and sued for a cash accounting to achieve an immediate balance. The Oklahoma Court of Appeals reversed the trial court and granted this cash balancing request. It reasoned that because the parties had no balancing agreement, industry custom and usage was incorporated into the operating agreement among the parties. As to industry custom and usage, the court found that:

It is a matter of common knowledge that when a split connection exists there will be differences in the "take" by the separate purchasers. It is the general custom and usage in the gas industry that "the take" be balanced in kind if possible.<sup>36</sup>

Applying this custom, the court assumed that no further imbalance could occur because the split connection had been eliminated and observed no reason for waiting until depletion for the parties to balance in cash. Thus, the court determined that "the equities dictate an immediate accounting and cash balancing between the owners of interest in the well."<sup>37</sup> The principle that emerged from *Beren* is that in the absence of a balancing agreement imbalances are "made up" in kind if possible, unless other circumstances would cause this remedy to be inequitable. Thus, Oklahoma law may be aptly characterized as that of "equitable balancing."

More precisely, the principle of equitable balancing is based upon a hierarchy of remedies, preferred in the following order:

1. Balancing in kind. A balancing in volumes. In effect the underproduced party takes a certain percentage of the over-produced party's gas until the "imbalance" has been "made up."
2. Periodic cash balancing. Here, the underproduced party receives cash, and the well is immediately brought into balance.
3. Cash balancing upon reservoir depletion. The parties endeavor to maintain a reservoir balance during the life of the well, and on depletion, the overproduced party accounts to the underproduced party in

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36. *Beren*, 546 P.2d at 1359.

37. *Id.* at 1360.

cash.<sup>38</sup>

The *Beren* court ordered the second remedy, which presumably is more equitable than, and thus preferred over, cash balancing upon depletion because of the time value of money (*i.e.*, the interest factor).<sup>39</sup>

*United Petroleum*<sup>40</sup> is the second Oklahoma case directly addressing gas balancing. Like *Beren* it also involved a multiple owner well with two different gas purchasers. Unlike *Beren* the imbalance was created when only one purchaser was connected, and thus when only one party could sell, thereby creating the imbalance. After the other parties had obtained their purchaser's connection and all parties were producing and selling in approximate balance, the underbalanced parties sued for an immediate cash accounting to bring the owners back into balance at the fair market value of the gas (*i.e.*, the higher price that the underbalanced parties would have received under their contract from their purchaser). In the alternative, the plaintiff underbalanced parties requested the right to produce and deliver more than their working interest share of the wellstream until they had "made up" the imbalance in kind. The plaintiffs cited *Beren* in support of their alternative request.<sup>41</sup>

The court rejected the plaintiffs' request and instead ordered an immediate cash balancing at the lower price received by the overbalanced owner. It reasoned that the underbalanced parties had a right to balance in kind only if they were physically capable of taking their share of gas at the time the imbalance was created. Because at that time they were

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38. *Id.* at 1359.

39. In its original opinion, the Oklahoma Court of Appeals chose the first remedy, balancing in kind. It ordered the over-balanced parties to allocate to the underbalanced parties half of their three-fourths interest in the proceeds of gas purchases attributable to their interests until the imbalance was eliminated, and provided for cash balancing only if the well had not been rebalanced before depletion. 46 OKLA. B.J. 1523, 1525 (August 5, 1975). Upon review, the Oklahoma Supreme Court issued its "Order Granting Certiorari for the Limited Purpose of Striking Certain Language from the Court of Appeals Opinion and Substituting Other Language Therefor," in which it struck the balancing-in-kind remedy applied by the Oklahoma Court of Appeals and substituted the cash balancing remedy that appears in the published court of appeals opinion in the first full paragraph at 546 P.2d at 1360. 46 OKLA. B.J. 2205 (Nov. 10, 1975). After substituting the supreme court's remedy, the opinion was released for publication by order of the court of appeals on February 26, 1976. *Beren*, 546 P.2d at 1356. The supreme court did not provide any reasoning to support its substitution of the less-preferred, cash balancing remedy. Such unreasoned imposition of the second remedy leaves the published opinion somewhat mysterious, and not entirely consistent with the reasoning set forth by the court of appeals. Thus we are left to conjecture why the supreme court substituted the cash balancing remedy. Professor Eugene Kuntz was puzzled by other facets of the *Beren* opinion and noted the many questions left unresolved. *Beren*, 53 OIL & GAS REP. 531 discussion note at 538 (MB 1976).

40. 511 F. Supp. 127 (W.D. Okla. 1980).

41. *Id.* at 129.

awaiting connection by their purchaser, they in effect forfeited their customary remedy to take in kind and could not refuse the overproduced owner's offer to share in sales under its lower price contract.

This result represents a complete departure from the remedial scheme enunciated in *Beren*, despite the *United Petroleum* court's statement that "the reasoning applied by the court in *Beren* is sound and should be followed."<sup>42</sup> The point of the *United Petroleum* court's departure was its assumption that the gas sold by the overbalanced party was owned by all of the working interest owners in proportion to their working interests. Thus, it miscast the controlling issue as follows:

The dispute between these parties is not that Premier's actions in reducing to possession a quantity of gas has resulted in a hampering of United's ability to conduct its own operation to obtain possession of a quantity of gas from the same supply source. Rather, this dispute is over whether a part owner of a producing gas well can disclaim title to that portion of the production occurring while it is physically unable to take possession of its fair share, and assert instead an absolute ownership over a mathematically balanced volume of production *after* possession capability is provided.<sup>43</sup>

The above-quoted statement of the issue is wrong for the following two reasons. First, it assumes that a cotenancy exists among all of the working interest owners in the gas as it is produced. Although the court noted that the parties presented conflicting authority on this point,<sup>44</sup> it

42. *Id.* at 130.

43. *Id.*

44. The *United Petroleum* court noted the overbalanced party's argument that the unitization of the subject well required it as operator to produce and market the gas produced from the well for the benefit of all owners of interest in the unit pool. *Id.* at 129. The three cases that the overbalanced operator cited in support of this proposition are not on point. *Earp v. Mid-Continent Petroleum Corp.*, 167 Okla. 86, 27 P.2d 855 (1933), relied upon the rule that a cotenant in oil and gas rights may explore and develop without consent of its cotenants subject to its obligation to account to such cotenants for their share of net profits. *Barton v. Cleary Petroleum Corp.*, 566 P.2d 462 (Okla. Ct. App. 1977), addressed the rights of unleased mineral owners to participate in production from a well drilled on another mineral owner's land before the unleased land was included in that well's production unit pursuant to OKLA. STAT. tit. 52, § 87.1 (1971). *Dilworth v. Fortier*, 405 P.2d 38 (Okla. 1974), relied primarily upon the rule that a good-faith trespasser upon an oil and gas lease may recover its reasonable expenses incurred in obtaining production.

None of these three cases imposes a duty upon an operator appointed in a pooling proceeding to produce and market production for the joint account. Unless the pooling order specifically imposes such a duty, each party in the well retains its common law right separately to dispose of its share of the production and to make its own marketing decisions. OKLA. STAT. tit. 52, § 87.1(e) (Supp. 1988) states that, "[t]he portion of the production allocated to the owner of each tract or interests included in a well spacing unit formed by a pooling order shall, when produced, be considered as if produced by such owner from the separately owned tract or interest . . . ." For a case that does address the proposition raised by the overbalanced operator in *United Petroleum*, but under Louisiana's pooling statute, see *Amoco Prod. Co. v. Thompson*, 516 So. 2d 376 (La. Ct. App. 1987), *writ*

never decided this issue or even further addressed it. It implicitly assumed the conclusion that such a cotenancy existed. The court therefore mistakenly viewed the controlling issue as whether the underbalanced party could "disclaim title" to its share of the gas produced by the overbalanced party before the second pipeline connection was added to the well. This concept of a cotenancy in gas as it is produced is inconsistent with the rule of capture.<sup>45</sup> In Oklahoma, gas is not owned in place under the land: ownership may be asserted only when it is severed and brought to the surface. The severed gas is owned by the well owner who produces it and delivers it at the wellhead.<sup>46</sup> In *United Petroleum* the only party capable of doing so during the period the imbalance accrued was Premier, the overbalanced defendant.

