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Slouching Toward Babel: Oklahoma's First Marketable Product Problem

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SLOUCHING TOWARD BABEL: OKLAHOMA'S FIRST MARKETABLE PRODUCT PROBLEM

I. INTRODUCTION

One of the most divisive issues taking hold in the oil and gas industry is the debate concerning the deductibility of post-production costs from royalty payments.[1] From this controversy flows a minefield of judicial interpretations among the major oil and gas-bearing states.[2] On one side of the spectrum is the established and majority "at the well" approach, while on the other is the minority "first marketable product" approach.[3] Generally, states that follow the at the well approach allow deduction of post-production costs (costs incurred after severance of gas from the well) in the calculation of royalty payments.[4] For states following the first marketable product approach, there is no clearly defined rule for its application across jurisdictions.[5] More often than not, however, the likelihood that a lessee will incur the bulk of post-production costs, without deduction of such costs in royalty calculations, is considerable in these states.[6] Over the course of several judicial opinions, the Oklahoma Supreme Court has thrown its hat into the first marketable product bloc.[7]

This article argues that Oklahoma's adoption of the first marketable product doctrine is a poor alternative to the more reasonable and established at the well approach, and based on unwieldy Oklahoma court decisions as well as recent decisions in other gas-bearing jurisdictions, the state should abandon it and adopt the at the well approach. Part II of this article focuses on the basic fundamentals of royalty clauses and provides

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1. Scott Lansdown, *The Marketable Condition Rule*, 44 S. TEX. L. REV. 667, 668-69 (2003) (propounding that the deductibility of post-production costs is a widely litigated issue in the oil and gas industry).

2. David E. Pierce, *Royalty Jurisprudence: A Tale of Two States*, 49 WASHBURN L.J. 347, 348 (2010) (describing the existence of the two major judicial views in controversy and discussing the individuals or groups that frequently align themselves with one view or the other based on their position and interest in the litigation); *see generally* Russell L. Schetroma, *General Reflections upon the Evolving Eastern Oil and Gas Lease*, 30 ENERGY & MIN. L. INST. 448, 460-61 (2009) (discussing that deductibility of post-production costs is highly litigated and that a major factor in such litigation relates to disparate judicial interpretations).

3. Byron C. Keeling, *A New Era in Oil and Gas Royalty Accounting*, 2 OIL & GAS FIN. J. 1-2, *available at* http://www.ogfj.com/articles/print/voulme-2/issue-7/features/a-new-era-in-oil-and-gas-royalty-accounting.html.

4. 8-A HOWARD R. WILLIAMS & CHARLES J. MEYERS, OIL AND GAS LAW 72 (Matthew Bender & Co. ed., LexisNexis 2012).

5. Keeling, *supra* note 3.

6. *See generally* Wellman v. Energy Res., Inc., 557 S.E.2d 254, 265 (W. Va. 2006) (determining that the implied covenant to market demands that lessees bear all post-production expenses necessary to achieve a marketable product); Rogers v. Westerman Farm Co., 29 P.3d 887, 905-06 (Colo. 2001) (holding that lessee must achieve a marketable product and as such incurs, in addition to other post-production costs, all transportation costs necessary to satisfy this requirement).

7. *See* Mittelstaedt v. Santa Fe Minerals, Inc., 954 P.2d 1203 (Okla. 1998); TXO Prod. Corp. v. State *ex rel.* Comm'rs of Land Office, 903 P.2d 259 (Okla. 1994); Wood v. TXO Prod. Corp., 854 P.2d 880 (Okla. 1992).

useful background that enables a better understanding of the overarching issue. Part III largely examines the two conflicting approaches as well as provides brief synopses of states that have adopted the first marketable product approach. The discussion in Part IV covers Oklahoma's variation of the approach and focuses on the court cases that ultimately led to its adoption in the state. Part V parses through the Supreme Court of Oklahoma's rulings in an attempt to synthesize a singular definition of the first marketable product doctrine and addresses the many problems that exist with its application and use in the state. In Part VI, the discussion looks at the increasingly growing trend away from the first marketable product approach and expands on how these trends should prompt the Oklahoma Supreme Court to modify its approach. Part VII concludes by reiterating the need for Oklahoma to make a concerted effort to change its stance on the deduction of post-production costs.

II. FUNDAMENTALS

As this discussion focuses on the deduction of post-production costs in the calculation of royalty payments, it is important to mention a few distinctions between the different types of royalty clauses.[8] Generally, it is understood that a royalty is "a share of [or interest in] production, free of expenses of production."[9] Put simply, the royalty holder is free from any costs that might occur in the course of bringing about and completing production.[10] However, interpretations vary significantly with respect to the exact point at which production ceases and the sharing of costs begins, if such cost sharing is deemed necessary at all.[11]

Oil and gas differ physically in that oil can be stored or contained at sites separate from the well, whereas it is not economically feasible to store natural gas in this manner.[12] Consequently, in most leases, there is a distinction between royalty clauses concerning oil and those concerning gas.[13] Oil royalty clauses are commonly "in-kind," meaning the royalty holder is entitled to his share in the form of oil itself.[14] However, royalty owners frequently receive cash payment instead of oil.[15] Given the economic infeasibility of paying out royalties for gas in-kind, parties usually construct clauses to provide payment based on "market value" or "proceeds."[16] It is generally understood that there are two methods for calculating these payments: the "comparable sales method" and the "work-back method."[17] For market value leases, the preferred method is comparable sales, in which "lessee[s] determine[] the market value of . . . oil or gas production

8. 8-R HOWARD R. WILLIAMS & CHARLES J. MEYERS, OIL AND GAS LAW 64 (Matthew Bender & Co. ed., LexisNexis 2012).

9. *Id.*

10. *Id.*

11. *See* Keeling, *supra* note 3; *see also* Rogers v. Westerman Farm Co., 29 P.3d 887 (Colo. 2001); Mittelstaedt v. Santa Fe Minerals, Inc., 954 P.2d 1203 (Okla. 1998); Sternberger v. Marathon Oil Co., 894 P.2d 788 (Kan. 1995).

12. JOHN S. LOWE ET AL., CASES AND MATERIALS ON OIL AND GAS LAW 433 (5th ed. 2008).

13. *Id.*

14. *See* 3-6 HOWARD R. WILLIAMS & CHARLES J. MEYERS, OIL AND GAS LAW § 659 (Matthew Bender & Co. ed., LexisNexis 2012).

15. *Id.*

16. *Id.*; *see also* LOWE ET AL., *supra* note 12.

17. Byron C. Keeling & Karolyn King Gillespie, *The First Marketable Product Doctrine: Just What is the "Product"?*, 37 ST. MARY'S L.J. 1, 31-32 (2005).

at the wellhead by averaging the prices that the lessee and other producers are receiving . . . comparabl[y] . . . ."[18] However, more often than not, the comparable sales method is not a viable option because there are frequently no comparable sales available to evaluate, and use of the work-back method is generally permitted.[19] For proceeds leases, lessees calculate payment based on the price of the produced gas at the wellhead, typically using the work-back method, if post-production costs are incurred.[20] Work-back involves the adjustment of payments based on the post-production costs a lessee expends in bringing the gas to market.[21] The amount is calculated proportionally to the interest of the royalty holder.[22] It is worth mentioning, however, that the application of work-back in deduction situations varies by jurisdiction depending upon the jurisdiction's view on the deductibility of post-production costs.[23] For the purposes of this article, the distinction between "market value" and "proceeds" is largely unimportant, as work-back—which frequently is the more used calculation method—generally operates the same for both when determining payments.[24]

III. FROM THE PRODUCER'S PURSE OR THE INTEREST HOLDER'S PURSE: THE TWO VIEWS ON DEDUCTIBILITY

A. "At the Well"

Historically, and until a string of court decisions in a handful of states over the last few decades, the at the well approach has been the predominant and established means for calculating royalty payments.[25] This approach interprets at the well and similar leases as allowing for deduction of costs incurred post-production from royalty payments.[26] This is because in these kinds of leases, which are fairly common, the lessee determines payment based on the price of the produced gas at the wellhead.[27] If the gas is simply sold at the wellhead and the lessee incurs no post-production costs, then the lessee does not make deductions, and instead pays the royalty holder his proportion of that sale.[28] Processes and expenses occurring after this point (post-extraction), however, typically add to the value of the product and are therefore deducted proportionately.[29] These post-production costs generally are incurred in the furtherance of creating a sellable or more sellable product and may include "transportation, gathering, processing, treating, and marketing expenses."[30] Costs prior to extraction are considered production costs and de-

