

# **Mineral Royalties, Deductions, and *Fawcett v. OPIK*: Continuity and Change in the Revised-But-Still-Standing Kansas Marketable-Product Rule**

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I. *FAWCETT V. OPIK*: ABRUPT CHANGE, MINOR NARROWING, OR SOMETHING IN BETWEEN?

The Kansas Supreme Court, which issued the first state-court decision setting what has been called the marketable-product or marketable-condition rule back in 1964 in *Gilmore v. Superior Oil Co.*<sup>1</sup>

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1. 388 P.2d 602, 606 (Kan. 1964). Compare *Gilmore*'s 1964 decision with the Colorado, Oklahoma, and West Virginia decisions cited *infra* note 21. Howard Williams and Charles Meyers claim that the marketable-product distinction began with a 1960 federal case, *California Co. v. Seaton*, 187 F. Supp. 445 (D.D.C. 1960), *aff'd sub nom. California Co. v. Udall*, 296 F.2d 384, 387–88 (D.C. Cir. 1961). 3 HOWARD WILLIAMS & CHARLES MEYERS, OIL AND GAS LAW § 645.2 (14th ed. 2006). The first state court to apply the doctrine was the Kansas Supreme Court in *Gilmore*, which is the earliest state decision Williams and Meyers cite as a state authority applying a marketable-product doctrine. *Id.*

Maurice Merrill's treatise does cite pre-*Gilmore* precedent in its description of the marketable-product rule. MAURICE MERRILL, COVENANTS IMPLIED IN OIL AND GAS LEASES § 85, at 214 & n.23 (2d ed. 1940 & Supp. 1959). For instance, the text of the 1940 edition lists three citations for Merrill's statement that lessees should bear the cost of making minerals marketable. *Id.* at 214 n.23. For a discussion of the cases cited by Merrill, see *infra* note 205.

a decision that generally requires lessees to bear on their own the full costs of making gas marketable, has just imposed a practical limitation on its rule by holding that lessees can effectively deduct marketability costs if they “sell” their gas at the well to mid-stream, field-service companies—companies established to supply anticipated demand for unbundled provision of “mid-stream,” field marketability services.

In *Fawcett v. Oil Producers, Inc. of Kansas (OPIK)*,<sup>2</sup> the Kansas Supreme Court did reaffirm its support for its venerable marketable-product rule that generally imposes all related costs on lessees and reiterated two traditional limits on what sales can qualify to support royalty payments: the sales must be in good faith and satisfy the duty to market. Nonetheless, if the court was correctly advised that most gas in Kansas is handled in the same way as the gas in *Fawcett*,<sup>3</sup> it has opened an exception to the marketable-product rule without any sign that it considered and understood the likely consequences of its holding. Only subsequent litigation will tell how far the exception will swallow the general Kansas rule.

In general, oil and gas jurisdictions are divided over the marketable-product rule. At present, most jurisdictions enforce one or another variation of the rule, using standards that are grouped around a core of common standards. The supreme courts in Colorado, Oklahoma, and West Virginia have joined the Kansas Supreme Court in authoring the leading marketable-product decisions; Arkansas, Alaska (for at least most of its producing acreage), Virginia, and New Mexico seem to agree. The federal government (the largest producing jurisdiction by far) bars many marketability deductions; and Nevada, Wyoming, and Michigan have statutory marketable-product rules.<sup>4</sup> There are some differences in these rules, and *Fawcett* has opened an exception of as-yet-untested size

The Kansas Supreme Court issued a series of earlier decisions about deductions in which the court grappled with deductions under “free of cost” lease delivery language that is common to oil royalty clauses. These cases were not decided in the context of today’s implied duty; for a discussion, see *infra* Part III.E.

2. 352 P.3d 1032 (Kan. 2015), *rev’d* 306 P.3d 318 (Ct. App. 2013).

3. *Id.* at 1034.

4. For a discussion of states adopting a marketable-product rule, see JOHN BURRITT MCARTHUR, OIL AND GAS IMPLIED COVENANTS FOR THE TWENTY-FIRST CENTURY: THE NEXT STEPS IN EVOLUTION 237–65 (2014). For a more detailed consideration of how to measure the majority rule, both by number of states and by volume of production, see John Burritt McArthur, *Some Advice on Bice, North Dakota’s Marketable-Product Decision*, 90 N.D. L. REV. Issue No. 3 (forthcoming Fall 2015), discussing the frequently seen misstatement that the marketable-product doctrine is a minority rule, and why that view is incorrect. For Kansas-neighbor Oklahoma’s standard, see John Burritt McArthur, *Clarifying Oklahoma’s Marketable-Product Royalty Rule*, 86 OKLA. B. J. 370 (2015) [hereinafter *Clarifying Oklahoma*].

to the Kansas rule, but all of these jurisdictions accept the proposition that, in general, the lessee has to produce a marketable product at its own expense.

In contrast, Texas and Louisiana lead the states rejecting marketable-product rules and generally allowing deduction of all costs incurred beyond the well. They have been joined by decisions that adopt this Texas-type rule—or at least seem likelier to follow it—in California, Kentucky, Mississippi, Montana, Pennsylvania, North Dakota, and Utah.<sup>5</sup>

The debate between these two views has been fought out in the context of a massive transformation of the natural gas market, in which interstate prices were regulated for decades. Congress and the Federal Energy Regulatory Commission took a series of steps to deregulate the industry in the mid-to-late 1980s and early 1990s. Economically, the industry transformed itself from one in which regulated interstate pipelines purchased and often even developed most of the gas produced in the United States, took title to the gas at the wellhead, and delivered it to customers hundreds and thousands of miles away, to a very different market in which true, independent arm's-length sales tend to occur away from the well and downstream of gas processing plants. Natural gas liquids (NGLs) have assumed a greater importance to the economics of the industry as part of this transformation. One of the challenges in this changed environment is how to preserve the lessee's traditional duty to produce a marketable product when the point of marketing has moved so markedly. The two main groups of jurisdictions have devised diametrically opposite solutions to this challenge.

Lessees have repeatedly tried to distinguish or limit the rule established in *Gilmore*—an effort that finally paid dividends in *Fawcett*.<sup>6</sup>

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5. For states rejecting the marketable-product rule, see MCARTHUR, *supra* note 4, at 265–75.

6. Some of the restiveness is due to the Tenth Circuit's remand of certification of a Kansas class. For a closer look at individual issues, see *Wallace B. Roderick Revocable Living Trust v. XTO Energy, Inc.*, 725 F.3d 1213 (10th Cir. 2013). A federal judge used some of the concerns in *Roderick* to decertify a class in *Arkalon Grazing Association v. Chesapeake Operating, Inc.*, No. 09-1394-CM, 2014 WL 3089556 (D. Kan. July 7, 2014), stayed pending developments in *Fawcett* (Jan. 6, 2015). The parties filed a stipulated dismissal after *Fawcett* was decided. Pl.'s Stipulation of Dismissal, *Arkalon Grazing Ass'n v. Chesapeake Operating, Inc.* (D. Kan. July 15, 2015) (No. 09-1394-CM). At the same time, the Kansas Court of Appeals issued a strong affirmation of a certified gas deduction class in *Farrar v. Mobil Oil Corp.*, 234 P.3d 19, 30 (Kan. Ct. App. 2010), and a federal court affirmed an even broader ExxonMobil class (in a case that later settled) in *Hershey v. ExxonMobil Oil Corp.*, No. 07-1300-JTM, 2011 WL 1234883, at \*15 (D. Kan. Mar. 31, 2011), aff'd in pertinent part, 550 F. App'x 566 (10th Cir. 2013). The *Hershey* trial court cited four other cases in which Kansas federal district courts certified similar claims; six Kansas state court decisions doing the same; and similar decisions from Oklahoma and Colorado. *Id.* at \*10–12.

Lessees also have continued to challenge the overall rule, as some amici did unsuccessfully in *Fawcett* when they urged the court to overturn the full Kansas marketable-product rule, not just one select application of the rule. The Oklahoma marketable-product rule<sup>7</sup> and New Mexico's anticipated-marketable-product rule also have spawned extensive litigation.<sup>8</sup> Given the resources available to many lessees and the amounts at stake, the persistent litigation should hardly be a surprise.

*Fawcett* will be easy to misinterpret. Some will overlook its affirmation of the core Kansas rule that lessees cannot bill for field services until after the lessees made the gas marketable and will claim that *Fawcett* signals the end of a division that has long separated oilfield jurisdictions into two main camps on this issue.<sup>9</sup> Others may find in

7. For an example of the split of views on the Oklahoma standard among federal trial courts, see *Clarifying Oklahoma*, *supra* note 4.

Some issues about the Oklahoma marketable-product rule seemed likely to be settled when a court of appeals reversed a class certification and the Oklahoma Supreme Court took the appeal, but the high court then ordered the intermediate court's decision depublished, a sign of disapproval and a step that should prevent courts from relying on the decision, without saying why, leaving Oklahoma litigants with the state's prior marketable-product rule. *See Fitzgerald Farms L.L.C. v. Chesapeake Operating, Inc.*, No. 111,566 (Okla. Civ. App. Feb. 14, 2014), *cert. denied and intermediate decision withdrawn from publication*, 2014 WL 8400016 (Okla. June 2, 2014). The *Fitzgerald* case settled after remand, with the settlement approved in June 2015; one objector, who has been severed from the class, has appealed. *See Br. in Supp. of Pls.' Mot. for Prelim. Approval of Class Action Settlement, Fitzgerald Farms, L.L.C. v. Chesapeake Operating, Inc.*, No. CJ-2010-38 (Okla. D. Ct. Beaver County, Jan. 5, 2015), <https://s3.amazonaws.com/s3.documentcloud.org/documents/1508108/fitzgerald-v-chesapeake-operating-inc-brief-on.pdf>. Not many months after the depublication decision in *Fitzgerald*, the Oklahoma Supreme Court reversed three partial summary judgment orders in favor of plaintiffs in another gas deduction case and sent the case back for further factual development, but again the court failed to say anything to explain its decision or to alter Oklahoma's well-established marketable-product rule. *Pummill v. Hancock Exploration L.L.C.*, 341 P.3d 69, 69 (Okla. 2014).