Second, even if a cotenancy in severed gas existed, it does not necessarily follow that a cotenant is precluded from producing and delivering more than its working interest share of the wellstream. Although a non-operating cotenant may demand an accounting from the operating cotenant that is producing all of the gas, it is not obligated to do so. It may waive such right and choose to take its share of the gas at a later time. By doing so, it does not "disclaim title" to its share of the wellstream, it merely follows a marketing strategy different from that of its cotenants. If the parties have not entered into an agreement concerning the procedures and timing by which their respective operating rights (or "correlative rights") may be exercised, then they must fall back on the common law, which may be founded upon custom and usage in the industry. Therefore, the issue properly before the *United Petroleum* court was precisely what it denied was the issue: whether "Premier's actions in reducing to possession a quantity of gas has resulted in a hampering of United's ability to conduct its own operation to obtain possession of a

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*denied*, 520 So. 2d 118 (La. 1988) (imposing duty upon operator of pooled unit to market gas on behalf of non-contracted owners).

45. Although inconsistent with the rule of capture, a cotenancy in gas may, however, exist under a cross-conveyancing theory in states such as Texas, which recognize ownership of oil and gas in place. See Smith, *supra* note 8, at 15-17, examining the theory enunciated in *Gilling Oil Co. v. Hughes*, 618 S.W.2d 874 (Tex. Ct. App.—Beaumont 1981, no writ), that an operating agreement establishes a cross-conveyancing of working interests, which gives rise to cotenancy in gas produced. See also Hillyer, *supra* note 3, at 266, where the author notes that "[i]f the lessees within the unit may agree on a proper basis of sharing, by cross-assigning undivided interests in the various leases in proportions based on the respective shares, the leases themselves become co-owned and there is no future problem as to balancing among the lessees." (original emphasis). Mr. Hillyer's opinion may be correct under an ownership-in-place theory of gas ownership, but not under the exclusive-right-to-take theory, in which ownership does not vest until the gas is produced and controlled.

46. *Frost v. Ponca City*, 541 P.2d 1321, 1323 (Okla. 1975); 1 E. KUNTZ, *supra* note 8, at § 2.4.

quantity of gas from the same supply source.”<sup>47</sup>

If the *United Petroleum* court had chosen to decide the correct issue before it, and if it had properly applied the hierarchy of remedies set forth in *Beren*, it would have granted United’s alternative request and would have allowed it to take some additional, equitable share of the wellstream in excess of its working interest share until the imbalance was eliminated. Premier had not hampered United’s ability to obtain its share of the reservoir by selling all of the wellstream to its purchaser for the few months during which United was awaiting its purchaser’s connection. After the split connection was established, United could feasibly have made excess deliveries until the imbalance was eliminated.

If this were the only oversight in the *United Petroleum* opinion the court might have at least considered United’s alternative argument that “requiring a party to provide appropriate facilities for capture, as a precondition to the actual taking of gas in kind, places owners of oil and gas interests at the mercy of third parties such as pipeline purchasers.”<sup>48</sup> The court did not address this argument, probably because it never directly addressed the cotenancy question.<sup>49</sup>

The *United Petroleum* court, however, was further distracted from a faithful application of *Beren*’s hierarchy of equitable balancing remedies by overlaying upon that hierarchy its own overriding remedial principle: to restore the underbalanced party to the position it would have occupied if the imbalance had not occurred.<sup>50</sup> This expectation remedy has its origins in the law of contracts.<sup>51</sup> Its employment by the *United Petroleum* court implies that the overbalanced party was obligated to market gas on behalf of all of the working interest owners and thus keep all owners in balance. Such an obligation does not exist between working interest owners in an oil and gas well absent an agreement.

The overbalanced party in *United Petroleum* was, however, the operator and as such it had a duty to act reasonably and prudently in dispatching gas to the separate pipelines connected to the well so as to keep

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47. *United Petroleum*, 511 F. Supp. at 130.

48. *Id.* at 129.

49. United’s alternative argument appealing to the sympathy of the court is not very persuasive. Assuming United was regularly engaged in the exploration and production business, it could have foreseen possible delays in obtaining a new connection. First, it assumed that risk when it accepted a higher price but with an unconnected purchaser. Second, it could have addressed losses it might suffer from connection delays in its purchase contract with the unconnected pipeline.

50. *United Petroleum*, 511 F. Supp. at 131.

51. 5 A. CORBIN, CORBIN ON CONTRACTS § 992 (1964 & Supps. 1971 & 1989); 11 S. WILLISTON, A TREATISE ON THE LAW OF CONTRACTS § 1338 (1968 & Supp. 1987).



the various owners in reasonable balance.<sup>52</sup> Generally, however, under the Model Form Operating Agreement an operator is not liable to the non-operators unless it is grossly negligent in performing its duties.<sup>53</sup> In *United Petroleum*, there was only one pipeline connection at the time the imbalance accrued; therefore, the operator did not breach any duty, whether arising from contract or otherwise, when it delivered the well's gas to its purchaser. It had no other choice consistent with its implied duty to market owed to the royalty owners in the well.<sup>54</sup> Because there was no contract between the parties with respect to marketing and because the court did not find any breach of Premier's duties as operator, it should not have relied upon a contract principle in imposing a remedy.

When contracts are entered into among working interest owners concerning joint operations, each party typically reserves its right to take its share of the oil or gas in kind.<sup>55</sup> Thus each owner asserts the right to make its own marketing decision with respect to its share of the reservoir and to undertake its own independent marketing effort. This is precisely what happened in *United Petroleum*: the underbalanced parties chose not to dedicate their interest to Premier's purchaser. They did not want to sell their gas under Premier's contract, which was executed before a substantial escalation in market prices had occurred. Instead, they chose to contract with another purchaser at the higher current market price. There was no equitable reason enunciated in *United Petroleum* for forcing the underbalanced owners to accept Premier's lower price for their "imposed" share of the wellstream before the split connection was established.

*United Petroleum* should be viewed as a federal court's attempt to craft an equitable solution to a very difficult problem. Its assumptions and reasoning, however, depart from Oklahoma law. *Beren* is consistent with Oklahoma's general oil and gas law and should be accepted and followed as Oklahoma's statement of the common law of gas balancing.

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52. See *Beren*, 546 P.2d at 1358-59 (quoting Ellis, *The Production of Gas from Joint Interest Properties*, 21 INST. ON OIL & GAS L. & TAX'N 47 (1970)).

53. See Section 5 of the 1956 version and Article V of 1977 and 1982 versions of The Model Form Operating Agreement; Smith, *supra* note 8, at 22 (noting that all three versions of the Model Form Operating Agreement contain exculpatory language which limits the liability of the operator to situations in which its failure to perform duties to non-operators exceeds ordinary negligence).

54. A variety of implied covenants arise from a typical oil and gas lease, including an implied promise of the lessee to market within a reasonable period of time and for the best price available. See 5 H. WILLIAMS & C. MEYERS, *supra* note 7, §§ 801-78; J. LOWE, OIL AND GAS LAW 303-45 (2d ed. 1988).