18. *Id.* at 31.
19. *Id.* at 33 n.129.
20. *Id.* at 33-34.
21. 8-W HOWARD R. WILLIAMS & CHARLES J. MEYERS, OIL AND GAS LAW 31 (Matthew Bender & Co. ed., LexisNexis 2012).
22. *Id.*
23. Keeling & Gillespie, *supra* note 17, at 35-37.
24. *Id.* at 33-35.
25. Lansdown, *supra* note 1, at 671.
26. Keeling, *supra* note 3, at 1.
27. *Id.*
28. WILLIAMS & MEYERS, *supra* note 4.
29. *See generally* Keeling, *supra* note 3, at 1 (expressing that the value of gas increases with the addition of post-extraction processes and therefore royalty interest holders generally disfavor the at the well approach).
30. *Id.*

ductions from royalty payments for these expenses are not permitted.[31] With the at the well approach, lessees frequently use the work-back method for royalty payment deductions or adjustments.[32]

Naturally, energy companies and lessees attempting to bring the product to market prefer this deduction framework, which allows a more evenhanded distribution of costs, and royalty interest holders disfavor it.[33] Although giving the appearance of benefitting the producing party to the detriment of the royalty holders, the expectation that producers should solely shoulder the bulk of post-production costs seems no more reasonable.[34] Because a royalty is, by definition, "a share of production, free of expenses of *production*,"[35] it reasonably follows that royalty holders should not be free from sharing costs incurred *post-production*.[36] Consequently, the use of this method provides a practical way for lessees to adjust payments based on expenses that go beyond the point at which gas is extracted from the wellhead.[37] Texas, Louisiana, and several other states follow this interpretation and continue to use the at the well approach, allowing for a work-back method in the calculation and deduction of royalty payments.[38]

B. First Marketable Product Doctrine

Unlike the at the well approach, which has a general consistency in its definition across jurisdictions, the first marketable product doctrine is the subject of many interpretations, and there is no single cross-jurisdictional definition or approach for the principle.[39] Very generically, the first marketable product doctrine can be expressed as "[a] judicial rule of royalty clause interpretation . . . that where a lease is silent as to allocation of costs, the implied covenant to market obligates the lessee to incur costs necessary to render the gas marketable."[40] Part of the jurisdictional fragmentation arises from two separate, though overlapping, viewpoints that courts often use for justifying the approach.[41] Professors Kuntz and Merrill of the University of Oklahoma provide helpful commentary in explaining these justifications.[42] Their respective contributions are discussed in turn below.

Professor Kuntz adopts an express language view, arguing that "absent clarifying

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31. WILLIAMS & MEYERS, *supra* note 14, § 645.1.
32. Keeling, *supra* note 3, at 1.
33. *See generally* Pierce, *supra* note 2 (discussing that lessees involved in litigation often attempt to convince courts to follow the Texas at the well view, while lessors generally attempt to argue use of the Colorado first marketable product view).
34. *See generally* David E. Pierce, *Developments in Nonregulatory Oil and Gas Law: The Continuing Search for Analytical Foundations*, 47 INST. ON OIL & GAS L. & TAXATION § 1.07[4][c] (1996) (arguing that lessees should not have to share with lessors the rewards gained from post-production endeavors free of cost).
35. WILLIAMS & MEYERS, *supra* note 8 (emphasis added).
36. *See generally* Martin v. Glass, 571 F. Supp. 1406, 1410 (N.D. Tex. 1983) ("[A] royalty is an expense-free interest, paid out of production . . . It is free of all costs of development and production . . . but may share in any costs incurred subsequent to production.").
37. Keeling & Gillespie, *supra* note 17, at 35-37.
38. Keeling, *supra* note 3, at 1.
39. *Id.* at 1-2.
40. 8-M HOWARD R. WILLIAMS & CHARLES J. MEYERS, OIL AND GAS LAW 12 (Matthew Bender & Co. ed., LexisNexis 2012).
41. LOWE ET AL., *supra* note 12, at 475.
42. *Id.*

lease language, the default rule for royalty valuation should depend upon when oil and gas is deemed to be produced under the lease."[43] He further contends that "the acts which constitute production have not ceased until a marketable product has been obtained."[44] In other words, the obligations of a lessee extend as far as necessary to achieve a marketable product and costs associated with such necessities are not deductible.[45] Under the most common types of gas royalty provisions, Professor Kuntz argues that one should interpret a lessee's production obligations within the fundamental meaning of such clauses.[46]

Conversely, Professor Merrill contends that the first marketable product approach more appropriately stems from the implied covenant to market.[47] He argues that lessees inherently have a duty to market the gas and must therefore engage in the steps necessary to render it ready for sale.[48] Based on this rationale, he concludes that "[n]o part of the costs of marketing or of preparation for sale is chargeable to the lessor [royalty interest holder]."[49] Further, it is worth mentioning that, "[a]lthough courts adopting the marketable-product rule have often cited Professor Kuntz, their opinions are often closer to . . . the view of Professor Merrill."[50] The courts often push Professor Merrill's view a step further by lessening the amount of deference given to the actual royalty language.[51] To an extent, the generic definition of the first marketable product doctrine given above appears to be in line with court applications of the approach and therefore may help with parsing together the many variations scattered throughout various jurisdictions.[52] The discussion below will demonstrate, however, that it is difficult to weave together a single definition that encompasses the variations in the doctrine.[53]

C. Jurisdictional Synopses of the First Marketable Product Doctrine

The major players advancing the first marketable product approach are Colorado, Kansas, West Virginia, and Oklahoma, with each taking a different spin on its application.[54] For background purposes, only a brief discussion of the first three states' interpretations is provided, as the focus of this article is specifically on Oklahoma's implementation of the approach. It is perhaps best then to start with one of the more radical of the lot: Colorado.[55]

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43. *Id.*; 3-40 KUNTZ, LAW OF OIL AND GAS § 40.5(b) (2012).
44. LOWE ET AL., *supra* note 12, at 475; KUNTZ, *supra* note 43, § 40.5(b).
45. *See* LOWE ET AL., *supra* note 12, at 475.
46. KUNTZ, *supra* note 43.
47. LOWE ET AL., *supra* note 12, at 475.
48. *Id.*; MAURICE H. MERRILL, THE LAW RELATING TO COVENANTS IMPLIED IN OIL AND GAS LEASES 15, 214-215 (2d ed. 1940).
49. LOWE ET AL., *supra* note 12, at 475; MERRILL, *supra* note 48.
50. LOWE ET AL., *supra* note 12, at 475.
51. *Id.*
52. *See, e.g.*, Wellman v. Energy Resources, Inc., 557 S.E.2d 254, 264-65 (W. Va. 2006); Rogers v. Westerman Farm Co., 29 P.3d 887, 906 (Colo. 2001); TXO Prod. Corp. v. State *ex rel.* Comm'rs of Land Office, 903 P.2d 259 (Okla. 1994).
53. *See infra* Part III.C.
54. WILLIAMS & MEYERS, *supra* note 14, § 645.
55. Keeling, *supra* note 3, at 2.

1. Colorado

The first marketable product approach in Colorado is the antithesis of the historical view, largely discarding the traditional meaning of at the well clauses.[56] The Colorado Supreme Court has held that where a lease does not provide express allocation of costs, the implied duty to market imposes upon the lessee all costs necessary to bring the gas to a marketable state, including transportation costs.[57] Further, in leases that use the "at the well" language, the court, while acknowledging that the majority view is to the contrary, has held that such terminology is silent as to costs.[58] The court has concluded that it is therefore unnecessary in these cases to allow a calculation using work-back because the post-productions costs generally deducted under the at the well approach are often expenses required to place gas in marketable condition.[59]

Further expanding, and perhaps complicating, the meaning of the approach, the Colorado Supreme Court has held that to determine if marketable gas exists, courts must evaluate its "condition" and "location."[60] The condition factor simply relates to a state at which the gas is capable of commercial sale; the complication arises with the "location" element.[61] Pursuant to the court's location analysis, a lessee must incur all transportation expenses and must additionally bring the gas to a "commercial marketplace."[62] Effectively, the lessee must transport gas, which may already be in a marketable condition at the well, to a location where an actual sale can occur.[63] This transportation is of course all at the expense of the lessee.[64] Despite the potentially harsh implication of this approach on lessees, a degree of leeway with cost allocation is allowed where, after gas becomes marketable (remember, it has to be able to reach a commercial marketplace first), further transportation or enhancements add value.[65] Unfortunately, this leeway does not reduce the likelihood that, despite contractual expectations, lessees or producers will unfairly shoulder most, if not all, of the post-production expenses incurred to reach the required commercial marketplace.[66]

2. Kansas

The Kansas Supreme Court takes a slightly more moderate approach than Colorado.[67] Although Kansas, like Colorado, imposes upon the lessee the bulk of post-

56. *See generally Rogers*, 29 P.3d at 906 (the court determined that the at the well leases under review were silent as to allocation of post-production costs and that, in accordance with the first marketable product doctrine, the lessee must incur all costs necessary to render a product marketable).

57. *Id.*

58. *Id.* at 899-901, 906.