8. For the New Mexico standard, see *MCARTHUR*, *supra* note 4, at 264 n.156. For a thoughtful review of the by-now baroque edifice of New Mexico precedent, see *Anderson Living Trust v. ConocoPhillips Co.*, 952 F. Supp. 2d 979, 1012–14, 1022–24 & n.7 (D. N.M. 2013).

9. E.g., Daniel M. McClure & Lauren Brogdon, *Kansas Curbs Marketable Product Rule in O&G Royalty Cases*, LAW360 (July 13, 2015, 8:45 AM), [http://www.law360.com/energy/articles/677727?nl\\_pk=bd5617e5-e31f-4b90-8b68-6312bbc91ae7&utm\\_source=newsletter&utm\\_medium=email&utm\\_campaign=energy](http://www.law360.com/energy/articles/677727?nl_pk=bd5617e5-e31f-4b90-8b68-6312bbc91ae7&utm_source=newsletter&utm_medium=email&utm_campaign=energy) ("The *Fawcett* decision, and its express rejection of the Colorado *Rogers* case, may turn the tide in a long-running, national divide among the states on the duty to market in royalty cases."). In one of the first responses to *Fawcett*, OXY USA moved to decertify the class in the Tenth Circuit case *Wallace B. Roderick Revocable Living Trust v. XTO Energy, Inc.*, 725 F.3d 1213 (10th Cir. 2013). OXY claims that *Fawcett* rejected the "expansive application of the marketable product rule," "put to rest several of the underlying bases for which [the XTO] [p]laintiffs claim class certification is appropriate," "proved the nail in the coffin of Plaintiffs' theory that lease terms, gas quality and marketing arrangements are irrelevant to the analysis of a royalty underpayment claim," "confirmed that examination of the lease language is critical," and confirmed that "the determination of when and where gas is first marketable is a fact-intensive inquiry requiring a detailed [fact] analysis" that cannot be performed on a common basis. Def.'s Renewed Mot. to Decertify Class Action at 2, 17,

certain too-general language about “at the well” royalty terms an abandonment of the basic Kansas rule, although Part II.B explains why this is likely a misreading of *Fawcett*. The basic division between the conflicting jurisdictions remains after *Fawcett*.

Unless *Fawcett* is modified in application, though, or the court’s language about good faith and implied duties turns out to frequently limit *Fawcett*’s new service-company exception—which it may—*Fawcett* will allow lessees who use service-company arrangements like those in *Fawcett* to share all major marketability costs with their royalty owners. In Kansas, arrangements with mid-stream service companies that pass title at the wellhead and include certain sales aspects no longer will require the express negation of the marketable-product rule that Kansas previously required before allowing cost deductions, although these arrangements still can be challenged on a case-by-case basis as violations of the duty to market and to act in good faith.

In addition, the Kansas Supreme Court has spoken with favor about the Colorado marketable-product rule under which lessees not only must make gas physically marketable but also bring it to a market location at their own expense. It is only two years ago that the court discussed Colorado law approvingly on this point in *Coulter v. Anadarko Petroleum Corp.*<sup>10</sup> With almost no explanation of why it would reverse course, the *Fawcett* court unexpectedly distinguished the Colorado standard from the Kansas rule. It did so, however, in a context in which Colorado, too, would have allowed deductions, making the purported distinction not only dictum but meaningless dictum. This new language, which is discussed in Part III.C, inevitably will lead to further litigation.<sup>11</sup>

On the occasions when service arrangements now are treated as sales under *Fawcett*, the Kansas rule will resemble in application the Texas production/post-production distinction, at least, if a lessor cannot prove bad faith or breach of the duty to market. The revised rule may increase the weight given in at least some circumstances to the lease terms, because if the court is going to give more weight to the term “at the well” in the service-agreement context, then to be consistent it should reject “at the well” deductions whenever leases lack this geographic reference.

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22 n.13, 24–25, Wallace B. Roderick Revocable Living Trust v. XTO Energy, Inc., 725 F.3d 1213 (D. Kan. Aug. 21, 2015) (No. 12-CV-1215).

10. 292 P.3d 289 (Kan. 2013). For a discussion of *Coulter*, see *infra* notes 173–76, 179–80 & accompanying text.

11. See *infra* Part III.C.

*Fawcett* may open a new battle over whether courts should enforce pure-proceeds and gross-proceeds leases as written when wellhead service-arrangements are at issue.

These changes come in a decision written as if it flows naturally from existing Kansas law. In reality, *Fawcett* is a retrenchment of uncertain scope from existing Kansas law. The court changed one key application of its marketable-product rule, suggested it may not extend the rule to certain gas movement services, and issued a much-too-broad observation about “at the well” terms. The court ignored or misconstrued a variety of its past holdings, as Parts III.B–F show, and it created an exception—one it did not persuasively justify—to the Kansas rule.

The Kansas rule is important to more than just Kansas producers and royalty owners—important though they are. Kansas oilfield jurisprudence has influenced the entire oil patch. That is little surprise given the state’s long position as a leading producer. The Hugoton field is the largest gas field ever discovered in the United States. In cumulative production, it is one of the largest gas fields in the world and for quite a time was the largest helium field in the world.<sup>12</sup> Well before the Hugoton field was discovered, Kansas already was a major oil producing state.<sup>13</sup> The state also lays claim to being the site of the first well to use hydraulic fracturing (fracking), a beginning traditionally

12. The federal trial court decision in the famous helium case *Northern Natural Gas Co. v. Grounds*, 292 F. Supp. 619 (D. Kan. 1968), *aff’d in part, rev’d in part*, 441 F.2d 704 (10th Cir. 1971), described the Hugoton field as sprawling over 21 million acres, with dimensions 210 miles north to south and 160 miles east to west when the Texas and Oklahoma portions of the field are included with the Kansas portion. *Id.* at 645. The first Texas well was completed in 1918, the first Kansas well in 1922. *Id.* Testimony identified the Hugoton as “the largest single pressure-connected gas reservoir in the world.” *Id.* While the field is no longer the largest gas field in the world, it remains by far the largest gas field by estimated total recovery in the United States, see *infra* note 197, and one of the top ten natural gas fields in the world. E-mail from Washington Lem, Economist, Econ One, to John Burritt McArthur (Jan. 5, 2015) (on file with author). From 1918 to 1965, some 15,000 wells were drilled in the field. *N. Nat.*, 292 F. Supp. at 646. A write-up prepared in 1948 for the American Bar Association cites a *Saturday Evening Post* article from the early 1940s that describes the Hugoton field as a “bubble beneath the whole dust bowl . . . the biggest bubble in the world . . . a bubble of natural gas.” Jay C. Kyle, *Kansas 1937–1948*, in *CONSERVATION OF OIL AND GAS: A LEGAL HISTORY* 165 (Blakely Murphy ed., Am. B. Ass’n 1949) (citation omitted).

The Hugoton at one time was believed to hold more than 99% of all helium available for exploitation in the United States. *N. Nat.*, 292 F. Supp. at 645.

13. Harold Williamson’s detailed history of American petroleum describes Kansas oil production as reaching a million barrels by 1900 and then jumping to more than six million barrels in 1904 with the discovery of production in Eastern Kansas. HAROLD WILLIAMSON ET AL., THE AMERICAN PETROLEUM INDUSTRY 1899–1959: THE AGE OF ENERGY 21–22 (1963). For development of pipeline trunk lines and independent drillers located in the Mid-Continent region, including Kansas before the initial Hugoton gas production, see generally *id.* at 90–96.

traced to a Kansas gas well that Stanolind—the exploration and production vehicle of the Indiana Standard Oil Company—drilled in the Hugoton field in 1946.<sup>14</sup> It is no surprise, given this prominent role as a producer, that Kansas has been a leader in oil and gas jurisprudence as well.

The Kansas Supreme Court has authored a number of opinions that have influenced oil-and-gas law across the country.<sup>15</sup> It was a Kansas royalty dispute over lack of development that gave rise to the most important implied-covenant royalty case in American mineral law, *Brewster v. Lanyon Zinc Co.*,<sup>16</sup> the 1905 federal decision by Judge Van De Vanter. A Kansas case, *Shutts v. Phillips Petroleum Co.*,<sup>17</sup> is one of

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14. For a discussion of this first “failed” well, the theory behind it, and subsequent successes, see RUSSELL GOLD, THE BOOM: HOW FRACKING IGNITED THE AMERICAN ENERGY REVOLUTION AND CHANGED THE WORLD 70–77 (2014).