55. See *supra* note 8 and accompanying text.

### B. *House Bill 1221: Statutory Balancing*

In May 1983, House Bill 1221<sup>56</sup> became the law in Oklahoma. Its purpose was to protect the so-called "correlative rights" of owners capable of producing gas in certain wells for which they could not obtain a gas purchase contract.<sup>57</sup> The remedy was to allow those non-contracted owners to share in sales proceeds obtained by any other owner in the same well who did have a contract.<sup>58</sup> Each contracted owner was obligated to share sales proceeds obtained under its gas purchase contract with other owners who so demanded, in proportion to their respective interests in the well.

One might ask why such remedial legislation was needed when Oklahoma had already enacted common purchaser legislation that required all pipelines operating in Oklahoma to "purchase all the natural gas in the vicinity of, or which may be reasonably reached by its pipelines, or gathering branches, without discrimination in favor of one producer or one person as against another . . . ."<sup>59</sup> On its face, such a requirement should protect any gas owner from a pipeline's discrimination in refusing to buy its gas while purchasing that of another owner in a well.

Although not included in the legislative record, producers were probably concerned that Oklahoma's common purchaser requirements could not be enforced against interstate pipelines without violating the commerce clause of the United States Constitution. In *Northern Natural Gas Co. v. State Corporation Commission*,<sup>60</sup> the United States Supreme Court held that a Kansas State Corporation Commission rule requiring that an interstate pipeline take gas ratably from all wells connected to its system in a common source of supply unconstitutionally infringed upon

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56. 1983 Okla. Sess. Laws 236 (codified as OKLA. STAT. tit. 52, §§ 541-547 (Supp. 1988)).

57. *Seal v. Corporation Comm'n*, 725 P.2d 278, 283-84 (Okla. 1986), *appeal dismissed sub nom. Amerada Hess Corp. v. Corporation Comm'n*, 479 U.S. 1073 (1987).

58. OKLA. STAT. tit. 52, § 543(A) (Supp. 1988) provides that:

For wells producing or capable of producing natural gas or casinghead gas on and after the effective date of this act, in the event that one or more owners in a well receives a contract for the sale of only their portion of the gas production from the well to the exclusion of other owners in the well, all owners having no contract shall be entitled to share ratably in the revenue from the sale of each contract's production to the extent of their net revenue interest, except for any owner who elects or has elected in writing not to so sell. This act shall not be construed to prevent any owner from receiving the price agreed upon by contract.

*Id.*

59. OKLA. STAT. tit. 52, § 23 (1981).

60. 372 U.S. 84 (1963). *Northern* was recently reaffirmed in *Transcontinental Gas Pipe Line Corp. v. State Oil & Gas Bd.*, 474 U.S. 409 (1986); *see infra* note 66.

the exclusive province of the FPC to regulate the purchase of gas in interstate commerce. The Supreme Court, however, acknowledged that the states were free to regulate the production and gathering of oil and gas.<sup>61</sup> The critical distinction in determining whether a state's conservation regulations infringed upon interstate commerce was whether such measures were aimed directly at interstate purchasers and wholesalers for resale, or were confined to producers and production.<sup>62</sup> Because House Bill 1221 was directed only to producers and how they allocated revenues among themselves, and did not prescribe any action by interstate pipelines, it passed the constitutional test established in *Northern*.<sup>63</sup>

Time was of the essence for gas producers in 1983. It was a time of great financial fear in the industry.<sup>64</sup> Some producers of gas who had contracts in certain wells were the only owners capable of selling gas and there was substantial anxiety that as those producers became overbalanced they might be unable to cash balance if they were to enter bankruptcy or otherwise become unable to meet their financial obligations in full. In addition, producers had recently witnessed double-digit interest rates and were much more sensitive to the time value of money, which typically remained in the overbalanced party's pocket until depletion or until long after the overbalance began accruing.<sup>65</sup> Accordingly, many producers rallied behind House Bill 1221 which provided a basis for immediate, ongoing cash balancing; at the time this probably appeared preferable to attempting litigation against the interstate pipelines over common purchaser legislation.<sup>66</sup>

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61. *Northern*, 372 U.S. at 93.

62. *Id.* at 94.

63. Note that in *Seal v. Corporation Comm'n*, 725 P.2d 278 (Okla. 1986), *appeal dismissed sub nom. Amerada Hess Corp. v. Corporation Comm'n*, 479 U.S. 1073 (1987), the challengers of House Bill 1221 did not even argue that it constituted an infringement upon federal regulation of interstate gas purchasing in violation of the commerce and supremacy clauses of the United States Constitution.

64. See Kinzie & Dancy, *The Statutory Oil and Gas Lien in Oklahoma*, 20 TULSA L.J. 179, 180 (1984) (describing indices of downturn in gas industry and resulting economic problems).

65. See *Seal*, 725 P.2d at 285 (describing interest lost and added risk of financial failure suffered by underbalanced parties).

66. In hindsight the producers exercised good judgment because the United States Supreme Court reaffirmed *Northern Natural Gas Co. v. State Corp. Comm'n*, 372 U.S. 84, (1963) in *Transcontinental Gas Pipe Line Corp. v. State Oil & Gas Bd.*, 474 U.S. 409 (1986). In *Transcontinental*, a smaller working interest owner sought relief under Mississippi's common purchaser rules when an interstate pipeline purchaser stopped taking its share of a pool's gas under the operator's favorably priced take-or-pay contract. The Supreme Court overturned the Mississippi Oil and Gas Board order granting relief to the producer on the ground that the order, which required ratable taking on the same terms as the operator's contract, impermissibly interfered with the federal scheme of gas regulation established by the Natural Gas Act of 1938 (NGA) and the NGPA together. The Court rejected the producer's argument that state ratable take regulation was no longer conflicting with the

This statutory attempt to adjust obligations and relations among producers represented a major departure from common law. House Bill 1221 created a "kind of cotenancy" in sales proceeds which producers receive under their gas purchase contracts.<sup>67</sup> At common law and under typical operating agreements no such cotenancy exists.<sup>68</sup> Under House Bill 1221, if a producer is unsuccessful in its efforts to market its gas from a particular well, it may make demand upon a contracted owner to share its sales proceeds.<sup>69</sup> Operators of wells drilled after the effective date of the Act are obligated to offer to market the gas of non-operating owners, which may be refused in writing.<sup>70</sup> Again under typical operating agreements, the operator has the right, but not the obligation, to market a non-operator's share of gas.<sup>71</sup> Despite these departures from the common law and prevailing industry custom and usage, the Oklahoma Legislature attempted to preserve some semblance of existing law and contract relations. It expressly reserved to each owner the right to take its share of production in kind, thus maintaining each owner's marketing independence.<sup>72</sup>

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NGA, as determined in *Northern*, because section 601 of the NGPA exempted price-deregulated gas from the FERC's jurisdiction under the NGA. The Court held that state regulation in an area expressly deregulated would still impermissibly interfere with the overall federal scheme of gas regulation, based upon the federal/state conflict principles announced in *Northern*. *Transcontinental*, 474 U.S. at 423-24.

67. *Seal*, 725 P.2d at 285.

68. Article III(B) of both the 1977 and 1982 versions of the A.A.P.L. Form 610 Model Form Operating Agreement contain express language indicating that nothing contained therein shall be deemed to create a cross-conveyancing of mineral interests in the contract area. *See Smith, supra* note 8.

69. *See supra* note 58 and accompanying text.

70. OKLA. STAT. tit. 52, § 543(B) (Supp. 1988) provides that:

Each owner receiving a contract to sell as described in subsection A of this section shall send written notice of the terms of the contract to all other net revenue interest owners not having an existing contract for the purchase of their share of the gas production. Said owners shall have thirty (30) days from receipt of the notice of the terms of the contract to elect in writing not to deliver their ratable share of gas production for sale. Failure by any owner to give said written notice shall be deemed acceptance by that owner of the terms of the contract and said owner shall deliver his ratable share of production for sale.