59. *Id.* at 904.

60. *Id.* at 905.

61. *See Rogers*, 29 P.3d at 905.

62. *Id.* at 906.

63. *See id.*

64. *Id.*

65. *Id.*

66. *See generally* Keeling & Gillespie, *supra* note 17, at 88 (discussing that when a court chooses not to follow the plain meaning of contracts, it violates the relationship formed between the parties, in some cases completely disregarding their expectations).

67. *Compare* Sternberger v. Marathon Oil Co., 894 P.2d 788, 800 (Kan. 1995) (allowing for deduction of post-production costs involving transportation) *with Rogers*, 29 P.3d at 906 (disallowing the deduction of post-production cost, including transportation, unless they occur after the creation of a marketa-

production costs necessary to achieve a marketable product, it does allow for deduction of reasonable transportation costs.[68] Kansas courts also impose the implied covenant to market, which requires that lessees render gas in a marketable condition, and thus, the lessee bears the costs needed to achieve this state.[69] Interestingly, the Kansas Supreme Court has held that gas might be considered marketable at the well, even without the existence of a market at the well, so long as all that remains to bring the gas to a market is a pipeline.[70]

In Kansas, if there is no market at the well for which the lessee can sell the produced gas and the gas is otherwise in marketable form, then the lessee may deduct from the royalty interest holder's payment reasonable transportation expenses incurred in bringing the gas to market.[71] This is in stark contrast to Colorado's first marketable product approach, which would not find gas marketable where no commercial market for it exists at the well, nor would it allow deduction for such transportation costs.[72] Despite Kansas's variation on the first marketable product doctrine with respect to transportation costs, its approach still imposes an economic burden on lessees that seemingly defies party expectations and forces them to shoulder the bulk of post-production expenses.[73]

3. West Virginia

The West Virginia Supreme Court of Appeals is one of the more recent states to adopt its own variation of the first marketable product doctrine, and it bears similarity to Colorado's approach.[74] Although West Virginia has limited case law, the court determined that under the implied covenant to market, lessees must bear all costs necessary to create and bring marketable gas to the point of sale.[75] Further, the court has held that leases containing "at the well" clauses are ambiguous as to the allocation or deduction of post-production costs.[76] Thus, absent express language allocating such costs between lessor and lessee, the lessee must bear all post-production costs, including transportation.[77] When evaluating the language of the lease, the court has held that as a "general rule . . . oil and gas leases . . . will generally be liberally construed in favor of the lessor and strictly against the lessee."[78] These rulings stand for the proposition that the stance of West Virginia is one that, much like other marketable product states, does not shy from placing a financial burden on the lessee.[79]

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ble product).

68. *Sternberger*, 894 P.2d at 800.
69. *See* Smith v. Amoco, 31 P.3d 255 (Kan. 2001).
70. *Sternberger*, 894 P.2d at 800.
71. *Id.*
72. *See Rogers*, 29 P.3d at 906.
73. *See generally* Keeling & Gillespie, *supra* note 17, at 88 (discussing that when a court chooses not to follow the plain meaning of contracts, it violates the relationship formed between the parties, in some cases completely disregarding their expectations).
74. *Compare Rogers*, 29 P.3d at 906 (imposing the bulk of post-production costs on the lessee via an application of the implied covenant to market) *with* Wellman v. Energy Res., Inc., 557 S.E.2d 254, 264-65 (W. Va. 2006) (imposing the bulk of post-production costs on lessee via the implied covenant to market).
75. *Wellman*, 557 S.E.2d at 264-65.
76. Estate of Tawney v. Columbia Nat. Res., L.L.C., 633 S.E.2d 22, 28 (W. Va. 2006).
77. *Id.* at 30.
78. *Id.* at 29 (quoting Martin v. Consol. Coal & Oil Corp., 133 S.E. 626, 628 (W. Va. 1926)).
79. *See id.* at 30.

IV. OKLAHOMA'S GRAVITATION AWAY FROM DEDUCTIBILITY

Unlike its behemoth oil and gas producing sister to the south, Oklahoma has rebelled against the at the well approach by adopting its own variation of the first marketable product doctrine.[80] Through an analysis of some of the most prominent cases over the last few decades, a better picture of Oklahoma's variation of the doctrine will come to light.[81] It will also aid in demonstrating that Oklahoma's adoption of the principle is problematic and not in the best interests of the state.[82]

A. Origins

In 1970, the Supreme Court of Oklahoma began laying the groundwork for the state's own variation of the first marketable product doctrine.[83] In *Johnson v. Jernigan*,[84] the lessors brought suit against the lessees, alleging that they improperly deducted transportation costs from their one-eighth royalty interest in production proceeds.[85] The lease provided that the lessors would receive "[one-eighth] of the gross proceeds at the prevailing market rate for all gas sold off the premises."[86] The lessors argued that such language entitled them to a portion of the proceeds free from deduction of transportation and marketing costs.[87] The court disagreed.[88] In reaching its decision, the court focused on the clause language providing that the lessors' payment was to be determined by the prevailing market rate.[89] The court asserted that "[m]arket rate means the rate at which the gas is commonly sold in the vicinity of the well. It is the market rate at the wellhead or in the field that determines the sale price, and not the market rate at the purchaser's location."[90]

Despite finding that no such market existed at the well,[91] the court ruled that the lessees had no obligation to lay pipeline beyond the area described in the lease.[92] However, the court clarified, that this was not to say that the lessees did not have a duty to reasonably take steps to maximize the value of the gas.[93] In aligning with the consensus view, the court explained that a lack of market price can generally be attributed to an absence of a pipeline connection to the place of sale.[94] In these cases, there are instances in which a lessee must construct a pipeline beyond the leased premise to reach the market.[95] If this need occurs, "the market price of the royalty gas is the price paid at the place of

80. *See* Mittelstaedt v. Santa Fe Minerals, Inc., 954 P.2d 1203, 1205, 1210 (Okla. 1998); TXO Prod. Corp. v. State *ex rel.* Comm'rs of Land Office, 903 P.2d 259, 263 (Okla. 1994); Wood v. TXO Prod. Corp., 854 P.2d 880, 883 (Okla. 1992).

81. *See infra* Part IV.A-C.

82. *See infra* Part V.B.

83. *See* Johnson v. Jernigan, 475 P.2d 396, 398 (Okla. 1970).

84. *Id.* at 396.

85. *Id.* at 397.

86. *Id.*

87. *Id.* at 397-98.

88. *Johnson*, 475 P.2d at 398-99.

89. *Id.*

90. *Id.* at 398.

91. *Id.*

92. *Id.* at 399.

93. *Johnson*, 475 P.2d at 399.

94. *Id.* at 398.

95. *Id.*

sale, less the additional cost of transporting to market"—[96] a proposition in accord with the court's ruling that the lessees properly deducted transportation costs for the construction of the pipeline.[97] It is important to note that in releasing its decision, the court explicitly limited its holding to transportation expenses only.[98]

B. The Great Upheaval

1. *Wood v. TXO Production Corporation*

Oklahoma's more apparent shift toward the first marketable product doctrine began with the 1992 case of *Wood v. TXO Prod. Corp.*,[99] where the Oklahoma Supreme Court responded to a certified question asking whether a lessee may deduct the expenses from compression when calculating royalty payments.[100] In *Wood*, the lessee built compressors during the course of production so that it could meet the necessary well pressure levels for delivery of the gas to market.[101] The lessee subsequently deducted compression costs from the lessor's royalty payment proportionate to his interest.[102] The lessor brought suit, claiming that such deductions from his royalty payment were prohibited.[103] The royalty in the lease provided for "3/16 at the market price at the well for gas sold."[104] Interestingly, in siding with the lessor, the court rejected the lessee's argument that compression costs fell under the definition of transportation costs as provided in *Jernigan*.[105] The court explained that gas is "sold" at the point in which it enters the pipeline and that because the pipeline was located on the property, there were, in effect, no transportation costs for the lessee to deduct.[106] Further, the court reasoned, if the parties intended to allocate compression costs to the lessor, they could have expressly agreed to do so in the lease.[107]

In a more measurable shift toward the first marketable product approach, the court aligned itself with the Supreme Court of Kansas, finding that the duty to market demands that the lessee prepare gas for market or achieve a marketable product, which, in Oklahoma, includes compression as well as associated costs.[108] Notably, it appears that "the court simply assumed that compression was necessary to put the gas in marketable condition without even attempting to explain how it reached this conclusion . . . ."[109] Further, the mere act of compressing the gas before sending it to market is not, as a general matter, a condition precedent to creating a marketable product.[110] Unfortunately, the court continued to expand its list of prohibited deductions beyond compression a couple