15. The Kansas Supreme Court has amassed an impressive body of jurisprudence concerning oil and gas, even if one focuses primarily on cases about implied covenants and certain related issues. *See, e.g.*, *Rose v. Lanyon Zinc Co.*, 74 P. 625 (Kan. 1903) (express preemption issue in dispute over timing of exploration); *Mills v. Hartz*, 94 P. 142 (Kan. 1908) (abandonment issue); *Howerton v. Kan. Nat. Gas Co.*, 106 P. 47 (Kan. 1910) (examining duty to engage in marketing and mutual benefit nature of lease), *rev’d*, 108 P. 813 (Kan. 1910); *Culbertson v. Iola Portland Cement Co.*, 125 P. 81 (Kan. 1912) (deciding common-drainage issue); *Skinner v. Ajax Portland Cement Co.*, 197 P. 875 (Kan. 1921) (cautionary, but surely incorrect, case holding that a \$1 nominal signing bonus indefinitely held a lease); *Rolander v. Sanderson*, 43 P.2d 1061 (Kan. 1935) (holding on delay rentals and development); *Myers v. Shell Petrol. Corp.*, 110 P.2d 810 (Kan. 1941) (very influential decision on profitability as part of the development standard); *Fischer v. Magnolia Petrol. Co.*, 133 P.2d 95 (Kan. 1943) (ruling on the objective standard for development, including role of production-limitation regulations as part of the objective test), *aff’d on reh’g*, 137 P.2d 139 (Kan. 1943); *Temple v. Cont’l Oil Co.*, 320 P.2d 1039 (Kan. 1958) (leading case on pace of development); *Renner v. Monsanto Chem. Co.*, 354 P.2d 326 (Kan. 1960) (adjudicating between drainage and a conservation statute); *Maddox v. Gulf Oil Corp.*, 567 P.2d 1326 (Kan. 1977) (marketing best-price decision); *Parkin v. Corp. Comm’n*, 677 P.2d 991 (Kan. 1984) (holding on relation between development and unit regulation); *Smith v. Amoco Prod. Co.*, 31 P.3d 255 (Kan. 2001) (pricing and regulation issue); *Crawford v. Hrabe*, 44 P.3d 442 (Kan. 2002) (duty to engage in secondary recovery); *Hockett v. Trees Oil Co.*, 251 P.3d 65 (Kan. 2011) (interpretation of the common lease term “proceeds”); *see also Gilmore v. Superior Oil Co.*, 388 P.2d 602 (Kan. 1964) (leading marketable-product decision); *Schupbach v. Cont’l Oil Co.*, 394 P.2d 1 (Kan. 1964) (same); *Sternberger v. Marathon Oil Co.*, 894 P.2d 788 (Kan. 1995) (same); *Coulter v. Anadarko Petrol. Corp.*, 292 P.3d 289 (Kan. 2013) (same). During the regulated-price era, the Kansas Supreme Court also decided a very prominent (although in this author’s view wrongly decided) series of cases treating the term “proceeds” as intending a different royalty price from “market value.” *See Matzen v. Hugoton Prod. Co.*, 321 P.2d 576 (Kan. 1958); *Waechter v. Amoco Prod. Co.*, 537 P.2d 228 (Kan. 1975), *aff’d on reh’g*, 546 P.2d 1320 (Kan. 1976); *Lightcap v. Mobil Oil Corp.*, 562 P.2d 1 (Kan. 1977); *Holmes v. Kewanee Oil Co.*, 664 P.2d 1335 (Kan. 1983).

16. 140 F. 801 (8th Cir. 1905). Another very important federal case arising out of a Kansas dispute concerned how broad a scope of minerals is encompassed by the standard oil-and-gas lease, a question prompted by disputes over lease coverage for helium in the Hugoton field. *N. Nat. Gas Co. v. Grounds*, 441 F.2d 704 (10th Cir. 1971).

17. 679 P.2d 1159, 1166 (Kan. 1984), *aff’d in part, rev’d in part*, 472 U.S. 797 (1985). *Shutts*, a decision on an interest-suspense issue that ultimately went to the United States Supreme Court, has had influence far beyond the state’s borders. It is one of a group of Kansas interest-suspense class

the leading cases on the mutual nature of the lessor-lessee relationship and led the United States Supreme Court to one of its most important class action decisions. The same kind of interest-suspense dispute spawned another leading class action decision by the United States Supreme Court in *Sun Oil Co. v. Wortman*.<sup>18</sup>

The Kansas Supreme Court has been a leader in marketable-product jurisprudence, too. In a 1910 decision, *Howerton v. Kansas Natural Gas Co.*, the court recognized a general, implied duty to market as well as to develop leased mineral properties.<sup>19</sup> Roughly fifty years later (but still more than fifty years ago), the *Gilmore* court held that unless a lease authorizes specific deductions, the duty to market requires the lessee to turn natural gas into a marketable product at its own expense.<sup>20</sup> The lessee cannot pass a share of the resulting costs on to its royalty owners unless expressly empowered to do so by the lease.

As Kansas developed its marketable-product rule in the years after *Gilmore*, the court indicated that gas movement costs, like other field service costs, cannot be deducted when related to services needed to make gas marketable—at least not unless the lease has unusual language expressly authorizing deduction. Although this rule was criticized in a recent issue of this law review, the Kansas rule influenced the three other leading marketable-product jurisdictions: Colorado, Oklahoma, and West Virginia.<sup>21</sup> These and other marketable-product jurisdictions are the

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cases, many of them certified by the same Kansas trial judge, Judge Keaton Duckworth.

18. 474 U.S. 806 (1986), *vacating* 690 P.2d 385 (Kan. 1984).

19. 106 P. 47, 50 (“It is difficult to distinguish in principle between a case like that, where the default consists in failure to explore at all, and a case like the present one, where a well has been drilled and the gas found, but no effort has been made to utilize or market it. . . . [T]his is a barren result if [the lessor’s] expected returns therefor may be indefinitely postponed at the will of the lessee.”), *rev’d on other grounds*, 108 P. 813 (Kan. 1910).

20. *Gilmore*, 388 P.2d at 606. The duty to market and the marketable-product rule also theoretically apply to the oil side of the lease, but differences in lease terminology and distribution networks seem to have kept deductions from being as live an issue when the product is oil, not natural gas. For an example of these differences in oil, see cases discussed *infra* Part III.E.

21. For the leading decisions in Colorado, Oklahoma, and West Virginia, see, for Colorado, *Garman v. Conoco, Inc.*, 886 P.2d 652, 658 (Colo. 1994) and *Rogers v. Westerman Farm Co.*, 29 P.3d 887, 899 (Colo. 2001) (*en banc*); for Oklahoma, *Wood v. TXO Production Corp.*, 854 P.2d 880, 882 (Okla. 1993), *TXO Production Corp. v. Commissioners of Land Office*, 903 P.2d 259, 262 (Okla. 1994), and *Mittelstaedt v. Santa Fe Minerals, Inc.*, 954 P.2d 1203, 1207, 1210, 1217 (Okla. 1998); and for West Virginia, *Wellman v. Energy Resources, Inc.*, 557 S.E.2d 254, 264 (W. Va. 2001) and *Estate of Tawney v. Columbia Natural Resources, LLC*, 633 S.E.2d 22, 28–29 (W. Va. 2006). For a critical view of the Kansas marketable-product rule, see John Broomes, *Waste Not, Want Not: The Marketable Product Rule Violates Public Policy Against Waste of Natural Gas Resources*, 63 U. KAN. L. REV. 149 (2014), advancing a new argument that the marketable-product rule violates public policies against waste. For recent criticism of the Kansas approach, via criticism of the *Fawcett* court of appeals decision, by a Kansas-based critic, see David E. Pierce, *2014 Survey*

majority among major producing jurisdictions, even though they often are wrongly fingered as holding a minority position.<sup>22</sup> *Gilmore's* leading position in this area—serving as it has as a model for other states—makes detailed discussion of the changes wrought by *Fawcett* warranted, as it does discussion of the portions of the Kansas rule left unchanged.

To address the significance of this new Kansas decision, as well as why it is that Kansas remains a marketable-product state, Part II discusses seven ways in which *Fawcett* reaffirms existing law. The decision: (1) confirms again the traditional Kansas marketable-product rule; (2) does not adopt a simple “at the well” standard, although some unfortunately loose language may suggest otherwise; (3) cites with great favor the routine principle—routine but a principle that will be more important in Kansas after *Fawcett*—that the lessee’s sales must be in good faith and comply with the duty to market; (4) confirms that gas-movement costs incurred as part of other marketability services are not deductible; (5) addresses the marketability duty as a common issue for the 25 *Fawcett* leases; (6) rightly treats the existence of a duty to market as a question of law; and (7) confirms that the standard for proving when gas is marketable remains a factual one. All of these anchoring points are addressed in order in Part II.

Part III turns to what changed with *Fawcett*, particularly its acceptance of a service arrangement as generating a “sale” for proceeds purposes and its seeming rejection of at least part of the Colorado requirement that lessees must bring gas to a marketable location at their own expense as a responsibility independent of the duty to put it into marketable condition.<sup>23</sup> The rejection is only “seeming” because the situation discussed by the court is one in which the two states’ rules come out the same way. Part III.A discusses *Fawcett*’s rejection of the plaintiffs’ pipeline-ready theory of marketability. Part III.B turns to the inconsistency between *Fawcett* and the Kansas Supreme Court’s recent decision in *Hockett v. Trees Oil Co.*, which required that payment under “proceeds” leases be on the gross sales price,<sup>24</sup> while Part III.C discusses *Fawcett*’s oddly unnecessary and probably ineffectual dictum on the Colorado marketable-product locational rule as well as its failure to address adequately the court’s recent decision in *Coulter v. Anadarko*

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on Oil and Gas—Kansas, 1 TEX. A&M L. REV. 79, 79–85 (2014).

22. See discussion *supra* note 4.

23. See *Fawcett*, 352 P.3d at 1041–42.

24. 251 P.3d 65, 72 (Kan. 2011).

*Petroleum Corp.*<sup>25</sup> Part III.D describes the court's revisionist history of two of its three leading marketable-product cases, *Gilmore* and *Schupbach v. Continental Oil Co.*<sup>26</sup> a revision perhaps intended to downplay the changes potentially wrought by *Fawcett* itself. Part III.E turns to the court's unpersuasive reliance on certain readily distinguishable older oil cases, and Part III.F addresses its equally unpersuasive reliance on older market value/proceeds cases.

The last major section of this Article, Part IV, discusses factual questions about marketability that remain open after *Fawcett*. As the court itself stated, the decision in *Fawcett* does not define what marketability means (although it may stake out one particular meaning of marketability).<sup>27</sup> The court did criticize a distinction between salability and marketability, but its reminders of the need for any qualifying sale to be in good faith and to satisfy the duty to market show that the mere fact of sale is indeed not enough to guarantee that a price will qualify as a proper royalty price.<sup>28</sup> Part IV discusses the need for true markets, comparability issues, affiliate problems, and the duties of good faith and to get the best price possible as issues that should help courts flesh out what marketability means and police the prices appropriate for use in royalty computations.