*Id.*

71. Article VI(C) of the 1977 and 1982 versions of the Model Form Operating Agreement provides that in the event a non-operator fails to make arrangements to dispose of its share of production, the operator may sell it at the best available price and under a contract term which shall not exceed one year. Such a sale remains subject to the non-operator's right of revocation to take its share of production in kind at any time. Note that such right of revocation, which may be exercised at any time without notice, is inconsistent with the right of the operator to commit non-operator gas for a term up to one year. This inconsistency has not caused practical problems in the industry because it was not inserted to govern the practice in the industry. Rather it was superimposed upon operating agreements for tax reasons. *See infra* notes 109-10 and accompanying text.

72. OKLA. STAT. tit. 52, § 542(D) (Supp. 1988) provides in part that "[n]othing in this act shall be construed to prevent any owner or owners from receiving the price agreed upon by contract or to

Despite all of the attention focused upon House Bill 1221 at the time of its enactment, it has had little impact upon the gas industry. This is largely because its focus was upon a very ephemeral problem in the gas industry—a producer's inability to get a purchase contract at any price. In 1983, the interstate pipelines, which purchased most of the domestic supply of gas, were simply not interested in contracting for any additional gas.<sup>73</sup> They had a large oversupply at their high, regulated prices and could not make any profit on the purchase and sale of gas as a commodity. In addition, they were already committed to purchase more gas under expensive take-or-pay contracts than they could market under their commodity rates. Buying additional, lower-priced gas in order to lower their WACOGs only exacerbated their already mounting take-or-pay liabilities. Ironically, deregulation of the interstate pipeline market structure provided the remedy that the Oklahoma Corporation Commission sought to achieve in the rules it promulgated under authority of House Bill 1221 (the Rules).<sup>74</sup>

As the FERC opened the interstate gas transportation grid to third-party purchasers, many newly created "paper pipelines" entered the wholesaler gap left by the interstate pipelines. These new marketing entities were not subject to the FERC's Natural Gas Act (NGA) jurisdiction and thus had the flexibility to buy and sell gas at whatever price the market would bear, as long as they did not pay more than any applicable ceiling price set forth in Title I of the NGPA.<sup>75</sup> In addition, the FERC introduced certain deregulatory initiatives that provided the pipelines with some flexibility to increase the marketability of gas supplies dedicated to their system. As the free market for gas emerged, the log jam of a producer's inability to get a gas contract at any price was quickly cleared, and House Bill 1221 was largely obviated in that regard.

The next issue that gained attention was the price which the various producers were receiving for their gas. In many cases producers who were "blessed" with high-price take-or-pay contracts sought to enforce

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prevent any owner or owners from taking their share of production in kind or separately disposing of their share."

73. See *supra* notes 25-26 and accompanying text.

74. Pursuant to its Order No. 250,466 the Oklahoma Corporation Commission promulgated the Rules to implement and administer House Bill 1221 under authority of OKLA. STAT. tit. 52, § 547 (Supp. 1988). The validity of the Rules, with minor deletions and modifications, was upheld in *Seal v. Corporation Comm'n*, 725 P.2d 278 (Okla. 1986), *appeal dismissed sub nom. Amerada Hess Corp. v. Corporation Comm'n*, 479 U.S. 1073 (1987).

75. See Marston, *Alternatives and New Directions in Marketing Natural Gas*, in NATURAL GAS MARKETING II, Paper No. 14, at 5-8 (1988).

those contracts against recalcitrant pipelines. Generally, while such litigation was pending, the pipeline took little or no gas under such contracts.<sup>76</sup> If there was any other owner in the same well as the litigating party that did not have a high-price contract, or that had released such a contract, it would often sell gas at a lower price and an imbalance rapidly developed. Even in the absence of litigation, imbalances developed whenever the various owners in a well were entitled to receive significantly different prices. The size of the imbalance created was generally a function of the difference in price, because under the rapidly developing free market for gas, purchasers could market more low-price gas than high-price gas. House Bill 1221 did not affect this operation of the free market because it expressly preserved each owner's independence and right to market its own gas at whatever price it could receive under a contract.<sup>77</sup>

House Bill 1221 was hastily enacted to address a problem that was rapidly resolved by the market forces unleashed by deregulation at the federal level. Although House Bill 1221's original mission is somewhat a dead letter, it remains the law of Oklahoma. If strictly enforced, its sweeping provisions may create great potential liability for operators and overbalanced owners who have either ignored it entirely or have only partially complied with its solicitation, notice, and reporting requirements. Indeed, one knowledgeable commentator has described this potential liability for the gas industry as a "ticking time bomb."<sup>78</sup>

The reason this time bomb may explode is primarily a function of declining gas prices. First, as prices have fallen producers have concentrated drilling and production efforts in established reservoirs, basins, and other common sources of supply. Some producers have attempted to compensate for lower prices by trying to drill more wells into the common source of supply or by adding compression so they can produce more gas. The strategy is to sell as much gas as possible at market price in order to fund still more drilling and production efforts.

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76. See Medina, McKenzie & Daniel, *supra* note 4. In *Seal*, the Oklahoma Supreme Court expressly acknowledged that:

In the early 1980s discriminatory practices resulted from a surplus in deliverability of natural gas. Pipelines had burdensome contractual obligations to take gas which greatly exceeded their ability to market. This circumstance caused pipelines to either ignore their contractual obligations to take under existing contracts or exercise their options to "market out."

725 P.2d at 285.

77. See *supra* note 72.

78. Address and Materials by Lewis G. Mosburg, Jr., *Problems with Natural Gas Balancing: A Ticking Time Bomb*, presented to Oklahoma and Tulsa County Bar Associations (1989).

This strategy tends to be more successful in a time of falling prices because if an owner becomes overbalanced as a result, the underbalanced owners are left to balance in kind, except in those relatively rare instances in which they have a balancing agreement that provides for periodic cash balancing before depletion. Balancing in kind in a declining market leaves underbalanced owners at a competitive disadvantage in relation to the overbalanced owners. First, they may not have the cash flow to fund further drilling and production efforts and thus enhance their ability to capture more of the gas available in common sources of supply. Second, their return on investment in the imbalanced wells will be lower because of the lower price they receive when they balance in kind.

Such disadvantaged producers may look to the remedies provided under House Bill 1221 in order to "balance" this competitive disadvantage. After all, House Bill 1221 provides for periodic cash balancing, which is not preferred at common law, and generally not provided for in existing balancing agreements. The Act applies to wells producing gas on and after May 3, 1983 (the effective date of the Act). It requires an operator of a well drilled after such date to "offer by written notice to each owner of the well having the right to sell an election whereby the operator shall attempt to market that owner's ratable share of the gas or some part thereof as designated by the owner."<sup>79</sup> If an operator fails to comply with this requirement, then under the Act he could be liable to the underbalanced, non-selling owners for three times their share of the revenues received plus interest and any costs or attorney's fees the underbalanced owner incurs in enforcing the Act.<sup>80</sup> This was precisely the

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79. OKLA. STAT. tit. 52, § 542(B) (Supp. 1988). The subsection further provides that: [e]ach owner shall have thirty (30) days from the receipt of the notice of the offer to elect in writing to have the operator attempt to market his share of gas production. Upon receipt of these elections, the operator shall seek to timely and competitively market such owners' share of the production at the best price and terms available in the area and in no event upon a price or terms less favorable than that received by the operator. Upon receipt of written notice of the terms of a bona fide offer to purchase, each owner electing to have the operator market his share of gas production shall have thirty (30) days within which to reject the same. Failure by any owner to reject the offer shall be deemed acceptance of the offer. If the operator has not secured a written bona fide offer to purchase within one hundred twenty (120) days of an owner's election, that owner may rescind such election in writing.