96. *Id.*
97. *Id.* at 400.
98. *Johnson*, 475 P.2d at 400.
99. *See* Wood v. TXO Prod. Corp., 854 P.2d 880, 882-83 (Okla. 1992).
100. *Wood*, 854 P.2d at 880.
101. *Id.* at 880-81.
102. *Id.*
103. *Id.* at 881.
104. *Id.* at 880.
105. *Wood*, 854 P.2d at 881.
106. *Id.*
107. *Id.* at 885.
108. *Id.* at 882.
109. Lansdown, *supra* note 1, at 686.
110. *Id.*

years later in another precedential case.[111]

2. *TXO Production Corporation v. State ex rel. Commissioners of Land Office*

In *TXO Prod. Corp. v. State ex rel. Comm'rs of Land Office*,[112] the Supreme Court of Oklahoma addressed whether a lessee could deduct post-production costs including "compression, dehydration, and gathering" from the lessor's royalty payment.[113] The court concluded that such post-production costs were not allocable to the lessor and, pursuant to the lessee's duty to achieve a marketable product, it must bear all related expenses.[114] Pointing to its decision in *Wood*, the court expressed that it had already determined that compression costs were necessary for placing gas in marketable form, but acknowledged that it had not specifically addressed dehydration or gathering.[115] It looked to the definitions of both processes to reach its conclusion.[116] The court defined dehydration as "removal of moisture from gas before it enter's [sic] the purchaser's pipeline,"[117] while it defined gathering as "the process of collecting gas at the point of production (the wellhead) and moving it to a collection point for further movement through a pipeline's principal transmission system."[118] The court concluded that because the processes occurred prior to entering the purchaser's pipeline, they were necessary for the preparation of marketable gas.[119] Thus, it appears that the court simply made a blanket assertion that these costs were required for the formation of a marketable product, providing no cost-sharing leeway absent a provision expressing otherwise.[120] Reiterating its ruling in *Wood*, the court explained that with regard to post-production costs, it expressly rejected the Texas view allowing for proportionate deduction,[121] thereby cementing Oklahoma as an adopter of the first marketable product approach.[122]

3. *Mittelstaedt v. Santa Fe Minerals, Inc.*

In *Mittelstaedt v. Santa Fe Minerals Inc.*,[123] the Supreme Court of Oklahoma answered a certified question asking whether a lessee may deduct post-production costs such as "transportation, compression, dehydration, and blending" from a royalty interest payment.[124] The court muddied the waters of its variation of the first marketable product doctrine by effectively responding with a resounding "maybe."[125] In this case, the lessee sent the gas offsite to third parties who dealt with the post-production processes.[126] The

111. *See* TXO Prod. Corp. v. State *ex rel.* Comm'rs of Land Office, 903 P.2d 259, 260 (Okla. 1994).
112. *Id.* at 259.
113. *Id.* at 260.
114. *Id.* at 262.
115. *Id.*
116. *TXO Prod. Corp.*, 903 P.2d at 262.
117. *Id.*
118. *Id.*
119. *Id.* at 262-63.
120. *See id.*
121. *TXO Prod. Corp.*, 903 P.2d at 263.
122. *See id.*
123. Mittelstaedt v. Santa Fe Minerals, Inc., 954 P.2d 1203 (Okla. 1998).
124. *Id.* at 1204-05.
125. *See id.* at 1205.
126. *Id.*

lessee paid fees to these third parties and when they were finished with their work, they sent the gas downstream to a pipeline where a sale could be made.[127] The lessors sued the lessee because the lessee deducted from royalty payments those costs incurred in marketing the gas.[128] The language of the lease expressed that the lessee would pay the lessor "3/16 of the gross proceeds, at the mouth of the well, received by lessee for the gas."[129] Based solely on the language of the lease, the Supreme Court of Oklahoma concluded that deduction of post-production costs from the payment was impermissible.[130] However, with an apparent itch to further modify its stance on deductibility, the court explained that in some circumstances, a lessor is obligated to bear his proportionate share.[131] It is already difficult for a lessee to know when such circumstances are present and the court only made this determination more difficult by forcing lessees to satisfy a complex set of factors.[132] The court expressed that a lessee may deduct costs if it can show the following: "(1) [T]hat the costs enhanced the value of an already marketable product, (2) that such costs are reasonable, and (3) that actual royalty revenues increased in proportion with the costs assessed against the nonworking interest."[133]

The Supreme Court of Oklahoma had previously determined that post-production costs, except for transportation, were not allocable to the lessor.[134] This rule changed with the adoption of the above-mentioned factors, which allowed proportionate sharing if the process enhanced an already marketable product.[135] In answering the question, and despite the factors, the court implied that the lessee had not satisfied them.[136] It concluded that gas must be in marketable form before these factors can apply and that costs from offsite work necessary to achieve this form are not deductible.[137] Further, agreeing with the Kansas view, the court concluded that the lessee must solely bear even the transportation costs incurred in bringing the gas to the third parties.[138] Thus, the court did not invalidate *Jernigan*, which allowed sharing transportation costs; rather, it established that the lessee must bear all transportation costs necessary to achieve a marketable product.[139]

Of significant importance is the dissent, which mentioned one of the major flaws that flowed from both the *Mittelstaedt* opinion as well as from the ruling in *Wood*.[140] In these cases, the court required a lessee to render a product marketable, but in determining whether a product was in fact marketable, it treated the issue "*as a question of law rather than one of fact*."[141] The court simply glossed over factual questions that naturally and inevitably arise in gas disputes, particularly when the determination of market conditions

127. *Id.*
128. *Mittelstaedt*, 954 P.2d at 1204.
129. *Id.* at 1206.
130. *Id.* at 1205.
131. *See id.*
132. *See* Lansdown, *supra* note 1, at 688.
133. *Mittelstaedt*, 954 P.2d at 1205.
134. *Id.*
135. *Id.*
136. *Id.* at 1210.
137. *Id.*
138. *Mittelstaedt*, 954 P.2d at 1210.
139. *Id.*
140. *Id.* at 1213-14 (Opala, J., dissenting).
141. *Id.* at 1213.

is involved.[142] Instead, in its ruling on the issue, "the court arbitrarily declare[d] certain costs as necessary to produce a marketable product . . . [and] [*s*]*ans* factual inquiry, it is impossible to determine the very existence of a market."[143] Although the dissent went on to disapprove of the at the well approach and concocted its own variation of marketable product, the premise still stands with respect to the majority ruling: that treatment of marketability as a question of law is particularly flawed.[144] This is not to say however, that treating the marketable product determination as a question of fact is a sufficient remediation of the inherent problems with the first marketable product doctrine either.[145]

C. Odd Man Out: The Oklahoma Overriding Royalty Interest Exception

In 1998, the Supreme Court of Oklahoma deviated from its first marketable product approach when it ruled on a case concerning deduction of post-production costs from an overriding royalty interest, which is different from the standard royalty interests.[146] Defining this type of interest may be helpful, so putting it simply, an overriding royalty interest is "[a]n interest in oil and gas produced at the surface, free of the expense of production, and in addition to the usual landowner's royalty reserved to the lessor in an oil and gas lease."[147] In *XAE Corp. v. SMR Property Management Co.*,[148] the court was faced with determining whether overriding royalty interest owners were entitled to compensation for the deduction of "gathering, processing, and compress[ion]" expenses from their payments.[149] The defendant's predecessor in title conveyed the interest holders an in-kind interest that was "free and clear of all costs and expenses whatsoever."[150] Although in-kind interests are not typically associated with gas royalty clauses due to factors such as economics or infeasibility of storage,[151] the conveyance in this case was actually in-kind for gas.[152] However, rather than accept an in-kind payment, the interest holders opted to grant the lessee the right to market the gas.[153] After the lessee deducted post-production costs, the interest holders sued, alleging that such deductions were disallowed pursuant to Oklahoma law as well as the implied duty to market or to achieve a marketable product.[154]

The court declined to grant the overriding interests the same protection afforded to royalty interests, holding that "unless expressly assumed, implied covenants of oil and gas leases do not extend to lease assignments with reservation of overriding royalty interest."[155] Of particular importance, the court noted that the assignment of the overriding

142. *See id.* at 1214.
143. *Mittelstaedt*, 954 P.2d at 1214 (Opala, J., dissenting).
144. *See id.* at 1214-15.
145. Lansdown, *supra* note 1, at 702-03.
146. See, for example, Part IV.B for more information about standard royalty interests; *see also* XAE Corp. v. SMR Prop. Mgmt. Co., 968 P.2d 1201, 1204 (Okla. 1998).
147. 8-O HOWARD R. WILLIAMS & CHARLES J. MEYERS, OIL AND GAS LAW 55 (Matthew Bender & Co. ed., LexisNexis 2012).
148. *XAE Corp.*, 968 P.2d at 1201.
149. *Id.* at 1202.
150. *Id.*
151. *See* WILLIAMS & MEYERS, *supra* note 14; *see also* LOWE ET AL., *supra* note 12.
152. *XAE Corp.*, 968 P.2d at 1202.
153. *Id.* at 1202-03.
154. *Id.* at 1203.
155. *Id.* at 1202, 1204.