This Article concludes that *Fawcett* will likely have a large and unfortunate, but not revolutionary, impact on the Kansas marketable-product rule. It certainly will not end the great division between marketable-product and "at the well" jurisdictions, however often those enthusiastic about *Fawcett* may predict that it will.

## II. *FAWCETT LEAVES THE CORE THEORY BEHIND THE KANSAS MARKETABLE-PRODUCT RULE INTACT.*

The dispute in *Fawcett* concerned service arrangements that also have aspects of sales agreements—hybrid agreements that are not ordinary sales agreements. The lessee, OPIK, agreed to accept less than the full downstream sale price (sometimes less than the full sales volume) to compensate the nominal purchasers, companies in business as mid-stream service companies, for providing services that ordinarily are

25. 292 P.3d 289 (Kan. 2013).

26. 394 P.2d 1 (Kan. 1964).

27. *Fawcett*, 352 P.3d at 1041 ("What it means to be 'marketable' remains an open question."); see also discussion *infra* Part IV.

28. See *Fawcett*, 352 P.3d at 1042.

applied to turn raw gas into marketable gas.<sup>29</sup> It was the purchasers who took the physical steps to turn OPIK's gas into a condition where it was ready for sale downstream, after the processing plant, and who first received the price that was the basis for OPIK's gross revenues and the resulting royalty computations.<sup>30</sup> But they received most of the sales revenue on behalf of OPIK and passed the lion's share of the revenues right back to OPIK. This is hardly the way a true sales agreement functions.

The service companies that supplied services to OPIK were ONEOK Midstream Gas Supply LLC, Unimark LLC, DCP Midstream LP, and Duke Energy Field Services LP.<sup>31</sup> These purchasers variously described the services they provided as gathering, compression, dehydration, conditioning, fuel reimbursement, treating, and transporting.<sup>32</sup> They took title to the gas at the well, provided field services in return for payments that included a small part of the gas or price received, sold the gas and liquids downstream, and deducted the charges for their services before passing the bulk of the proceeds right back to OPIK.<sup>33</sup> As an example of how this arrangement worked, one of the "buyers" received 8% of the dry gas and liquids volumes and a gathering fee. The rest of the proceeds, including proceeds of 92% of the dry gas and liquids stream (net any other fees charged by that purchaser), went to OPIK. In general, while the "purchasers" may have taken title to 100% of the raw gas at the well, OPIK—not the purchasers—received the bulk of the gas value.<sup>34</sup> That value was set at the market downstream of the plant, not at or near the wellhead. The value received could not be determined without that

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29. For the ordinary function of these services, see *infra* notes 102–06 & accompanying text; see also a list of industry statements and writings on gas quality and marketability compiled by Daniel Reineke, an Oklahoma-based petroleum engineer who frequently testifies on behalf of the class in deduction cases, filed with papers that led to approval of a statewide settlement class of roughly 168,000 members and attached as Exhibit B ("Table of Statements on Marketable Condition") to Exhibit I ("Declaration of Daniel T. Reineke Regarding Marketable Condition" (June 17, 2015)) to Settlement Class's Brief in Support of Final Approval of Class Settlement, Notice, and Plan of Allocation and in Opposition to Non-Fee Objections, Fitzgerald Farms, LLC v. Chesapeake Operating, Inc., No. CJ-2010-38 (Okla. D. Ct. Beaver County) (June 22, 2015).

30. See *Fawcett*, 306 P.3d at 319, 325–26 (court of appeals describing question facing it as to "whether OPIK can avoid its obligations under the implied duty to market the gas by negotiating and contracting with a gas purchaser for a gross sale price of the gas sold at the well and then allow the gas purchaser to deduct from that gross sale price any amount used to compress, dehydrate, treat, and gather the gas").

31. See Brief of Appellant at 5, *Fawcett v. Oil Producers, Inc. of Kan.*, 306 P.3d 318 (Kan. Ct. App. 2013) (No. 12-108666-A) [hereinafter *Fawcett* Brief of Appellant].

32. *Fawcett*, 306 P.3d at 320.

33. *Fawcett* Brief of Appellant, *supra* note 31, at 5.

34. *Id.* at 13.

downstream market, which was the primary determinant of the lessee's return and the royalty owners' income.<sup>35</sup> This is not what one thinks of as a sale, no matter who holds title as the gas flows through the various mid-stream facilities.

The trial court granted partial summary judgment for the class on its motion to bar deduction of gathering, compression, dehydration, processing and fuel charges, as well as lost fuel and third-party marketing expenses.<sup>36</sup> The court applied what it believed was clear Kansas precedent in holding that OPIK could not deduct "expenses incurred to make the gas marketable."<sup>37</sup> As far as the wellhead arrangements, it understood that they were far more (and in key ways pertaining to how small a share the four purchasers received of the sales price, far less) than just sales agreements. It held that "[t]he name of the contract is not important to this Court. What is important is what the contract provides or charges."<sup>38</sup> The parties themselves sometimes called the contracts "gas purchase contracts" and sometimes "gas conditioning service contracts."<sup>39</sup> In the trial court's view, the defendant "can't do indirectly what it can't do directly."<sup>40</sup> The defendant could not bury nondeductible "gas conditioning" services in a sales form to avoid its duty to make gas marketable. In other words, a cat put on a leash or fitted with a dog collar is still a cat, not a dog.

The Kansas Court of Appeals affirmed.<sup>41</sup> It too looked past the fact that portions of the third-party contract included a "sale" by OPIK and that the third-party companies had a role as nominal "purchasers."<sup>42</sup> As it phrased the issue:

Next, we must consider whether OPIK can avoid its obligations under the implied duty to market the gas by negotiating and contracting with a gas purchaser for a gross sale price of the gas sold at the well and then allow the gas purchaser to deduct from that gross sale price any

35. See *infra* notes 131–34 & accompanying text (explaining briefly how OPIK's contracts operated).

36. Order on Motion for Partial Summary Judgment and Class Certification at 11, ¶ 60, *Fawcett v. Oil Producers, Inc. of Kan.*, No. 2011-CV-000090 (D. Ct. Kan. Sep. 5, 2012) [hereinafter *Fawcett* Partial Summary Judgment Order]

37. *Id.*

38. *Id.* at 4, ¶ 19

39. *Id.* at 4, ¶ 18.

40. *Id.* at 11, ¶ 55.

41. *Fawcett*, 306 P.3d at 319, 326.

42. *Id.* at 320.

amount used to compress, dehydrate, treat, and gather the gas.<sup>43</sup>

The Kansas Supreme Court reversed. In doing so, the court rejected the views of both lower courts and treated OPIK's wellhead arrangements as if their having any sales aspects was all it needed to know.<sup>44</sup> It described the elaborate field-service provisions without acknowledging that they are nothing like an ordinary gas sales contract and, as soon as it decided that the sales aspects would let it characterize the contracts as sales contracts, easily found that the revenues received were "proceeds."<sup>45</sup> The court repeatedly described the arrangement as a "sales" or "purchase" arrangement and never as the service arrangement that it was.<sup>46</sup> The court apparently was satisfied that as long as these midstream companies took control of the gas at the well under an agreement that called itself a sale, at least in a setting where the leases provided for royalty payments on proceeds "at the well" or "well mouth," the net price OPIK received after the service companies deducted field-service costs would satisfy the proceeds leases.<sup>47</sup> The arrangement proved to the court's satisfaction that the gas was marketable at the well.

The court did frame its final characterization of its holding as resting in part on the leases' provision for payment "at the well" and "our caselaw giving effect to the 'at the well' language,"<sup>48</sup> thus limiting the holding's scope and leaving open questions about whether *Fawcett* will apply at all to leases without such a limiting reference.

*Fawcett* means that any lessee whose royalty clause states "at the well" (or perhaps uses the term "net proceeds") can bill royalty owners for services that ordinarily would be nondeductible because they are needed to make gas marketable, as long as a lessee finds a third party to nominally buy the gas at the well, provide field services, and deduct the resulting costs from the downstream price.

At the same time, it is important not to lose sight of what *Fawcett* does not change. Nothing in the decision changes the rule that if the gas is not marketed either by a good-faith, arm's-length sale at the well that also complies with the duty to market or in a service arrangement like

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43. *Id.* at 325.

44. See *Fawcett*, 352 P.3d at 1038.

45. *Id.* at 1041–42.

46. See *infra* notes 145–48 & accompanying text.

47. *Fawcett*, 352 P.3d at 1041–42.

48. *Id.* at 1042. For discussion of the role of "at the well" language in *Fawcett*, see *infra* Part II.B.

those in *Fawcett* that can survive that standard, the term “at the well” is not enough to remove the lessee’s implied duty to make gas marketable at its own expense.

Some lessees will tout *Fawcett* as a breach in the line of marketable-product states and a turn toward the Texas “at-the-well” rule.<sup>49</sup> While it will require litigation to determine *Fawcett*’s full impact, the court in no way rejected the basic premise of the Kansas marketable-product rule that the lessee has a duty to make gas marketable at its own expense. In other words, *Fawcett* does not reject the basic *Gilmore* rule. Contrary to the approach in states like Texas, *Fawcett* does not make the wellhead the automatic, presumptive point of valuation; the point of marketability, which determines the valuation boundary, still must be proven factually. The Kansas Supreme Court even went out of its way to assure readers that the oft unremarked but surely unexceptional related principle that lessees have to perform their duties, including securing an appropriate sale price, in good faith and in compliance with their duty to market, remains as true in Kansas after *Fawcett* as before.<sup>50</sup> The court discussed all twenty-five leases as posing a single issue on appeal, even though some leases had different terms, thus again demonstrating that many royalty disputes present primarily common questions.<sup>51</sup> And it also reaffirmed one of the hallmarks of the marketable-product rule—that marketability is generally a question of fact.<sup>52</sup>

#### A. Fawcett Did Not Change the Lessee’s General Duty to Make Gas Marketable At Its Own Expense.

The importance of *Fawcett*’s application will await some dust settling after the inevitable litigation over what the new standard means. For a time *Fawcett* will tend to generate more litigation about the Kansas deduction standard—not less. But it would be a mistake to conclude that the Kansas Supreme Court has turned Kansas into a Texas-type state or endorsed the “at the well” interpretation common there. It would be a mistake as well to conclude that the duty to make gas marketable is restricted to services rendered near the well or on the lease. Neither standard is endorsed in *Fawcett*.