*Id.*

80. OKLA. STAT. tit. 52, § 547 (Supp. 1988). Note, however, that this section does not expressly provide for threefold recovery of revenues withheld, but rather for threefold recovery to "any owner who is injured in business or property . . ." *Id.* Arguably, the legislature intended treble damages to be awarded only in extraordinary cases involving losses beyond a simple delay of cash flow.

remedy granted to the plaintiff non-operators in *Chester Maxwell v. Samson Resources Co.*<sup>81</sup>

In that case, the operator had failed to offer to market the plaintiffs' share of gas from the well prior to first production, which occurred in February 1984. Instead, the operator sold the plaintiffs' share of the production stream and became overbalanced in relation to the plaintiffs. In order to compensate the plaintiffs for the operator's non-compliance with the Act, the court awarded them their revenue interest share of the operator's sales for the period February 1984 through February 1988 with interest, as provided by statute, and then tripled that amount in accordance with title 52, section 547 of the Oklahoma Statutes. In addition, the court awarded the plaintiffs a reasonable attorney's fee and their costs.

If the Act is literally applied, a similar judgment may be assessed against a non-operator who has become overbalanced. The Act provides that:

The amount of gas produced daily, irrespective of the owner producing, belongs to, is owned by, and shall inure to the benefit of each owner in the well in proportion to each owner's interest in the well. Each owner who produces natural gas or casinghead gas and who separately sells or otherwise disposes of the gas must account to each other owner in the well not selling or otherwise disposing of gas from the well for that owner's part of the gas so disposed of or sold.<sup>82</sup>

The Act, however, implies a procedural predicate to its enforcement. An owner must affirmatively elect to share revenues obtained under another owner's contract.<sup>83</sup> In *Energy Search Petroleum, Inc. v. Amoco Production Co.*,<sup>84</sup> the court held the Act applied when a non-operator terminated its purchase contract and made demand to revenue share under the operator's contract. The operator refused such a demand. The court held that this refusal constituted a violation of the Act and that the operator's disposal of the non-operator's share of the gas produced after its rights under the Act had vested constituted conversion.<sup>85</sup> The court

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81. No. C-87-159 (18th Judicial Dist., Pittsburg County, Okla. Sept. 30, 1988).

82. OKLA. STAT. tit. 52, § 544 (Supp. 1988).

83. See *supra* notes 58 and 70.

84. No. 87-C-375-E (N.D. Okla. Apr. 20, 1989) (order granting summary judgment).

85. The court's finding of conversion is questionable. Conversion is the intentional interference with another's rights to possession. W. PROSSER & W. KEETON, *THE LAW OF TORTS* § 16 (1984). In *Energy Search*, the overproduced operator was within its rights to sell more than its share of the production stream. This is precisely why imbalances are legally created. The *Energy Search* court found that the operator's overproduction constituted conversion based on OKLA. STAT. tit. 52, § 544 (Supp. 1988), which provides that gas is owned in proportion to the owners' interests in the well, regardless of which owner is selling. This provision, however, is in derogation of the common law and was intended to remedy a perceived inequity created by operation of the prevailing law—hence,



awarded triple damages and attorney's fees pursuant to the terms of the Act, but no tort remedy.

Before an owner can make an election to revenue share under the Act, it must have the contract information of every owner in a particular well. It is the obligation of the operator to gather and disseminate such information for purposes of allowing each owner to exercise its election under the Act.<sup>86</sup> A non-operator may request specified contract information and payment of its share of revenues by electing to revenue share with contracted owners.<sup>87</sup> Again, it is the operator's responsibility under the Act comprehensively to account for the volumes of gas sold, the applicable contracts, the applicable prices, elections to share revenues, and the balancing positions of the various owners.<sup>88</sup>

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the "balancing problem." Therefore, the operator in *Energy Search* may have violated the Act, but it did not also commit the common law tort of conversion. The court's finding in this regard appears moot because it imposed only the penalty provided under the Act, and did not award a tort remedy.

86. For example, Corporation Commission Rule 6-102(B) provides that:

Within thirty (30) days of the effective date of these Rules [January 1, 1984], the operator of the well shall notify each interest owner in the well and shall request that each interest owner notify the operator, within thirty (30) days, of:

1. The specific percentage of said owner's interest in the well;
2. Whether said owner has a gas contract covering such interest;
3. Date of the execution of the base contract and any amendments thereto;
4. The identity of the purchaser in such instance;
5. The name and address to which information should be sent under these Rules;
6. Information as to all transfers of ownership which may have been made (name of transferee and specific percentage interest conveyed); and
7. The existence and identity of those, if any, who have the right to take in kind.

*Id.*

87. Corporation Commission Rule 6-102(E) provides that:

Each contracted party whose revenues are shared by a non-contracted party hereunder shall maintain an account showing the volume of gas sold during each calendar month by the contracted party, the proceeds received from such sale, and each non-contracted party's share of such proceeds. Within sixty (60) days after the end of each calendar month during which production is sold, the contracted party shall pay or cause to be paid to the non-contracted party his share of such proceeds. Upon written request by the non-contracted party, the contracted party shall furnish within thirty (30) days a written statement of accounts in support of such payment.

*Id.*

88. Corporation Commission Rule 6-104(B) provides that:

On or before the end of each calendar month, each interest owner in the well separately selling or otherwise disposing of produced gas, other than that used for lease purposes, shall furnish the well operator a statement showing the total volume of gas taken by that interest owner during the preceding month. He shall also notify the operator of the non-contracted parties who are to share in revenues, together with the effective date of such revenue-sharing. The operator shall then account to all interest owners for all volumes produced, and shall subsequently provide this accounting to each contracted party. The information included therein shall include the total volume produced from the well the preceding month, the volumes produced on behalf of each contracted party for said month, and the volumes attributable to each non-contracted party by each contracted party for revenue sharing.

*Id.*

Because the applicability of, and obligations under the Act are triggered by solicitation, notice and reporting requirements that fall almost entirely upon the operator, it is the operator who is most likely to be held liable for an underbalanced party's losses resulting from non-compliance with the Act. Accordingly, operators are probably at greatest risk of liability under House Bill 1221 and its Rules if imbalances have accrued in favor of certain owners. A court is likely to be less sympathetic with a non-complying operator that has sold more than its share of the production stream. This will be especially true in cases in which the operator appears to have gained an advantage from the resulting overbalanced position, which should have been shared with the joint account.

#### IV. IS THE CURRENT LAW OF "EQUITABLE BALANCING" EQUITABLE?

As examined in the previous section, Oklahoma's current law with respect to gas balancing is an amalgam of the common law of "equitable balancing" overlaid by remedial legislation in House Bill 1221. The ideal pursued in the current law is to guarantee each owner in a gas well a fair chance to extract its share of the gas contained in the well's reservoir. Achieving this ideal has been elusive because the law governing gas balancing has changed at a slower pace than the gas industry. During the 1980s the gas industry has experienced radical restructuring because of deregulation. House Bill 1221 was based upon a snapshot of a rapidly moving scene and, in its present form, is no longer suited to the problems faced in the gas industry today. Inequities may result from this mismatch.

One major goal of deregulation of the natural gas pipeline industry is to allow producers access to the national transportation grid that has been constructed for natural gas. The ultimate objective is to allow a producer connected anywhere on the grid to sell gas to a customer connected anywhere on the grid and to compensate the pipeline for transporting it.<sup>89</sup> The sale of the gas and its transportation are thus "unbundled." This goal is rapidly becoming a reality.