interest contained no language indicating the imposition of the same obligations created by the underlying lessor-lessee relationship found in the lease.[156] Further, given that the overriding royalty interest was in-kind, the only payment due to the interest holders was that which the lessee produced and delivered at the wellhead.[157] The lessee's mere grant of permission to market the gas did not also impose upon it an obligation to incur costs associated with making the gas marketable.[158] Thus, in the case of an overriding royalty interest, the requirement for a marketable product is inapplicable, and the lessee may deduct post-production costs from the interest payment.[159]

XAE Corp. is particularly interesting because in discussing its ruling, the court rejected the Colorado Supreme Court's interpretation of Oklahoma law as imposing the implied duty to market on overriding royalty interests.[160] In disagreeing with Colorado's interpretation, the Supreme Court of Oklahoma looked to earlier case law, which notably occurred years before it adopted the marketable product doctrine, allowing for deduction of post-production costs from overriding royalty interests.[161]

V. PARSING IT ALL: UNDERSTANDING FIRST MARKETABLE PRODUCT IN OKLAHOMA AND ACKNOWLEDGING ITS FLAWS

A. Translating the Cases

From *Jernigan* to *XAE Corp.*, the Oklahoma Supreme Court weaved a web of decisions that, somewhat confusingly, expressed its view on the role of the first marketable product approach in Oklahoma.[162] From these rulings, it is clear that where a lease is silent as to the allocation of post-production costs, the implied duty to market or to achieve a marketable product controls.[163] These post-production costs include compression, dehydration, blending, gathering, and similar processes.[164] The court views these processes as necessary for achieving a marketable product, and therefore, a lessee may not deduct them from a lessor's royalty payment.[165] Although, it is interesting that the court, as a general matter, treats these processes as inherently necessary for rendering a product marketable.[166] This determination, according to the court, is a question of law rather than fact.[167] Transportation costs are generally proportionately allocable if the pipeline connecting to the point of sale is beyond the leased premise, but there is no sharing of the costs of transporting gas offsite for processing if the reason for doing so is to achieve a

156. *Id.* at 1207.
157. *XAE Corp.*, 968 P.2d at 1207.
158. *Id.*
159. *Id.* at 1208.
160. *Id.* at 1206.
161. *Id.* at 1205.
162. *See* Mittelstaedt v. Santa Fe Minerals, Inc., 954 P.2d 1203 (Okla. 1998); XAE Corp. v. SMR Prop. Mgmt. Co., 968 P.2d 1201 (Okla. 1998); TXO Prod. Corp. v. State *ex rel.* Comm'rs of Land Office, 903 P.2d 259 (Okla. 1994); Wood v. TXO Prod. Corp., 854 P.2d 880 (Okla. 1992); Johnson v. Jernigan, 475 P.2d 396 (Okla. 1970).
163. *See, e.g.*, *Mittelstaedt*, 954 P.2d at 1210; *TXO Prod. Corp.*, 903 P.2d at 262; *Wood*, 854 P.2d at 882.
164. *See, e.g.*, *Mittelstaedt*, 954 P.2d at 1205; *TXO Prod. Corp.*, 903 P.2d at 262; *Wood*, 854 P.2d at 881.
165. *See, e.g.*, *Mittelstaedt*, 954 P.2d at 1205; *TXO Prod. Corp.*, 903 P.2d at 262; *Wood*, 854 P.2d at 881.
166. *See* Lansdown, *supra* note 1, at 686.
167. *Mittelstaedt*, 954 P.2d at 1213 (Opala, J., dissenting).

marketable product.[168] As held in *Mittelstaedt*, if after achieving a marketable product a lessee can demonstrate enhancement, reasonable expenses, and a correlative increase in royalty revenue proportionate to the cost of improvement, it may deduct the costs of such enhancement.[169] Additionally, Oklahoma courts do not afford overriding royalty interests the protections of the implied duty to market that is derived from the lessor-lessee relationship, and therefore, unlike standard royalties, deductions for post-production costs are allowed.[170]

B. Problems with First Marketable Product in Oklahoma

The Supreme Court of Oklahoma's decision to adopt the first marketable product doctrine is problematic and largely serves as a complication for the oil and gas industry.[171] With major natural gas companies such as Devon Energy and Chesapeake Energy headquartered and conducting business in Oklahoma, it would seem entirely reasonable to avoid unclear or unwieldy jurisprudence that is unnecessarily burdensome and harmful to the expansion of the industry.[172] Unfortunately, based simply on the court's adoption of the doctrine, it is patently clear that it does not view such an approach as problematic for the handling of cost deduction disputes.[173] Perhaps the most obvious and frustrating issue with Oklahoma's variation—and for that matter, other states that have adopted the approach—is the lack of clarity in the definition of "marketable product" and when it is achieved.[174] A cursory reading of Oklahoma's rulings on the matter shows that the court has consistently failed to provide a true litmus test for determining whether a lessee has created a marketable product—save for a blanket requirement that mostly everything prior to reaching the purchaser's pipeline is nondeductible.[175] This understanding, of course, seemingly creates a presumption that processes occurring prior to sending gas to the purchaser's pipeline are strictly necessary to achieve a marketable product.[176] Oil and gas scholar Professor David Pierce of Washburn University School of Law contends that courts applying the approach "tend to push the royalty valuation point further downstream from the wellhead into separate business enterprises in which the lessor was never intended to participate."[177] As a consequence, he argues, "the lessor shares in the rewards of such separate businesses without exposure to any of the risks."[178]

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168. *See, e.g.*, *id.* at 1210.
169. *Mittelstaedt*, 954 P.2d at 1205.
170. XAE Corp. v. SMR Prop. Mgmt. Co., 968 P.2d 1201 (Okla. 1998).
171. *See generally* William F. Carr & Paul R. Owen, *Clear as Crude: Defending Oil and Gas Royalty Litigation*, 37 NAT. RESOURCES J. 695, 706 (1997) (discussing the damage the first marketable product doctrine can have on those states that have adopted it).
172. CHESAPEAKE ENERGY CORP., http://www.chk.com/Pages/Contact.aspx (last visited Nov. 1, 2013); DEVON ENERGY CORP., http://www.devonenergy.com/Pages/devon_energy_home.aspx (last visited Nov. 1, 2013).
173. *See Mittelstaedt*, 954 P.2d 1203; *XAE Corp.*, 968 P.2d 1201; TXO Prod. Corp. v. State *ex rel.* Comm'rs of Land Office, 903 P.2d 259 (Okla. 1994); Wood v. TXO Prod. Corp., 854 P.2d 880 (Okla. 1992); Johnson v. Jernigan, 475 P.2d 396 (Okla. 1970).
174. Brian S. Wheeler, *Deducting Post-Production Costs When Calculating Royalty: What Does the Lease Provide?* 8 APPALACHIAN J.L. 1, 10 (2008).
175. *See Mittelstaedt*, 954 P.2d at 1205; *TXO Prod. Corp.*, 903 P.2d at 262-63; *Wood*, 854 P.2d at 883.
176. *See Mittelstaedt*, 954 P.2d at 1205; *TXO Prod. Corp.*, 903 P.2d at 260-63; *Wood*, 854 P.2d at 883; *see also* Lansdown, *supra* note 1, at 686.
177. Pierce, *supra* note 34.
178. *Id.*

Moreover, the lack of clarity in what constitutes "marketable" produces a situation ripe for litigation that is both costly and judicially congesting.[179] Oklahoma's treatment of the term as one defined as a matter of law only serves to complicate this further because it skips often necessary factual inquiries,[180] such as whether a market for gas actually exists at all.[181] Surely such a factual determination is necessary when determining the marketability of a product.[182] As one Oklahoma Supreme Court justice remarked, "[t]reating marketability as a question of law ignores market realities."[183] This is not to say, however, that making the marketable product determination on a factual basis is any more rational.[184] Given the inevitable factual inquiries needed to determine whether processes constitute "preparation" or "enhancement" of a marketable product, the fodder for disputes is limitless.[185] Further, because of the inherent factual differences that will inevitably occur case-to-case, "the results of any particular case will be of virtually no use in determining the parties' rights and obligations in any other case."[186] These problems are only compounded by the lack of a clear test for determining whether a lessee has created a marketable product.[187] The uncertainty with making this determination leaves the lessee in a difficult position where it may not be able to comfortably conclude whether it has achieved a marketable product,[188] the consequence of which is a potential vulnerability to lawsuits brought by lessors claiming that the product is not marketable.[189]

Another issue with Oklahoma's approach is that it disregards the historical interpretation of at the well royalty clauses, and in doing so, it seemingly ignores the express language of such clauses.[190] As previously mentioned, at the well leases, which are fairly common, historically allowed for deduction from royalty payments those costs incurred post-production.[191] But the Supreme Court of Oklahoma has, of course, expressly rejected this interpretation.[192] By rejecting this interpretation, the court does what has become a common thread with marketable product states: it disregards the plain and understood meaning of these types of lease provisions.[193] Instead, the court construes at the well clauses as meaning something that goes beyond calculation at the wellhead, moving the calculation point into post-production processes.[194] This is problematic because it has the

179. Lansdown, *supra* note 1, at 701.

180. *See generally id.* at 702-03 (discussing that states adopting the first marketable product doctrine exacerbate the problem of frequent litigation by failing to provide "specific criteria" for resolving the many factual questions that arise).