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49. Gas deductions have become such a hot and contentious topic that some commentators immediately began proclaiming that *Fawcett* brings an end to the Kansas marketable-product rule. See *supra* note 9 & accompanying text.

50. *Fawcett*, 352 P.3d at 1042.

51. *Id.* at 1033.

52. *Id.*

The core of the marketable-product duty—the issue that divides all marketable-product jurisdictions from at-the-well courts—is whether the lessee has an implied duty to perform services that make gas marketable at their sole expense after gas emerges from the wellhead. Marketable-product states begin with a presumption that lessees have this duty, although it can be avoided by certain express lease language, while at-the-well jurisdictions begin with the assumption that the lessee can deduct a share of the costs for services rendered to gas after the well unless the lease expressly forbids such deductions.<sup>53</sup>

*Fawcett* reaffirms the basic idea that it is part of the implied duty to market that the lessee must produce a marketable product at its sole expense.<sup>54</sup> It correctly described the marketable-product rule as “requir[ing] operators to make gas marketable at their own expense.”<sup>55</sup> Later, summing up the three leading Kansas cases, the court concluded: “With the duty to market comes the lessee-operator’s obligation to prepare the product for market, if it is unmerchantable in its natural form, at no cost to the lessor (royalty owner).”<sup>56</sup>

The court approvingly cited the triumvirate of leading Kansas marketable-product decisions—*Gilmore v. Superior Oil Co.*,<sup>57</sup> *Schupbach v. Continental Oil Co.*,<sup>58</sup> and *Sternberger v. Marathon Oil Co.*<sup>59</sup>—with no indication that it was rejecting the logic of those decisions or abandoning them for an “at the well” standard.<sup>60</sup> *Sternberger*, although finding for lessee Marathon Oil Company on its facts, provided the broad articulation of the Kansas rule that the lessee “has the duty to produce a marketable product, and the lessee alone bears the expense in making the product marketable.”<sup>61</sup> Under this standard, “[the] nonworking interest owner is not obligated to bear any share of production expense, such as compressing, transporting, and processing,

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53. For a detailed treatment, see MCARTHUR, *supra* note 4, ch. VI.D.

54. See *Fawcett*, 352 P.3d at 1034–35; see also *Sternberger v. Marathon Oil Co.*, 894 P.2d 788, 799 (Kan. 1995) (“The lessee has the duty to produce a marketable product, and the lessee alone bears the expense in making the product marketable.”).

55. *Fawcett*, 352 P.3d at 1034–35.

56. *Id.* at 1040, citing *Gilmore v. Superior Oil Co.*, 388 P.2d 602 (Kan. 1964); *Schupbach v. Cont'l Oil Co.*, 394 P.2d 1 (Kan. 1964); *Sternberger v. Marathon Oil Co.*, 894 P.2d 788, 788 (Kan. 1995)).

57. 388 P.2d 602 (Kan. 1964).

58. 394 P.2d 1 (Kan. 1964).

59. 894 P.2d 788 (Kan. 1995).

60. *Fawcett*, 352 P.3d at 1040–42 (providing positive, if not entirely accurate, discussion of *Gilmore*, *Schupbach*, and *Sternberger*, the leading Kansas marketable-product decisions).

61. *Sternberger*, 894 P.2d at 799.

undertaken to transform gas into a marketable product.”<sup>62</sup> *Fawcett* does not change this standard.

Some of the *Fawcett* amici urged that Kansas has been on the wrong track for over fifty years, questioned whether the Kansas Supreme Court really adopted a full marketable-product rule in 1964 in *Gilmore*,<sup>63</sup> and asked the court to turn instead to what would be in reality the competing standard that Kansas consistently has rejected—the lessee-favoring “at the well” standard that treats that term as one that defines the point where the right to take deductions begins.<sup>64</sup>

The court did not accept this argument. As its favorable discussion of *Gilmore*, *Schupbach*, and *Sternberger* indicated (even if its discussion is incorrect in certain particulars), it approved yet again the core of the Kansas marketable-product rule. In all cases in which gas is not diverted into service arrangements with title passing at the well or otherwise sold at the well, Kansas lessees still will have to bear the full cost of making gas marketable.<sup>65</sup>

The key to *Fawcett* is that it did not change the basic Kansas marketable-product rule. Instead, it interpreted an at-least-substantially-service arrangement that begins at the well as a wellhead sale and treated such a “sale” as proving that the gas was marketable at the well. That it determined the nature of the arrangement as a matter of law, rather than leaving it as a fact matter, may be due to the posture of the case and strategic decisions that led each side to file dispositive motions. The court noted that both sides claimed there were no material facts; conspicuously cited the court of appeals’ decision as if that lower court found that the gas was “sold” at the well;<sup>66</sup> equated “sale” with marketability, at least, a “sale” in the circumstances of the case; and having established a sale, applied Kansas law as if finding any sale is

62. *Id.* at 800.

63. For discussion of *Gilmore* generally, see *infra* Part III.D.1.

64. See, e.g., Brief of E. Kan. Oil & Gas Ass’n as Amicus Curiae at 5, *Fawcett v. Oil Producers, Inc. of Kan.*, 306 P.3d 318 (Kan. Ct. App. 2013) (No. 108, 666) [hereinafter EKOZA Amicus Brief] (citing *Sternberger* as representing a standard that requires sharing “from [the] wellhead to market”) (emphasis in original); *id.* at 6 (criticizing court of appeals for “disregarding the wellhead pricing terms”) (emphasis in original); *id.* at 10 (accusing *Fawcett* court of “negat[ing] the express terms” of “at the well” or “at the mouth of the well”); Brief of Kan. Indep. Oil & Gas Ass’n as Amicus Curiae at 5–6, 15, *Fawcett v. Oil Producers, Inc. of Kan.*, 306 P.3d 318 (Kan. Ct. App. 2013) (No. 108, 666) (citing *Sternberger* for the proposition that in Kansas gas is marketable at the well).

65. *Fawcett*, 352 P.3d at 1042.

66. The Kansas Court of Appeals, like the trial court, clearly did not believe that the arrangement was a pure sale, or it would not have treated it as an impermissible effort to do indirectly what OPIK could not do directly. See *supra* notes 38–43 & accompanying text.

enough to hold that “when gas is sold at the well it has been marketed.”<sup>67</sup>

The new wrinkle injected by *Fawcett* is its holding about what it means to be marketable in one particular circumstance, as discussed in Part III.B. Yet even the kind of service-with-sale-aspects arrangement at issue in *Fawcett* remains—as the court emphasized—open to challenge if the facts suggest bad faith or a violation of the duty to market. *Fawcett* does not change the basic principle that the lessee ordinarily must bear all costs of making gas marketable. The decision’s significance is likely to be coextensive with the number of arrangements structured like OPIK’s, and whether they can weather good-faith, duty-to-market challenges.

#### *B. Fawcett Did Not Embrace A Broad “At the Well” Rule.*

One important aspect of *Fawcett* for understanding how far it represents a change, and how far not, is something it did not say. The court did not adopt the “at the well” rule applied by courts that reject the marketable-product rule.

As discussed in more detail in Part III.D, the Kansas marketable-product rule is based in part on the belief that the term “at the well” is not sufficiently specific to override the lessee’s duty to make gas marketable at its own expense. In *Gilmore*, the Kansas Supreme Court required a lessee to bear compression costs that were not incurred at the well mouth even though the leases required royalty payment “at the well mouth”; in *Schupbach*, with a similarly phrased royalty clause, the court indicated that the location of the compressor is “of little consequence” to whether the lessee has to bear compression costs.<sup>68</sup>

The twenty-five *Fawcett* leases had “at the well” language,<sup>69</sup> and the Kansas Supreme Court mentioned this language in its holding that when gas is sold at the well in a good-faith sale that satisfies the duty to market, royalty payments should be settled there.<sup>70</sup> And some of the court’s language is so casual that it could mislead readers into thinking that the court perhaps intended to retreat further from the Kansas rule than just in the situation of a service-plus-sales-aspects arrangement. In discussing *Sternberger*, a case in which the Kansas Supreme Court found

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67. *Fawcett*, 352 P.3d at 1037–38, 1040–41 (interpreting *Gilmore*, *Schupbach*, and *Sternberger*, as well as other Kansas cases).

68. See *infra* notes 198–202, 216–18 & accompanying text.

69. See *infra* note 129 & accompanying text.

70. *Fawcett*, 352 P.3d at 1042.

the gas already physically suitable for downstream sales in the condition it emerged at the wellhead, lacking only transportation to the market, the *Fawcett* court did state that, under *Sternberger*, “when royalties are to be paid on the value of gas at the well, but no market exists there, the royalty owner must bear a proportional share of the reasonable expenses of transporting the gas to market.”<sup>71</sup> Some might read this language as an endorsement of the well as the point of valuation. The court also mentioned in passing, toward the end of its review of Kansas law, “our caselaw giving effect to the ‘at the well’ language.”<sup>72</sup>

*Fawcett*, however, does not reject the court’s longstanding position that the duty to make gas marketable is a precondition for valuation under at-the-well leases, a traditional body of law discussed in some detail in Part III.D. The court could not have discussed the sequence of Kansas cases as a line of consistent precedent had it intended to now hold that “at the well” authorizes lessees to share all costs after the well no matter what condition the gas.