This means that imbalances may result among different working interest owners in the same well simply because they are pursuing different

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89. One industry expert summarized the technical sophistication of the interstate gas pipeline system as follows: "Today, the nationwide network is so interconnected that if direction of flow and institutional barriers were of no concern, practically anybody who sells gas could send it to anybody who buys gas, regardless of location." A. TUSSING & C. BARLOW, *supra* note 3, at 55.

marketing strategies. Some owners may decide that they do not wish to sell their share of the reserves during seasonal downswings, while others may not have the financial cushion to forgo the monthly cash flow surrendered by such a strategy.<sup>90</sup> Some producers may wish to commit their share of the reserves under a longer term contract in exchange for a higher price. Other producers may wish to exchange a higher gas price for other contract considerations such as waiver of past take-or-pay liabilities, an agreement to contribute to the cost of building a gathering system, or any number of other business considerations. House Bill 1221 and its Rules may restrain, or at least may economically inhibit, the freedom of each working interest owner to pursue its own gas marketing strategy. This is illustrated by the following example.

Assume a gas well in which all owners but one are selling under short-term sales contracts at the spot-market price. The other owner is committed under a long-term contract that cannot be terminated at will, but only for very limited reasons related to mechanical impossibility, depletion of reserves and the like. Also assume that the price under the long-term contract is substantially higher than the spot-market price.

House Bill 1221, when implemented by certain of its Rules, creates a danger that it will be misapplied to allow an unwarranted unitization of the gas contracts held by the various owners in a well. Corporation Commission Rule 6-105(A) provides that:

A contracted party whose contract finally expires shall, as a newly non-contracted party, share revenues under Rule 6-101, Rule 6-102, or Rule 6-103, which-ever is applicable. For the purpose of this Rule, the term "finally expired" shall be defined as the time when actual gas sales under the terms of the contract, including any roll-overs, permanently cease. Notice of the expiration of the contract shall be communicated in writing to the operator and to all the contracted parties. This notice shall include the date the gas contract expired. Each contracted party shall then account to such party sharing revenue, beginning from the first day of the month following said notice.

Literally applied, this Rule would allow the spot-market owners to cancel their contracts and demand that the high-price owner revenue share under the Act. If the high-price purchaser were not obligated, or refused, to take a sufficient amount of gas to allow the well to be produced efficiently, the well's operator (acting reasonably and prudently) would

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90. For a discussion of the problems producers may face in maintaining their leaseholds by shutting in gas production for market reasons, see Smith, *Royalty Issues: Take-or-Pay Claims and Division Orders*, 24 TULSA L.J. 509, 520-32 (1989) and Lowe, *Current Lease and Royalty Problems in the Gas Industry*, 23 TULSA L.J. 547 (1988).

be forced to dispose of the remaining share of the minimum efficient production stream on the spot market. Under a typical operating agreement the operator would have such right, especially when its exercise was necessary to maintain the minimum production level in order to maximize recovery of reserves.<sup>91</sup> The price received by each owner in such a hypothetical well would be a unitized blend of the volumes delivered under the high-price contract and the remaining volumes delivered under the lower, spot-market price contract.<sup>92</sup>

If the gas market experienced another rapid price rise, the undedicated, revenue-sharing, former spot-market owners could contract at prices that might even be higher than the original high-price contract. The original high-price owner, however, unable to cancel its contract on short notice, would not be able to invoke the benefits of the Act and thus could not share in the benefits of the higher price being received by its co-owners. This is clearly not an equitable result.<sup>93</sup>

Such a result could be avoided either by repealing House Bill 1221,

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91. Under all three versions of the A.A.P.L. Model Form Operating Agreement, the operator has the right, but not the obligation, to dispose of any gas for which disposition arrangements have not been made by any interest owner. See section 13 of the 1956 version and Article IV(C) of the 1977 and 1982 versions of The Model Form Operating Agreement, and *supra* note 8.

92. In order to illustrate the difference unitization would entail in payment, consider a gas well with two equal owners. One is dedicated under a long-term contract at a price of \$4.00 per mcf; the other is revenue sharing. The operator is selling 50% of the production stream under its high-price contract and the other 50% to a spot-market purchaser at \$1.00 per mcf. If the well delivers 1000 mcf to each of the well's two purchasers, then each owner would receive one-half of  $(1000 \text{ mcf} \times \$4.00) + (1000 \text{ mcf} \times \$1.00) = \$2,500$  each. If there were no revenue sharing, the producer with the high-price contract would receive \$4,000 and the spot-market producer would receive \$1,000 for the same deliveries of gas.

93. This is the hypothetical posed by Amerada Hess in *Seal v. Corporation Comm'n*, 725 P.2d 278, 290 (Okla. 1986), *appeal dismissed sub nom. Amerada Hess Corp. v. Corporation Comm'n*, 479 U.S. 1073 (1987), in support of its argument that House Bill 1221 substantially impairs the existing rights of long-term contract owners. See Note, *Oil and Gas: Gas Balancing or Juggling? A Comprehensive Look at the Current State of Judicial and Contractual Resolutions to Gas Balancing Problems*, 41 OKLA. L. REV. 352, 359 n.55 (1988) (noting that this situation will likely be the source of future litigation). The court rejected this argument based on the implicit assumption that all gas contracts were of a similar, long-term nature. Thus, the court reasoned that a non-contracted party could not share in the benefits of another party's contract without having to share in its burdens because the non-contracted owner was bound by any agreement which it eventually signed. This is an incomplete response to Amerada Hess's argument, even if the court's implicit assumption concerning the uniform, long-term nature of gas contracts is valid. After completion of the well, the non-contracted party could elect under House Bill 1221 to revenue share and could continue doing so until gas prices escalated above the price contained in the contract under which it was sharing. At that point, nothing in House Bill 1221 prevents that non-contracted owner from withdrawing from the revenue sharing arrangement and selling its gas under a new, higher-price contract. Thus, under House Bill 1221, Amerada Hess correctly noted that "a non-contracting party benefits under the contract but has no apparent burdens." *Seal*, 725 P.2d at 290. This situation underscores an underlying problem with House Bill 1221—it imposed no duty upon a non-contracted owner to act diligently in obtaining a contract.

or by extending it to provide for unitization of all gas purchase payments in any particular well. Alternatively, short of legislative action, the courts could limit application of House Bill 1221 to only those problems that it was originally intended to remedy.

The first alternative of unitizing all gas purchase payments finds precedent in Senate Bill 160,<sup>94</sup> which unitized all gas purchase payments for purposes of paying royalties. Under Senate Bill 160, each gas purchaser is obligated to pay each royalty owner in the unit its revenue interest share of the proceeds obtained under contract with any working interest owner. This is in contrast to the former practice of paying such proceeds only to the extent of the ordinary and usual one-eighth royalty interest.<sup>95</sup> Any holder of interest in excess of such one-eighth royalty was entitled to share only in proceeds from gas sold by its working interest lessee, who was responsible for ensuring that such payments were disbursed. Such "excess" royalty owners did not share in the higher price that might be received by another lessee in the unit.<sup>96</sup>

The other means of avoiding inequitable results that might follow from literal application of House Bill 1221 and its Rules is either legislative repeal or a restrictive judicial application of the Act to address only

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94. 1985 Okla. Sess. Laws, ch. 141 (1985) (amending OKLA. STAT. tit. 52, §§ 87.1, 540 (1981)). Because of the new liability imposed upon pipelines for the improper payment of royalty revenues, various interstate pipelines payment commenced an action in Panhandle E. Pipeline Co. v. Oklahoma, No. CIV-85-2659-P (W.D. Okla. July 15, 1988) (order granting partial summary judgment), seeking, in part, a judgment declaring that Senate Bill 160 is unconstitutional and void. In an unpublished order filed on July 15, 1988, the court granted partial summary judgment that Senate Bill 160 operates prospectively only and applies only to contracts entered into after the date of its enactment (June 7, 1985). Then, the court abstained from deciding the constitutional challenges, deferring to the Oklahoma Supreme Court's construction of Senate Bill 160. Finally, the court refused to certify the constitutional questions to the Oklahoma Supreme Court.