181. *Mittelstaedt*, 954 P.2d at 1213-14 (Opala, J., dissenting).

182. *See id.*

183. *Id.*

184. Lansdown, *supra* note 1, at 702-03.

185. *See id.*

186. *Id.*

187. *See generally* Wheeler, *supra* note 174.

188. Edward B. Poitevent, II, *Post-Production Deductions from Royalty*, 44 S. TEX L. REV. 709, 759 (2003).

189. *See id.*

190. *See* Wood v. TXO Prod. Corp., 854 P.2d 880, 882-83 (Okla. 1992); *see also* Carr & Owen, *supra* note 171 (contending that under the first marketable product doctrine, "little or no regard [is given to] . . . underlying lease language.").

191. Keeling, *supra* note 3, at 1.

192. *See* Mittelstaedt v. Santa Fe Minerals, Inc., 954 P.2d 1203 (Okla. 1998); TXO Prod. Corp. v. State *ex rel.* Comm'rs of Land Office, 903 P.2d 259 (Okla. 1994); *Wood*, 854 P.2d 880.

193. Keeling & Gillespie, *supra* note 17, at 85.

194. Poitevent, *supra* note 188, at 759-60.

potential to and likely does exceed the contractual intentions of the parties.[195] Courts should not exercise judicial construction when, even from a basic viewpoint, the plain meaning of a clause indicates where royalty calculation should occur.[196] A consequence of the Supreme Court of Oklahoma's modification of the meaning of at the well clauses is the creation of situations where lessors might receive benefits that they do not necessarily deserve.[197]

In a typical lease, a lessor receives a royalty interest that provides him with a share of that which the lessee produces.[198] Regardless of whether the lease stipulates an in-kind framework or a market value or proceeds framework, the most commonly constructed royalty provisions do not expressly go beyond "production,"[199] and courts typically interpret them as having this meaning, at least in the majority states.[200] Oklahoma's interpretation of such clauses as going beyond production into post-production seemingly enriches lessors at the expense of lessees.[201] If the lease is silent and contains no express provision setting forth the allocation of costs and duties beyond production, why should the lessee bear all the risks and costs that might arise after gas is severed from the well while the lessor participates without any risk whatsoever?[202] The simple answer is that it should not.[203] Oklahoma's answer to the question, in part, is the implied covenant to market, which, as the discussion below illustrates, has its own problems.[204] For justifying the assertion that the lessee should not bear the cost alone, one critic provides a very sensible assessment: "A royalty interest entitles a lessor to receive a share of the lessee's production, not a share of the lessee's profits."[205] Lessees should not have to share with lessors, free of costs and risks, benefits gained from after-production expenditures that make a product sellable or more sellable.[206] Further, this is not a dispute where one party has poorly contracted with another and a simple application of the tough luck standard will provide resolution; rather, what the Supreme Court of Oklahoma is effectively doing is granting lessors privileges and benefits that potentially go beyond that which the parties intended.[207]

The Supreme Court of Oklahoma justifies placing additional obligations on lessees in the post-production stage with the implied duty or covenant to market.[208] In Oklahoma, this implied duty demands that the lessee achieve a marketable product, and from

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195. *Id.*
196. Keeling & Gillespie, *supra* note 17, at 85.
197. *See generally* Pierce, *supra* note 34.
198. *See* Keeling & Gillespie, *supra* note 17, at 13-20; *see also* WILLIAMS & MEYERS, *supra* note 8.
199. *See* Keeling & Gillespie, *supra* note 17, at 13-20; *see also* WILLIAMS & MEYERS, *supra* note 8.
200. Keeling, supra note 3, at 1.
201. For a description of the general impact caused by pushing royalty payment calculation beyond the wellhead, see, Pierce, *supra* note 34.
202. *See id.*
203. *See id.*
204. *See* Mittelstaedt v. Santa Fe Minerals, Inc., 954 P.2d 1203, 1209-10 (Okla. 1998); TXO Prod. Corp. v. State *ex rel.* Comm'rs of Land Office, 903 P.2d 259, 263 (Okla. 1994); Wood v. TXO Prod. Corp., 854 P.2d 880, 882-83 (Okla. 1992).
205. Keeling & Gillespie, *supra* note 17, at 95.
206. Pierce, *supra* note 34.
207. *See generally Wood*, 854 P.2d at 882-83 (holding that at the well lease language was ambiguous, and stating that if the lessee intended to impose post-production costs on the lessors, it should have expressly included such language in the lease); *see also* Keeling & Gillespie, *supra* note 17, at 95-96.
208. *Mittelstaedt*, 954 P.2d at 1209-10; *TXO Prod. Corp.*, 903 P.2d at 263; *Wood*, 854 P.2d at 882-83.

this requirement arises the expectation that lessees, at their sole expense, engage in post-production processes when they are deemed necessary.[209] Traditionally, the implied covenant to market "has been viewed as a duty to use reasonable diligence in seeking a market and not as a duty relating to the amount of royalty to be paid."[210] Further, courts are not meant to apply it in situations where it runs counter to the lease's express language.[211] Despite this standard, the Supreme Court of Oklahoma has imposed the duty to market on lessees irrespective of the plain and express content of the specific lease under review.[212] Jurisdictions mixing the implied covenant to market with the deduction of post-production costs have endured criticism for the unwieldy marriage it produces.[213] This criticism arises because claims using the implied covenant as a basis often do not actually allege irresponsible marketing by the lessee, but instead involve the assertion that the lessee made improper royalty calculations.[214] By accepting claims like these as valid, the Supreme Court of Oklahoma has expanded the traditional meaning of the implied duty to market from a reasonable diligence standard to one that dictates royalty payment and calculation.[215] However, this expansion is fundamentally erroneous, as one commentator noted, the implied covenant "does not mean he [the lessee] is to pay all costs of marketing, nor that he is to process the gas. Expenses incurred in procuring a market must be borne proportionately by the lessor. The lessee is not obligated to move gas beyond the well mouth free of cost."[216]

Perhaps the biggest elephant in the room is the ruling in *XAE Corp*. concerning the deduction of costs from overriding royalty interests.[217] There is generally no question that overriding royalty interests are distinct from standard royalty interests.[218] When the court ruled that the assignment of the overriding royalty did not carry the implied covenant protection that the lease carried, it made clear the distinction between the two interests.[219] This discussion does not set out to criticize the court's decision to allow deductibility from the interest per se, but rather to emphasize, in general, the unpredictability of the court's implementation of the marketable product approach.[220] In disagreeing with the Colorado Supreme Court's interpretation of Oklahoma law, the Supreme Court of Oklahoma thrust into the picture a further variation in the marketable product approach.[221] The first issue with this is that it appears that even those courts opting to implement the marketable product approach have difficulty finding symmetry with sister

209. *See Mittelstaedt*, 954 P.2d at 1209-10; *TXO Prod. Corp.*, 903 P.2d at 263; *Wood*, 854 P.2d at 882-83.
210. Keeling & Gillespie, *supra* note 17, at n.345.
211. Scott Lansdown, *The Implied Marketing Covenant in Oil and Gas Leases: The Producer's Perspective*, 31 ST. MARY'S L.J. 297, 306 (2000).
212. *See Mittelstaedt*, 954 P.2d at 1209-10; *TXO Prod. Corp.*, 903 P.2d at 263; *Wood*, 854 P.2d at 882-83.
213. Lansdown, *supra* note 211, at 335-36.
214. *Id.*
215. *See Mittelstaedt*, 954 P.2d at 1209-10; *TXO Prod. Corp.*, 903 P.2d at 263; *Wood*, 854 P.2d at 882-83.
216. Marla J. Williams et al., *Determining the Lessor's Royalty Share of Production Costs: Is the Implied Covenant to Market the Appropriate Analytical Framework?* 41 ROCKY MTN. MIN. L. INST. 12.01, 12.04[1] (1995).
217. XAE Corp. v. SMR Prop. Mgmt. Co., 968 P.2d 1201 (Okla. 1998).
218. *See* WILLIAMS & MEYERS, *supra* note 147.
219. *See XAE Corp.*, 968 P.2d at 1202.
220. Keeling & Gillespie, *supra* note 17, at 82.
221. *See XAE Corp.*, 968 P.2d at 1208.