Indeed, *Fawcett* explicitly rejects this view. In describing the Kansas rule, the court held that when gas is sold at the well, the operator, first, “may not deduct any pre-sale expenses required to make the gas acceptable . . . .”<sup>73</sup> It then stated: “Additionally, the lessee must also bear the entire cost of putting the gas in condition to be sold pursuant to the court-made ‘marketable condition rule.’”<sup>74</sup> The court cited, without any sign of discomfort, a decision from the West Virginia Supreme Court—a state that holds “at the well” ambiguous and too general to dictate cost allocation.<sup>75</sup> Beyond these limits, of course, a wellhead sale that does not satisfy the duties of good faith and to market—that does not yield the best price reasonably possible—will not establish marketability because it does not fulfill the lessee’s royalty responsibility.

### C. Fawcett Affirmed that the Lessee’s Sales Must Satisfy Good-Faith and Duty-to-Market Requirements.

Another portion of *Fawcett* that confirms traditional standards, an aspect of the case that may be highly significant to its aftermath, is the court’s reminder that there is a “potential for claims of mischief [in

71. *Id.* at 1041.

72. *Id.* at 1042.

73. *Id.* at 1041.

74. *Id.* (citing *Coulter v. Anadarko Petrol. Corp.*, 292 P.3d 289, 362 (Kan. 2013)).

75. *Id.* (citing *Wellman v. Energy Res., Inc.*, 557 S.E.2d 254, 265 (W. Va. 2001)).

product sales] given an operator's unilateral control over production and marketing decisions.”<sup>76</sup> In its view, royalty owners are adequately protected from such risks by two implied duties:

[the] implied covenant of good faith and fair dealing and the implied duty to market. The latter demands that operators market the gas on reasonable terms as determined by what an experienced operator of ordinary prudence, having due regard for the interests of *both* the lessor and lessee, would do under the same or similar circumstances.<sup>77</sup>

In the oilfield, these two standards have allowed lessors to recover on a variety of claims including challenges to self-dealing, affiliate-favoring transactions, and for lessee failure to secure the best price reasonably possible.<sup>78</sup>

Part of the duty to market is the core responsibility to get the “best price” possible. Today’s wellhead prices often fail to satisfy this requirement. In all producing states, including Kansas and even (in general) lessor-hostile Texas, a lessee has an implied duty to get the best price reasonably possible.<sup>79</sup> The Kansas Supreme Court has cited this core responsibility favorably on several occasions, mentioning securing the “best price” as an ordinary function of lessees even in *Fawcett*.<sup>80</sup> A

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76. *Id.* at 1042.

77. *Id.*; see also *id.* at 1039 (confirming that whether price was adequate generally would seem to require “a fact-based analysis” to determine sale’s good faith and reasonableness).

78. See generally *infra* Part IV.

79. For a collection of these cases, see John Burritt McArthur, *A Minority of One? The Reasons to Reject the Texas Supreme Court’s Recent Abandonment of the Duty to Market in Market-Value Leases*, 37 TEX. TECH L. REV. 271, 289–94 (2005). For Kansas law on this point, see *id.* at 292–93 & n.122–27. Texas law has a quirk in that the Texas Supreme Court has held that no implied marketing duty applies to market-value leases, because they provide an “objective” standard of value. For criticism of the Texas position, see, in addition to the *Minority of One* article just cited, McArthur, *The Precedent Trap*, cited *infra* note 259.

80. While the court did not formally discuss the “best price” duty as a specific duty in *Fawcett*, it did note in passing that lessor and lessee interests ordinarily coincide because the lessee “will have everything to gain and nothing to lose by selling the product at the best price available.” *Fawcett*, 352 P.3d at 1040.

In *Waechter v. Amoco Production Co.*, 537 P.2d 228, 249 (Kan. 1975), the Kansas Supreme Court mentioned in passing, while discussing gas sold at the wellhead, the lessor’s reliance on “the lessee’s self-interest in obtaining the best price possible”—a phrasing so close to the standard phrasing of the duty to market that it is unlikely to be accidental. In *Maddox v. Gulf Oil Corp.*, 567 P.2d 1326, 1328 (Kan. 1977), Justice Schroeder, writing for the court, described Gulf’s duty as “to market the gas at the best prices obtainable at the place where the gas was produced.” That decision was issued, of course, when generally there was a real market near the point of production.

An unfortunately phrased passage in *Smith v. Amoco Production Co.*, 31 P.3d 255 (Kan. 2001), could be read to express hesitancy about the scope of the best-price duty. But the hesitancy appears to have merely been caution elicited by the complex factual situation. The dispute arose in an intricate regulatory setting. It concerned how the best price responsibility should be interpreted

price that violates the duty to market because it is not the best price surely cannot qualify as a price for “marketable” oil or gas.

Local wellhead prices are not likely to be the best prices possible even if there are multiple buyers and sellers at or near some wellheads in a producing field or basin. The general location of the best price has moved. In the decades before Congress and the Federal Energy Regulatory Commission combined in the late 1980s and early 1990s to deregulate the market for interstate natural gas and gas field services, the services whose cost deductibility is most often now in dispute, the best price often was a regulated “field” price that was paid at the well or in a field of wells.<sup>81</sup> With natural gas deregulation, the bulk of gas marketing

under a federal deregulation order, Order 451, through which the Federal Energy Regulatory Commission had hoped to spur restructuring of high-priced gas-purchase contracts for certain regulated gas. Amoco claimed that any duty to get the best price would conflict with express lease terms. The court did not disavow any of its past language about the duty to get the “best price possible,” language it cited. *Id.* at 269. And its discussion of the duty appears to have been hypothetical anyway because, it noted, the finding below that Amoco secured the “best possible price” meant that whether Amoco had a duty to do so was not really in issue. *Id.*

Nonetheless, the court did note that the dispute before it presented four reasons on its facts not to address the best price standard in the abstract: (1) the court did not want to deal with all hypothetical contexts in which the implied duty and express lease terms might conflict, as Amoco was inviting; (2) none of the court’s past decisions had involved Order 451 issues; (3) the trial court had phrased the issue as one of intentional low-price sales; and (4) none of the prior Kansas cases had “dealt with a ‘head to head’ contest between a best possible price claim . . . and express marketing provisions . . . .” *Id.* at 271. The phrase “best possible price claim” makes little sense unless the best-price duty is a recognized duty. None of this language disavows that, in general, a duty to get the best price reasonably possible attaches to all mineral leases in Kansas, even if application of the duty may be difficult in the presence of unusual Order 451 issues.

*Smith* also contains a discussion of *Robbins v. Chevron U.S.A., Inc.*, 785 P.2d 1010 (Kan. 1990), and certain language it cited from *Robbins* suggests that courts should not displace the business decisions of lessees. See *Smith*, 31 P.3d at 271–72 (discussing not “second-guessing” lessee in ordinary unconflicted cases). The court noted, however, that such deference assumes “no conflict of interest between lessor and lessee.” *Id.* at 271. Yet, the implied covenants generally arise in situations where experience has shown that the lessee’s interest often diverges from the lessor’s interest. Cf. 5 WILLIAMS & MYERS, *supra* note 1, § 856.3, at 411–12 (concluding that courts give “greatest possible leeway” to lessee because its interests ordinarily coincide with lessor’s, but that if interests “diverge and the lessee lacks incentive to market gas, closer supervision of his business judgment will be necessary”); see also John S. Lowe, *Developments in Nonregulatory Oil and Gas Law*, 27 INST. OIL & GAS L. & TAX’N 1–1, § 103[2], at 1–20 (1988) (“Evidence of self-dealing by the lessee, as was involved in *Hagen*, or other conflict of interest between the lessor and the lessee, is likely to have the practical effect of substantially lightening the lessor’s burden.”). Implied covenant disputes arise because of conflicts of interest between the two lease parties. As *Brewster v. Lanyon Zinc Co.*, 140 F. 801 (8th Cir. 1905), established long ago, the standard courts apply when conflicts do exist is the objective one of the reasonably prudent operator. *Id.* at 813–14. That standard allows neither lessor nor lessee’s subjective judgment to dictate the fair outcome; for many factors that can be part of the test, see *id.* at 814–15. For a clear rejection of a subjective standard in such conflict situations, see *Fischer v. Magnolia Petroleum Co.*, 133 P.2d 95, 99–100 (Kan. 1943) (endorsing objective standard, not “good faith” standard in development case).

81. The author has summarized the process of natural gas deregulation in several places, including John Burritt McArthur, *Antitrust in the New [De]Regulated Natural Gas Industry*, 18

and the best prices available shifted downstream. It is these downstream markets that are transparent and reported in published price indices. Once gas is processed, the “dry” gas generally is sold near the plant outlet while the liquids are sold or shipped further. Even in *Fawcett*, the price was not actually determined at the well, but instead it was based on downstream, after-the-plant sales, from which the buyers deducted charges for their mid-stream services.<sup>82</sup>

Marketability is a clearer standard—and a fairer one—than may seem likely because the link to the duty to market imposes a duty to find the best price reasonably possible. Natural gas deduction litigation too often centers on a fictional world in which companies that do not sell their gas at the wellhead and would not think of doing so, but instead aggregate wellhead gas in a single commingled stream, ship it downstream, and process it before selling it in large-volume sales, nonetheless scour nearby producing fields looking for isolated, small-volume wellhead sales by other producers that, they claim, prove “market” value for gas the companies are actually selling downstream. Even OPIK’s agreements with the service companies still included a base price—the indexed price—that was a downstream price.

Many producers today assert, when they are sued over deductions, that a handful of local sales near their wells prove “market value.” They may even say that unprocessed wellhead gas is in a “marketable condition” when there are no buyers nearby. But this is not realistic.