95. This was the procedure established in Shell Oil Co. v. Corporation Comm'n, 389 P.2d 951 (Okla. 1964), commonly referred to as the "*Blanchard* case." See Upchurch, *supra* note 5, at 670-73 (explaining how the *Blanchard* rule impacts payment of royalties).

96. In 1988 Op. Okla. Att'y. Gen. No. 76 (January 13, 1989) the Oklahoma Attorney General interpreted OKLA. STAT. tit. 52, § 87.1 (Supp. 1988) as requiring unitized payment of all royalties to "landowners," irrespective of whether same exceeded the ordinary and usual 1/8th. This opinion was rendered in response to a legislator's question concerning payment of "excess" royalty provided under a pooling order. What is left unclear in the Attorney General's opinion is whether the unitization of royalties extends to overriding royalty interests which are not paid to holders of royalty interest, but instead are carved out of the working interest that exists under the leases and rights which comprise the drilling and production unit. OKLA. STAT. tit. 52, § 87.1(e) (Supp. 1988) specifies that its provisions include the normal 1/8th royalty and "overriding royalties or other excess royalties owned in each separate tract by the royalty owner." What the legislature intended by the term "royalty owner" is somewhat unclear (*i.e.*, does it include non-landowner holders of overrides and production payments or owners who do not participate in the basic 1/8th royalty traditionally reserved by the landowner?). Although the scope of the statute appears to include owners of excess or overriding royalties, who do not own land or any of the basic 1/8th royalty, resolution of this question will almost certainly require judicial construction.

its remedial objective.<sup>97</sup> The primary remedial purpose of House Bill 1221 was to address the inability of some working interest owners to get a gas purchase contract.<sup>98</sup> If application of House Bill 1221 is strictly limited to addressing this problem, then in order to qualify for revenue sharing a working interest owner must demonstrate that it cannot, in the exercise of reasonable diligence, obtain a gas purchase contract. Because a free trading market has rapidly evolved since House bill 1221 was enacted, to the point where almost any owner can get a spot-market contract, House Bill 1221 would be practically moot under such a strict construction, although complete repeal would be more final.

Choosing between these two alternatives involves two primary policy considerations: (1) maintaining consistency with other applicable law, and (2) promoting economic efficiency.<sup>99</sup> Whether House Bill 1221 should be extended to unitize all gas purchase payments, or repealed or

97. Statutes in derogation of the common law, such as House Bill 1221, should be limited in their application to accomplishing the legislative objectives intended by their enactment. *Republic Bank & Trust Co. v. Bohmar Minerals, Inc.*, 661 P.2d 521, 523 (Okla. 1983); *In re Adoption of Graves*, 481 P.2d 136, 138 (Okla. 1971); *Fenton v. Young Chevrolet Co.*, 191 Okla. 161, 163, 127 P.2d 813, 814 (1942).

98. The legislative findings that prompted enactment of House Bill 1221 are as follows:

WHEREAS, the State of Oklahoma has the right under its police powers and conservation authority to protect the citizenry of this state from losses by reason of discrimination; and

WHEREAS, many mineral owners and participants in oil and gas well drilling projects are being discriminated against in the sale of the production of their wells in that purchases are being made from one co-owner as against another; and

WHEREAS, such inability of each co-owner to sell the production from a well may result in the Corporation Commission shutting-in such well to protect individual rights and correlative rights; and

WHEREAS, when many wells are placed into production, the pro rata share in the net revenue of many owners, including those with working interests, overriding royalties and mineral interests is not being respected and paid; and

WHEREAS, the net effect of such predatory practices in the sale of well production will cause financial distress to the smaller co-owner; and

WHEREAS, the inherent wealth of the great lands of Oklahoma is being diverted from its rightful recipients; and

WHEREAS, the continuance of discriminatory purchases and the dishonor of rightful pro rata shares in the production proceeds of many wells in Oklahoma will have serious effect upon the economic health of the State of Oklahoma.

S. Con. Res. 7, 1983 Okla. Sess. Laws 1172.

99. Internal consistency is certainly a significant goal of any jurisprudence based on precedent. *See L. FULLER, ANATOMY OF THE LAW* 89-112 (1968) (examining role of precedent in distinguishing statutory and adjudicative components of common law). Economic efficiency is also highly valued in Anglo-American jurisprudence. Although fairness is also a fundamental goal of any legitimate legal system, it is too amorphous a concept to provide a useful basis for comparing the alternatives in this instance. For example, is it more fair to favor established, high-priced contract producers by repealing House Bill 1211, or to favor less-established producers without any high-priced contracts, by extending House Bill 1211 so that they can share in the high prices contracted under the former regulated market regime. *See J. RAWLS, A THEORY OF JUSTICE* (1970), especially at 3-53, which formulates a "positional" framework for determining "justice as fairness."

judicially limited is an issue that invites comparison of the alternatives based upon each of these two criteria.

A. *Consistency with Other Applicable Law*

As previously indicated, extension of House Bill 1221 to unitize all gas purchase payments would be perfectly consistent with the revenue disbursement practice already mandated with respect to royalty owners under Senate Bill 160.<sup>100</sup> Such a unitization, however, would depart from the prevailing concept that each working owner is a "free actor" with respect to gas marketing decisions. Furthermore, such unitization would reduce the value of the higher-price contracts that some working interest owners currently enjoy. Such privileged owners would likely challenge any such extension of House Bill 1221 as an unconstitutional infringement or impairment of their existing contract rights.<sup>101</sup>

In many cases owners of high-price contracts have waived take-or-pay liabilities, committed to long-term dedications, or given other valuable consideration in order to obtain above-market prices for their gas. In other cases, they have endured the vicissitudes of the industry and luckily entered into long-term, favorably priced contracts at an opportune moment. Why should these owners share their good fortune with their co-owners? Unitizing gas purchase payments so that all owners receive the proportionate benefit of the higher-price contracts appears to be a redistribution of wealth.

Although such "socialism" might be challenged by the privileged owners as an unconstitutional impairment of their contract rights, such a challenge would likely fail. The government need only show that any impairment of contract rights is outweighed by the significant and legitimate public purpose of House Bill 1221.<sup>102</sup> Unitizing all gas purchase payments is a logical extension of other correlative right limitations already imposed upon the rule of capture: spacing and unitization, pooling, ratable-take regulations, production allowables, priority purchasing rules, and Senate Bill 160. Because gas purchasing has traditionally been heavily regulated, no reasonable expectations of the gas industry would

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100. See *supra* notes 94-96 and accompanying text.

101. This was one of the challenges posed by Amerada Hess in *Seal v. Corporation Comm'n*, 725 P.2d 278, 290-92 (Okla. 1986), *appeal dismissed sub nom.* Amerada Hess Corp. v. Corporation Comm'n, 479 U.S. 1073 (1987).

102. *Energy Reserves Group, Inc. v. Kansas Power & Light Co.*, 459 U.S. 400, 411-13 (1983).

be defeated by such an extension of House Bill 1221.<sup>103</sup> Viewed in this light, extension of House Bill 1221 to unitize all gas purchase payments appears very consistent with other applicable law, including the Constitution. Of course, repeal of House Bill 1221, or a very restrictive judicial construction, would likewise be consistent. Indeed, a conservative approach that values maintenance of the status quo would favor repeal or restricted application of House Bill 1221. Thus, based upon the criterion of consistency with other applicable law, limitation of House Bill 1221 appears slightly preferable.