jurisdictions.[222] Admittedly, it is a thin argument to claim a flaw exists simply because a court in one jurisdiction interpreted the law of another jurisdiction differently from the court actually seated there.[223] However, it does demonstrate that even the highest courts in these states appear to have trouble assessing the law of other states following the approach.[224] It begs the question then: how can corporations effectively engage in business and make decisions regarding deductibility in these states when the visible lack of consensus and clarity with the doctrine produces innumerable litigation risks?[225]

The second issue turns specifically on Oklahoma's refusal to apply the implied covenant to market to the overriding royalty interest.[226] The court justified its refusal by pointing to the lack of express language in the assignment granting the interest holder the same implied covenant benefits intrinsic in the lessor-lessee relationship.[227] It is interesting that the court chose to acknowledge the plain and express language of the agreement in the overriding royalty interest case when it so blatantly failed to do so in its rulings on deductions from standard royalties.[228] There is no denial that overriding royalty interests are distinct from standard royalty interests and that the assignment was a separate conveyance providing the interest.[229] However, based on recent Oklahoma jurisprudence prior to *XAE Corp*., it would have been entirely reasonable to conclude that the implied covenant applied to overriding royalty interests, much as the Colorado Supreme Court concluded.[230] Moreover, the *XAE Corp.* decision serves to further emphasize the abundant inconsistencies that present themselves among jurisdictions adopting the marketable product approach.[231]

VI. TRENDING THE OTHER WAY: ARE JURISDICTIONS REJECTING FIRST MARKETABLE PRODUCT?

A. Indications that States are Trending against First Marketable Product

1. Pennsylvania

In March 2010, the Supreme Court of Pennsylvania handed down a ruling in *Kilmer v. Elexco Land Services Inc.*[232] concerning the deductibility of post-production

222. *Compare id.* at 1206, 1208 (where the Supreme Court of Oklahoma disagreed with the Supreme Court of Colorado and concluded that overriding royalty interests may have post-production costs deducted) *with* Garman v. Conoco, Inc., 886 P.2d 652, 658 (Colo. 1999) (where the Supreme Court of Colorado, using Oklahoma law for guidance, concluded that post-production costs could not be deducted from overriding royalty interests).

223. *Compare XAE Corp.*, 968 P.2d at 1206, 1208 *with Garman*, 886 P.2d at 658.

224. *Compare XAE Corp.*, 968 P.2d at 1206, 1208 *with Garman*, 886 P.2d at 658.

225. *See* Lansdown, *supra* note 1, at 701-03.

226. *XAE Corp.*, 968 P.2d at 1206, 1208.

227. *Id.* at 1208.

228. *See* Mittelstaedt v. Santa Fe Minerals, Inc., 954 P.2d 1203 (Okla. 1998); TXO Prod. Corp. v. State *ex rel.* Comm'rs of Land Office, 903 P.2d 259 (Okla. 1994); Wood v. TXO Prod. Corp., 854 P.2d 880 (Okla. 1992).

229. *See* WILLIAMS & MEYERS, *supra* note 147, at 55-56.

230. *See* Garman v. Conoco, Inc., 886 P.2d 652, 658 (Colo. 1999).

231. *See generally* Keeling & Gillespie, *supra* note 17, at 37 (contending that the marketable product approach, "is the ambiguous product of a widely varying and internally inconsistent set of commentaries and opinions.").

232. Kilmer v. Elexco Land Servs., Inc., 990 A.2d 1147 (Pa. 2010).

costs from royalties.[233] In *Kilmer*, the lessors brought suit claiming that the lessee illegally deducted post-production costs.[234] The lessors made several arguments for cancellation of the lease, the first of which was that the lessee's deductions from royalty payments violated the statutory one-eighth royalty requirement.[235] The lessors further argued that the implied duty to market applied because it was known by the legislature when it drafted the statute and that, as such, it was intrinsically within the law.[236] Additionally, the lessors contended that the implied covenant to market required calculation of the royalty at the point of sale and not at the well.[237] The court declined to accept these arguments.[238] Under Pennsylvania law, when the language of a statute is clear and unambiguous, the court will not impose notions that go beyond its plain meaning.[239] Most notably, in this case, the court acknowledged that the statute did not define "royalty," nor did it provide a means for calculating royalties.[240] Because of this lack of definition, the court determined it must define the term "royalty."[241] Despite the lessors' definitional evidence that the determination point for royalties is the point of sale, the court held that under Pennsylvania law it must look to the meaning of "royalty" as the oil and gas industry actually uses it.[242] In doing so, the court held that the traditional definition of royalty provides lessors with a "share of production, free of expenses of production."[243] The court indicated that this definition was historically in line with the legislature's intent.[244] Additionally, the court noted that based on the time of drafting, the legislature did not have to provide a calculation point because at the well and point of sale were not distinguished from each other.[245] Thus, the court concluded that under Pennsylvania law, lessees may calculate royalty payments at the wellhead and deduct post-production costs in such calculations.[246]

Although the Supreme Court of Pennsylvania did not expressly reject the first marketable product doctrine, its actions indicate that, pursuant to its state law, the at the well approach controls.[247] Further reinforcing this assertion is the fact that nearly two years following *Kilmer*, the state legislature has not enacted any law that purports to reject the at the well approach or conversely adopts the first marketable product approach.[248] Interestingly, a bill that would have prohibited lessees from deducting post-production costs made it through a legislative committee, but gained no further trac-

233. *Id.* at 1149.
234. *Id.* at 1150.
235. *Id.* at 1151.
236. *Id.* at 1152.
237. *Kilmer*, 990 A.2d at 1152.
238. *Id.* at 1156-57.
239. *Id.* at 1156.
240. *Id.* at 1157.
241. *Id.*
242. *Kilmer*, 990 A.2d at 1157.
243. *Id.*
244. *Id.* at 1158.
245. *Id.* at 1157.
246. *Id.* at 1158.
247. *See Kilmer*, 990 A.2d at 1158.
248. *See, e.g.*, Michael Morris, Case Note, *Buyer's Remorse over Your Pennsylvania Gas Lease? The Pennsylvania Supreme Court Upholds Meager Royalty Payments and Protects the Profitability of Marcellus Gas Drilling in* Kilmer v. Elexco Land Services, Inc., 23 VILL. ENVTL. L.J. 25, 37 (2012).

tion.[249] If anything, the legislature's actions, or lack thereof, appear to indicate that it has no intention of statutorily countermanding the *Kilmer* ruling.[250]

2. Kentucky

In February 2011, the United States Court of Appeals for the Sixth Circuit ruled on *Poplar Creek Development Co. v. Chesapeake Appalachia, L.L.C.*[251] where it addressed a proposed class action by lessors for the lessee's deduction of post-production costs from royalty payments.[252] The leases in question included royalty provisions containing at the well language.[253] In bringing the gas to market, the lessee incurred expenses for "gathering, compression, and treatment" and subsequently deducted from royalty payments a proportionate share.[254] The court noted that lessors described such expenses as "production costs," but it concluded that as those expenses occurred after severance of gas from the wellhead, they should fall under the post-production cost categorization.[255] Reiterating an earlier district court ruling, the *Poplar* court stated that in Kentucky, "a presumption exists that the wellhead is the point of sale and delivery at which point the royalty is to be computed [on an oil and gas lease], absent an express stipulation to the contrary."[256] In the present case the lease provided an at the well royalty provision and contained no language stating otherwise.[257] Consequently, the court sided with the lessee, declaring that Kentucky is an at the well state that permits the deduction of post-production costs from royalty payments.[258]

Notably, as one scholar acknowledged, "Kentucky state courts have not recently addressed the implied covenant to market or the allocation of post-production expenses."[259] However, despite this lack of rulings as well as the fact that the *Poplar* decision comes from a federal court, the court's application of state law provides some insight into how a Kentucky court might rule if such a case arises.[260] Additionally, based on Kentucky law there is little indication that the court would break with it prior rulings, particularly regarding contract construction, to align itself with first marketable product states.[261] Until Kentucky directly rules on the issue, the at the well approach appears to control, and lessees may deduct post-production costs in the calculation of royalty payments.[262]

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249. *Id.*
250. *Id.*
251. Poplar Creek Dev. Co. v. Chesapeake Appalachia, L.L.C. 636 F.3d 235 (6th Cir. 2011).
252. *Id.* at 237-38.
253. *Id.* at 238.
254. *Id.* at 238-39.
255. *Id.* at 239.
256. *Poplar Creek Dev. Co.*, 636 F.3d at 242.
257. *Id.*
258. *Id.* at 244.
259. Patricia Proctor et al., *Moving Through the Rocky Legal Terrain to Find a "Safe" Royalty Clause or a "New" Market at the Well*, 19 TEX. WESLEYAN L. REV. 145, 165 (2012).
260. *Id.* at 166.
261. *See id.*
262. *See Poplar Creek Dev. Co.*, 636 F.3d at 244.