Natural gas producers know the best prices no longer generally are found at the well. If lessors secure internal documents of natural-gas companies that have their own field service or marketing division or affiliate, the companies likely will justify their provision of field-services or a distinct marketing function as needed to make oil and gas marketable.<sup>83</sup> This is a straightforward recognition of the fact that in the vernacular of the modern deregulated natural gas market, marketable gas

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ENERGY L.J. 1, 17–32 (1997). For a contrary view, arguing that the locus of gas deductions should be the well even if markets now are downstream of that point, see Richard B. Noules, *What Is Required for Gas to be a Marketable Product in Oklahoma?*, 85 OKLA. BAR. J. 139, 141–42 (2014), <http://www.okbar.org/Portals/13/PDF/OBJ/2014/OBJ2014Jan18.pdf>.

82. *Fawcett*, 352 P.3d at 1035–36.

83. *Parry v. Amoco Prod. Co.*, No. 94CV105, 2003 WL 23306663, at \*16 (D. Colo. Oct. 16, 2003) (Amoco documents); *id.* at \*19 (Amoco witness admissions); *see also Clough v. Williams Prod. RMT Co.*, 179 P.3d 32, 37–38 (Colo. App. 2007) (affirming judgment based on a jury’s rejection of the producer’s argument that the gas was marketable at the well, and upholding as well trial court’s discretionary exclusion of market evidence about the pre-1992 regulated gas market as too remote to claims in the 1996 to 2004 deregulated gas market); *Savage v. Williams Prod. RMT Co.*, 140 P.3d 67, 71 (Colo. App. 2005) (upholding trial court’s finding that gas “was not marketable at the wellhead because it had to be processed and transported to the pipeline”).

is processed gas, not raw gas at the well.<sup>84</sup> Lessees generally do not sell gas at the well if they can get it downstream into the markets for processed gas and for liquids. *Fawcett* preserves challenges to use of such local sales under the good faith and duty to market standards.<sup>85</sup> These duties also form a barrier against the affiliate problems in both the pricing arena and with cost deductions, as further discussed in Part IV.

*D. Fawcett Left Intact the Rule that Movement Costs Needed to Get Gas to Marketability Services Are Not Deductible.*

An aspect of the Kansas marketable-product rule established most clearly in *Sternberger v. Marathon* is that costs of gas movement services (gathering and even what the court called transportation) are not deductible if required to move gas to other services that are needed to transform unprocessed gas into marketable gas. The *Sternberger* court stated, without qualification, that “[t]he lessee has the duty to produce a marketable product, and the lessee alone bears the expense in making the product marketable.”<sup>86</sup> But because in *Sternberger*’s very unusual situation the gas was not modified physically before it was sold downstream, the court allowed deduction of the cost of transporting the

84. Distinctions that separate physical marketability from geographic marketability pretend that markets exist where they do not. A number of authorities have noted the lack of merit in efforts to value all production based on marginal wellhead sales. Justice Roberts, before he became Chief Justice of the country’s highest court, held in a coal-seam gas deduction case involving federal leases that it makes little sense for sales of much lesser volumes to control treatment of gas not sold at the well. *Amoco Prod. Co. v. Watson*, 410 F.3d 722, 730 (D.C. Cir. 2005), *aff’d on other grounds*, *BP Am. Prod. Co. v. Burton*, 549 U.S. 84 (2006). For even older federal precedent, see the discussion distinguishing “marketing” from “merely selling” in *California Co. v. Udall*, 296 F.2d 384, 387–88 (D.C. Cir. 1961). This presumably was the logic of the jury in *Rogers v. Westerman Farm Co.*, 29 P.3d 887 (Colo. 2001) (*en banc*), when it decided that gas sold at the well was marketable there, but unsold gas was not. *Id.* at 894. *Rogers* held that it is erroneous to instruct the jury in a way that could let it find marketability just from the fact that the lessee sold the gas. *Id.* at 910. Judge McAnany, the Kansas state court of appeals judge, has wisely pointed out (though in an observation disfavored in *Fawcett*) that given that “there is some point on every . . . [demand] curve where somebody would be willing to pay for the item,” the idea of marketability itself becomes “superfluous” if all it requires is any sale no matter what kind of sale. *Fawcett*, 306 P.3d at 327 (McAnany, J., concurring). Indeed, the concept of a sale becomes meaningless if any sale at all, no matter what the price or related conditions, satisfies the duty to market. The missing component is the required duty to seek the best price reasonably possible.

The definition in *Williams & Meyers* of a marketable condition is of a product “sufficiently free from impurities that it will be taken by a purchaser.” See *WILLIAMS & MEYERS*, *supra* note 1, at 692. But the apparent acceptance of any purchase at all is too simple a description to be accurate. Unfortunately, *Fawcett* accepts a “sale” that is not just a sale, although the decision may at least partially save itself from the worst excesses by its language about good faith and the duty to market.

85. *Rogers v. Westerman Farm Co.*, 29 P.3d 887 (Colo. 2001) (*en banc*) offers a reminder that the jury should be instructed separately on these issues. See *infra* note 182.

86. *Sternberger*, 894 P.2d at 799.

unchanged raw gas to its sale location downstream.<sup>87</sup> The transportation at issue was pure gas movement, not movement coupled with other marketability services. Marathon could take deductions because the gas sold downstream was in the same physical condition it had been in as it emerged from the well. The court allowed deduction of what it variously called gathering and transportation because they did not “enhance” (by which the court appeared to mean make marketable in some essential way) the gas’s physical condition.<sup>88</sup>

By 2013, the court appeared ready to jettison *Sternberger*’s singling out of gas movement as one service that would not be treated the same way as other physical activities required to get gas to market.<sup>89</sup> In *Fawcett*, however, it rejected the broadest parts of Colorado’s standard on movement costs. Yet the court did reaffirm its *Sternberger* position that gas movement costs cannot be deducted when needed in conjunction with services that physically transform gas into marketable gas.<sup>90</sup> Thus the Kansas Supreme Court affirmed this traditional rule, even though it did not extend it, as discussed in Part III.C *infra*.

#### E. Fawcett Discussed Deductions As A Common Question, Not As An Issue Rife With Individual Questions.

Because so many deduction disputes have been litigated as class actions, or at least filed in hopes of securing a class, one of the issues that has bedeviled deduction litigation is whether *common questions* predominate, in which case class certification is likely, or instead *individual questions* predominate. Royalty owners usually argue that class lease terms and marketability questions present common issues, while lessees take the opposite position, claiming that each lease must be analyzed on its own and that individual differences make every well materially different, so that there cannot be common treatment of classes of royalty deduction claims.

For example, in the Tenth Circuit appeal in *Wallace B. Roderick*

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87. *Id.* at 799–800.

88. See the *Sternberger* court’s stress on initial enhancement services as a requisite for deductibility in *Sternberger*, 894 P.2d at 799–800. In *Sternberger*, the court used “enhance” in the cited passage in the sense of making gas marketable, not of adding value to already marketable gas, while some marketable-product courts have used “enhance” and “enhancement” to refer to deductible services rendered after gas has become marketable. *See, e.g., Rogers*, 29 P.3d at 900, 903.

89. See the discussion of *Coulter* in text accompanying notes 173–79 *infra*; for *Sternberger*’s context and holding, see *infra* note 225.

90. *Fawcett*, 352 P.3d at 1041–42.

*Revocable Living Trust v. XTO*,<sup>91</sup> XTO claimed that gas markets vary from well to well, while the plaintiffs argued that no gas was marketable at the well.<sup>92</sup> The parties took the same positions in *Chieftain Royalty Co. v. XTO Energy, Inc.*,<sup>93</sup> a parallel class for Oklahoma royalty owners.<sup>94</sup> The Tenth Circuit assumed, without citing any evidence explaining why, that marketability is sufficiently likely to vary materially by well and that the trial court needed to investigate more deeply whether individual issues predominated.<sup>95</sup> In *Arkalon Grazing Association v. Chesapeake Operating, Inc.*,<sup>96</sup> after the trial judge decided to reconsider his certification, he adopted Chesapeake's argument that the relevant facts could vary from well to well on such factors as pressure, chemical composition, and heating value; and the judge cited those supposed potential variations as one reason to decertify.<sup>97</sup>

*Fawcett* did not decide any certification questions—only the substantive question of whether the trial court was correct in granting partial summary judgment to the class that their gas only became marketable when it was in pipeline-ready condition. But in reaching this issue, it is notable that the Kansas Supreme Court did not mention any individual issues that might require separate discussion. The court was not troubled by individual issues about lease terms, well conditions, or sales agreements.

The class covered twenty-five leases.<sup>98</sup> The court was willing to rule based on the parties' stipulation that the leases had "two general forms,"

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91. 725 F.3d 1213 (10th Cir. 2013).

92. *Id.* at 1216–17, 1219.

93. 528 F. App'x 938 (10th Cir. 2013).

94. *Id.* at 940–41.

95. *Id.* at 943; *Roderick*, 725 F.3d at 1219; see also *Fitzgerald Farms LLC v. Chesapeake Operating, Inc.*, No. 111,566, 2014 WL 813861, at \*5–6 (Okla. Civ. App. Feb. 14, 2014), withdrawn, 2014 WL 8400016 (Okla. June 2, 2014). The Tenth Circuit in *Roderick* did not cite any evidence in the record that gas varied in any aspect that was both disputed and material to gas value. Its main support for potential variations by well seems to be a citation to *Sternberger* for the proposition that gas "may be marketable at the well." *Roderick*, 725 F.3d at 1219 (emphasis in original). Yet, not only did *Sternberger* present an unusual situation because its gas apparently received no services except gas movement between the well and downstream sale, but nothing in *Sternberger*, which treated deductibility as a single question for its class, supports the idea that the gas before it varied materially from well to well. It is an irony of *Sternberger*, of course, that not even the plaintiffs denied that the gas was marketable "at the well" even though both parties agreed that no market existed there. Such a conclusion is possible only in courts that have not paid enough attention to what marketability really is and to the fact that marketability must, as its name suggests, be linked to some definition of an adequate market to have any real substance.