### B. *Economic Efficiency*

Maintaining the “free actor” gas marketing concept among working interest owners has resulted in added complexity in accounting for gas sales, volumes, and revenues, as well as operational difficulties in dispatching gas from a single well to any number of available purchasers. Unitization of all gas sales proceeds would greatly simplify these administrative and operational complexities, and thus should reduce overall transactional costs in the gas industry. For example, under the current “free actor” format, each purchaser must separately determine which percentage of a well’s ownership interest is dedicated under contract. If any purchaser is buying from more than one owner under separate contracts then it must resolve any discrepancies among those contracts (especially as to price) and properly disburse revenues among those owners. After each purchaser from a well has completed this process, each working interest owner and the operator must assure that all royalty, overriding royalty, and other production interests are timely paid. Finally, the operator must assimilate all production and payment information from the various purchasers and account for volumes, balancing, and payments.

This process could be simplified if all gas purchase payments were unitized. Each purchaser in a well could receive a comprehensive “pay list” from the operator of the well showing all of the net revenue interests entitled to payment of proceeds.<sup>104</sup> Because each working interest

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103. *See id.* at 416 (upholding state limitations imposed upon the operation of indefinite escalator clauses in gas purchase contracts because, “[p]rice regulation existed and was foreseeable as the type of law that would alter contract obligations”).

104. Typically, the operator of an oil and gas well will have a division order title opinion prepared upon the completion of a successful, producing well. Such an opinion is generally accepted by purchasers as evidence of ownership, and purchasers will use the opinion as a basis for disbursing revenues earned from the sale of the well’s oil or gas. A “pay list” or “pay sheet” is merely a



owner would contemporaneously receive its proportionate share of all gas sales proceeds, irrespective of which contract is used for the sale, the various working interest owners would remain in balance. The "villain"<sup>105</sup> that is currently creating so many imbalances in the gas industry would be removed.

In addition, gas marketing in a deregulated, free-market environment has become so much more complex than under the former regime of rigid regulation that centralization of marketing gas from a single well should be concentrated in the hands of the operator.<sup>106</sup> As a practical matter, the operator must respond to the dispatch requests of the various purchasers, has control of the well, and is generally in a better position than non-operators to market gas from the well. Marketing expertise would become another factor in choosing a well's operator. Under the House Bill 1221 Rules, the operator is entitled to an administrative expense equal to one percent of the shared revenues disbursed.<sup>107</sup> This could be modified by agreement to reimburse the operator more precisely for actual costs incurred in marketing for the joint account. Unitization of all gas purchase proceeds would induce the non-operators to yield their marketing independence to the operator because all parties would be proportionately interested in getting the best average price for gas marketed from the well.

As a practical matter, non-operators have always tended to follow the operator's lead in gas marketing. Indeed, before the NGPA the operator would commonly sell on behalf of non-contracted parties.<sup>108</sup> Historically, non-operators have maintained the facade of marketing

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summary of the identity, address, and interest of each owner in a well that is prepared or confirmed by the operator based upon the division order title opinion and other information accessible to it.

105. This was the term used by the court in *Beren* to describe split-stream connections, then the primary cause of imbalances. *Beren v. Harper Oil Co.* 546 P.2d 1356, 1359 (Okla. 1985).

106. See Hillyer, *supra* note 3, at 268-69, concluding that "the interminable paperwork of balancing, not to mention the wear and tear on the nerves of the parties" would justify a surrender by the co-owners of their separate interests in favor of centralizing the marketing function into the hands of the operator.

107. Corporation Commission Rule 6-108.

108. Taylor, *supra* note 26, at 90-94. The Supreme Court acknowledged this practice in *Transcontinental Gas Pipe Line Corp. v. State Oil & Gas Bd.*, 474 U.S. 409 (1986), as follows:

Some owners of interest in the Harper Sand pool, such as appellee Getty Oil Co., actually drill and operate gas wells. Others, such as appellee Coastal Exploration, Inc., own smaller working interests in various wells. Normally, these lesser owners rely on the well operators to arrange the sales of their shares of production, although some nonoperator owners contract directly either with the pipeline that purchases the operator's gas or other customers.

*Id.* at 412 (citation omitted).

independence, in part for tax reasons.<sup>109</sup> In the 1930s the Internal Revenue Service closely examined whether joint operations analogous to those conducted with respect to oil and gas wells should be treated as an association taxable as a corporation.<sup>110</sup> One of the elements the Service considered was whether the association relied upon centralized management authority.<sup>111</sup> To aid in avoiding such disfavored tax treatment, during the late 1940s producers began expressly reserving the right to dispose of their share of oil or gas production in kind.<sup>112</sup> Before this time it was very common in the gas industry to allow the operator to market gas for the joint account.

In reality the industry practice has not changed. There has been no incentive to market separately. Gas was of relatively low value and, after 1954, the price of gas sold in interstate commerce became subject to burdensome and rigid FPC regulations under the NGA, which stymied any market competition.<sup>113</sup> In today's complex, deregulated marketing environment, economics only dictate more strongly that marketing decisions be consolidated with the operator. Such consolidation would represent a departure from a tax facade, not from underlying industry practice and custom. This facade should yield to established industry practice and economic efficiency. Tax consequences should be addressed more directly, by requesting express legislative exemptive relief if necessary.

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109. The primary reason that the Model Form Operating Agreement expressly reserves to each non-operator the right to dispose of and market its share of production is that co-owners of a well wanted to avoid taxation as a corporation. Fell, *supra* note 32, at 120-24; Penn, *Cotenancy Problems: Is the Gas Balancing Agreement the Answer?* 33 ROCKY MTN. MIN. L. INST. § 18.02 (1987); Note, *Oil and Gas: Production Imbalance in Split Stream Gas Wells—Getting Your Fair Share*, 30 OKLA. L. REV. 955, 965 n.47 (1977).

110. See *Morrissey v. Commissioner*, 296 U.S. 344, (1935) (affirming Commissioner's ruling that golf club was an association taxable as a corporation). In light of *Morrissey*, the Service issued a ruling on joint operating agreements, I.T. 3930, 1948-2 C.B. 126, stating that for an organization to be classified as an association taxable as a corporation, there must be associates, joint profit, continuity of life, and centralized management. To avoid such classification, revisions to operating agreements were proposed which granted operators only revocable authority to dispose of production. The following year in 1949, the Service promulgated I.T. 3948, 1949-1 C.B. 161 interpreting I.T. 3930, in which it stated that discretionary authority, terminable at will, to enter into contracts for reasonable periods of time consistent with the minimum needs of the industry but not to exceed one year, would be consistent with revocable representative capacity as contemplated in I.T. 3930. This was the genesis of Article VI(C) of the 1977 and 1982 versions of the Model Form Operating Agreement limiting the operator's marketing authority to sales not to exceed one year.

111. Fell, *supra* note 32, at 120.

112. Fell, *supra* note 32, at 120.

113. *Phillips Petroleum Co. v. Wisconsin*, 347 U.S. 672 (1954).

## V. CONCLUSION

Deregulation of the gas pipeline industry to allow for increased marketing opportunities at the wellhead has multiplied the number of gas wells subject to imbalances. Oklahoma's common law of equitable balancing provides only general guidance and has not been applied with consistent, predictable results. Oklahoma's legislative remedy, House Bill 1221, was designed to address a problem that no longer persists, and literal application of the Act and its Rules in a more fully deregulated marketing environment can lead to inequitable results. Although repeal of House Bill 1221, or its restricted judicial application, would prevent such inequities and would maintain the status quo, economic efficiency favors its extension to unitize all gas purchase payments. While some owners of favored contract rights may be forced to share their good fortune, in the long run such unitization would promote consolidation of the gas marketing function in the operator, which follows industry custom and allows for greater economic efficiency.