3. New Mexico

In August 2012, the Supreme Court of New Mexico issued its ruling for *ConocoPhillips Co. v. Lyons*,[263] where lessees brought suit against lessor, state Commissioner, for his assessment of underpayment charges based on lessee's deduction of post-production costs in the calculation of royalty payments.[264] In New Mexico, the provisions of state oil and gas leases are based on statutory construction.[265] The statute provides for the formation of "net proceeds" leases.[266] In reviewing the enactment, the court concluded that the statutorily provided lease language intrinsically allows for the deduction of post-production costs because net proceeds, "[b]y definition . . . constitute[] 'the sum remaining from gross proceeds of sale minus payment of expenses.'"[267] In analyzing the case, the court stated that New Mexico courts have consistently adopted the view that at the well leases provide for calculation of payment based on that point of valuation at the wellhead.[268] The commissioner argued that the statute was ambiguous and that the phrase "in the field" set the point of valuation beyond that of the point of extraction at the well.[269] Despite the commissioner's contention, the New Mexico Supreme Court agreed with the district court's conclusion that based on the language of the statute, "requiring the state to pay reasonable compensation to state lessees for the use of their post-production facilities indicate[s] that the Legislature was aware of . . . [what] was occurring in the field with respect to post-production costs."[270] Consequently, the court ruled that the statutory language was not ambiguous and that it allowed for deduction of reasonable costs from royalty payments.[271] The court also denied the commissioner's counterclaim that the lessee breached its implied covenant to market and duty to render gas marketable.[272] It found that the language of the statute expressed the legislature's intent and review of the implied covenant to market in this case was unnecessary.[273]

It is important to note that the court specifically stated that its ruling was not meant to impact private oil and gas leases.[274] Further, the court stated that "the marketable condition rule [as] applie[d] in New Mexico [was an issue] not yet ripe for review."[275] Only time (and a litigious private lessor) will tell whether this ruling indicates how New Mexico will treat the marketable condition rule.[276] However, based on the court's definition of "net proceeds," there is hope that if a private suit against a lessee arises, and involves an at the well provision, the court will err on the side of history and tradition by permitting the deduction of post-production costs.[277]

263. ConocoPhillips Co. v. Lyons, 299 P.3d 844 (N.M. 2012)
264. *Id.* at 847-48.
265. *Id.* at 847.
266. *Id.* at 848.
267. *Id.*
268. *ConocoPhillips*, 299 P.3d at 851.
269. *Id.*
270. *Id.* at 853.
271. *Id.*
272. *Id.* at 859-60.
273. *ConocoPhillips*, 299 P.3d at 860.
274. *Id.*
275. *Id.*
276. *See id.*
277. *See id.* at 848; *see also*, Keeling, *supra* note 3, at 1 (indicating that New Mexico likely follows the at

4. North Dakota

In July 2009, the Supreme Court of North Dakota ruled on *Bice v. Petro-Hunt, L.L.C.*,[278] where it addressed a claim by a class of plaintiffs that the defendant inappropriately deducted post-production costs from royalty payments.[279] The plaintiffs requested that the state supreme court reverse the district court's ruling, that North Dakota allows for deduction of post-production costs in leases setting the valuation point at the well and to instead adopt the first marketable product approach.[280] The plaintiffs, in part, based their argument on the existence of an ambiguity in the lease language "market value at the well."[281] In rejecting their argument, the court found that the marketable product approach is problematic, particularly with respect to the achievement of a marketable product.[282] The court noted that "'even the states which follow the . . . 'marketable product' rule have failed to articulate a clear standard for determining when a marketable product has been created.'"[283] The court expressly rejected the first marketable product approach and aligned itself with the majority view finding no ambiguity in the "market value at the well" lease language.[284]

In what has been called a "significant victory,"[285] the *Bice* ruling provides lessees with peace of mind that reasonably deducting post-production costs from at the well or similar leases in North Dakota will not result in a storm of litigation.[286] Much like the states that have adopted the marketable product approach, the Supreme Court of North Dakota could have instead discarded the plain meaning of the leases under review and imposed the implied duty to market, thus forcing lessees to incur costs beyond production.[287] However, the court's steadfast rejection of the approach emphasizes that the inherent flaws and unworkability of the marketable product approach create discomfort with some courts faced with adopting it.[288]

B. What Should these Trends Mean for Oklahoma?

As the above cases demonstrate, courts ruling on the deduction of post-production costs appear to experience some discomfort with the prospect of adopting the tenets of the marketable product approach, or at the least expanding the traditional meaning of industry terminology.[289] The Supreme Court of Oklahoma should equally feel the same discomfort, and yet based on its rulings, it has no qualms with implementing an unwieldy

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the well approach).

278. Bice v. Petro-Hunt, L.L.C., 768 N.W.2d 496 (N.D. 2009).

279. *Id.* at 499.

280. *Id.* at 500.

281. *Id.*

282. *Id.* at 502.

283. *Bice*, 768 N.W.2d at 502

284. *Id.*

285. With Oklahoma and a handful of its sister states committing to the first marketable product doctrine, the ruling in *Bice* gives cause for celebration by lessees pursuing oil and gas interests in the state. *See* Lamont Larson, *Royalty Alert—North Dakota Upholds the Deduction of Post-Production Costs*, DGS LAW (July 17, 2009), http://www.dgslaw.com/images/materials/OG_Alert_071709.html.

286. *See Bice*, 768 N.W.2d at 502.

287. *See id.* at 501-03.

288. *See id.*

289. *See supra* Part VI.A.

doctrine that creates more questions than solutions and opens the floodgates for litigation.[290] If the rulings in these states are any indication of a growing unpopularity with the first marketable product approach, then the Supreme Court of Oklahoma should reevaluate its adoption.[291] Although the court is certainly not bound to the rulings of other jurisdictions, nor under any obligation to give credence to their rulings, at the least it should contemplate the concerns of the courts seated in these states.[292]

VII. CONCLUSION

The Supreme Court of Oklahoma should reconsider the problems that the first marketable product doctrine poses for the oil and gas industry in the state.[293] In addition to flying in the face of tradition and history, the doctrine creates innumerable lease interpretation problems, disregards fundamental contract principles, illogically expands the implied covenant to market, and produces unnecessary litigation risks.[294] Discarding the first marketable product doctrine and implementing the at the well approach would return Oklahoma to a standard that gives credence to the language of leases and, absent any express provisions, allows for a more evenhanded and fair allocation of post-production costs.[295] There is no question that the Supreme Court of Oklahoma takes issue with the at the well approach, and perhaps there are elements that the court can tweak to quell its concerns.[296] However, as the first marketable product doctrine does, such changes cannot so fundamentally alter the traditional meaning of legal principles that it renders them unworkable, causing more of a problem than a solution.[297] Further, recent court rulings in other states indicating discomfort with the first marketable product approach should give cause to the Supreme Court of Oklahoma to reexamine its adoption.[298] Consequently, it is in the best interests of the state and the oil and gas industry that the Supreme Court of Oklahoma abandon the first marketable product doctrine.

William T. Silvia *

290. *See generally* Mittelstaedt v. Santa Fe Minerals, Inc., 954 P.2d 1203, 1210 (Okla. 1998) (where the court reaffirmed its commitment to the first marketable product approach); *see also* Lansdown, *supra* note 1, at 701-03.

291. For reasons indicating oil and gas bearing states might be trending away from the first marketable product doctrine and instead maintaining the at the well approach, see *supra* Part VI.A.

292. For specific concerns contemplated by other jurisdictions as well as the potential impact of these issues, see *supra* Part VI.A.

293. *See supra* Part V.B.

294. *See, e.g.*, Keeling & Gillespie, *supra* note 17, at 85; Lansdown, *supra* note 211, at 335; Lansdown, *supra* note 1, at 701-03; *see generally* Wheeler, *supra* note 174.

295. *See generally* Pierce, *supra* note 2 (discussing that lessees involved in litigation often attempt to convince courts to follow the Texas at the well view, while lessors generally attempt to argue use of the Colorado first marketable product view).

296. *See* Mittelstaedt v. Santa Fe Minerals, Inc., 954 P.2d 1203 (Okla. 1998); TXO Prod. Corp. v. State *ex rel.* Comm'rs of Land Office, 903 P.2d 259 (Okla. 1994); Wood v. TXO Prod. Corp., 854 P.2d 880 (Okla. 1992).

297. See *supra* Part V.B for a more in-depth discussion on the unworkability and problems with the first marketable product doctrine.

298. For a more detailed discussion of these recent rulings as well as an elaboration of the discomfort that the first marketable product doctrine has produced with reviewing courts, see *supra* Part VI.B.

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