96. No. 09-1394-CM, 2014 WL 3089556, at \*3 (D. Kan. July 7, 2014). The parties subsequently stipulated to have the case dismissed. See *supra* note 6.

97. *Arkalon*, slip op. at \*3.

98. *Fawcett*, 352 P.3d at 1034.

the pertinent terms of which were, given the court's decision, "proceeds from the sale of gas as such at the mouth of the well" and "proceeds if sold at the well."<sup>99</sup> The parties and the Kansas Supreme Court discussed all leases as a group.

In addition, as the court noted, the parties also had "taken no exception" to the Kansas Court of Appeal's conclusion that the "geography of the sale of gas was at the well," and the "geography for calculation of the royalty was at the well."<sup>100</sup> The Kansas Supreme Court mentioned no differences in well characteristics or marketing arrangements. It did not mention variations in the kind of individual well aspects—pressure differences, different levels of impurities, processing differences, compression differences, differences in gathering system routing—that defendants so often raise in certification hearings. And even though sales were divided among four different service-company purchasers, each with its own arrangement, the court was content to provide an example from one of the four, ONEOK, to illustrate the general structure of this kind of arrangement.<sup>101</sup> Here too, then, it did not discuss individual differences. The court presumably understood that such local factors often are immaterial to what is disputed in deduction disputes.

When courts talk about field services, particularly when summarizing the natural and well-understood function of these services, they do not need to do so well by well. They speak generically of services that are applied consistently across producing fields. This is why the Tenth Circuit was able to explain as a general matter that, to find market value of unprocessed gas "at the well," the "producers sell refined natural gas and NGLs at the tailgate of the processing plant (i.e., after processing) to establish a base sales amount."<sup>102</sup> So the Oklahoma Supreme Court has called it "common knowledge that raw or unprocessed gas usually undergoes certain field processes necessary to create a marketable product."<sup>103</sup> These processes "include, but are not limited to, separation, dehydration, compression, and treatment to remove impurities."<sup>104</sup> In a bench trial over San Juan Basin gas, the trial judge cited "numerous statements" by Amoco that the facilities whose

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99. *Id.* at 1036.

100. *Id.* at 1039.

101. *Id.* at 1036.

102. Abraham v. BP Am. Prod. Co., 685 F.3d 1196, 1200 (10th Cir. 2012) (citing Elliott Indus. L.P. v. BP Am. Prod. Co., 407 F.3d 1091 (10th Cir. 2005)).

103. Mittlestaedt v. Santa Fe Minerals, Inc., 954 P.2d 1203, 1208 (Okla. 1998).

104. *Id.*

costs it wanted to deduct were needed “to market the gas, to get the gas to market, or to make the gas marketable.”<sup>105</sup> The Kansas Supreme Court gave a generic description of typical gas field services without descending into well-by-well differences in *Coulter v. Anadarko Petroleum Corp.*<sup>106</sup>

Marketability services usually apply across producing fields. They generally are performed at “postage-stamp” rates for each service or for all services bundled together, and the costs generally are deducted from all production in the gathering system by computer formula each month without “individual” variations. The input data may vary, with volume and heating (mmbtu) values affecting royalty payments, but those values usually are not disputed and are automatically incorporated in routine computations by business software programs. Class action analysis should not be so unrealistic as to assume that the processes structured so uniformly nonetheless vary materially well by well.

While the Kansas Supreme Court was not hearing an appeal from class certification in *Fawcett*, it remains striking how readily it discussed the appellate issues as a whole and not as individually variant questions. In treating potential differences as immaterial (by ignoring them), the court rightly treated those differences as just as immaterial as the industry treats them in its ordinary course of business.

#### *F. Fawcett Treated the Kansas Duty to Market Standard As A Question of Law*

Not only did the Kansas Supreme Court not discuss any individual questions, but it discussed the scope of the duty to market as a question of law in *Fawcett*, not as one of fact. The court’s treatment of deductions as posing a common legal question for the class of *Fawcett* leases could not have been inadvertent because OPIK raised the issue by arguing that one reason Kansas law is different from Colorado law is that Colorado treats implied covenants as existing in oil and gas leases as a matter of law, while in Kansas, per OPIK, their existence is a question of fact.<sup>107</sup>

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105. *Parry v. Amoco Prod. Co.*, No. 94CV105, 2003 WL 23306663, at \*16 (D. Colo. Oct. 6, 2003).

106. 292 P.3d 289, 293 (Kan. 2013).

107. *Fawcett* Brief of Appellant, *supra* note 31, at 37–8 (arguing that Kansas rejects Colorado’s “implied-in-law” approach, basing this argument on *Smith v. Amoco Prod. Co.*, 31 P.3d 255 (Kan. 2001), and on the basis of that alleged difference in procedural approach (question of law v. question of fact) trying to distinguish the *substantive* Colorado rule, which the Kansas Supreme Court has adopted and enforced, as a “minority rule” (which it is not—for discussion, see authorities cited *supra* note 4), and urging Kansas to adopt a Texas rule that the court has avoided for the more than

OPIK cited *Smith v. Amoco*, with its holding that the oilfield implied covenants are “factual” for limitations purposes, as standing for the proposition that whether implied covenants exist in a group of gas leases is a question of individually variant fact.<sup>108</sup> In *Smith*, the holding extended the years over the class of royalty owners could sue. It may be that OPIK rightly estimated that, if past decisions were a guide, it was likely to lose if the court treated the issue as one of law, and that it therefore hoped the court would simply overturn the summary judgment for Fawcett and send the case to trial. It certainly hoped that an inherently factual covenant would be ineligible for class certification. As it turned out, OPIK benefited from the court’s treating the nature of the service arrangements as presenting a uniform question of law, not factually variant questions.

The argument that *Smith v. Amoco* somehow suggests that Kansas has adopted an approach that the duty to market may or may not be in a lease, depending upon an individual analysis of the lease and surrounding circumstances, so that even leases with identical language would not need to have the same meaning, and that the Kansas Supreme Court has rejected the general implication of a marketable-product rule across all leases (unless specifically excluded), is not a new argument. Mobil raised it in *Farrar v. Mobil*, where the Kansas trial judge summarized one of Mobil’s arguments as follows:

The implied covenant to market no longer exists in every oil and gas lease in Kansas, because the decision in [*Smith v. Amoco*] requires each royalty owner to offer evidence, separate and apart from the lease itself, that the parties who signed the lease intended to impose such an obligation on the lessee.<sup>109</sup>

The *Farrar* trial court rejected Mobil’s argument. Instead, the court correctly held, “[t]here is an implied covenant to market minerals produced under all oil and gas leases in Kansas.”<sup>110</sup> If Mobil wanted to

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fifty years since *Gilmore*.

108. *Id.* at 37. On the holding about the covenant being factual for limitations purposes, see *Smith*, 31 P.3d at 264.

109. Journal Entry of Decision by the Court Certifying Class at 6, *Farrar v. Mobil Oil Corp.*, No. 01 CV 12, (D. Kan. Aug. 18, 2009). Of course, were a court to require individual party evidence to decide if a given covenant exists, then it presumably could also decide that a covenant exists in some leases but not others even if the leases are identical form leases, a chaotic outcome that certainly would not match the intent of leases structured as American leases are structured and one that would sow inefficiency, not efficiency.

110. *Farrar v. Mobil Oil Corp.*, 234 P.3d 19, 28 (Kan. Ct. App. 2010) (citing trial court).

avoid this implied covenant, its leases had to say so.<sup>111</sup>

In the federal class of royalty owners that ultimately edged out *Farrar* as the forum to decide Kansas deduction claims against ExxonMobil, Judge Marten reached the same conclusion in his certification decision.<sup>112</sup> He cited nine other Kansas state and federal cases (including *Smith v. Amoco*) in which classes were certified in spite of the examine-each-lease argument and “similar” decisions by Oklahoma and Colorado courts under their law.<sup>113</sup>

A careful reading of the Kansas cases, like those in every other jurisdiction in the United States, will show that while courts sometimes do consider the factual setting of the lease when they initially develop particular implied covenants, as the covenants become customary the courts apply them without analyzing intent anew every time a case arises.<sup>114</sup> This is another way of saying that courts treat the covenants as

111. *Id.* at 28–29 (if Mobil and predecessor wanted to avoid implied covenant, “they were obligated to include clear and express language to this effect . . . .” (citation to *Gilmore* omitted)).

The *Farrar* court of appeals rejected the factual variant argument in a reasoned decision when it affirmed class certification in 2010. *See id.* at 28–31. Like the trial court, the court of appeals held that while *Smith v. Amoco Production Co.* may classify covenants as “factual” for limitations purposes, the Kansas Supreme Court did not indicate that it was abandoning its longstanding rule that the various implied duties, including the duty to market, are implied in all Kansas leases unless expressly excluded. *Id.* The standard implied covenants do not depend upon the facts of each lease negotiation. *Id.* at 30. The court of appeals concluded, “indeed, one need not examine parole evidence, surrounding circumstances, or extant industry practice to determine whether such covenants should be implied. This has simply never been the law or practice in Kansas.” *Id.* Every one of the many cases the court of appeals cited on this point would have had to be rewritten if its fundamentals had *Mobil* been correct. For the cases, *see id.* at 29–30.

112. *Hershey v. ExxonMobil Oil Corp.*, No. 07-1300-JTM, 2011 WL 1234883, at \*8–12. (D. Kan. Mar. 31, 2011), *aff’d in pertinent part*, 550 F. App’x 566 (10th Cir. 2013).

113. *Id.* at \*12. Part of the reasoning in *Smith v. Amoco Production Co.* seems misplaced for other reasons, at least, if it is construed as for any purposes beyond limitations. The *Smith* court relied significantly on general Kansas contract cases, not oil and gas cases alone, and its ruminations over what kind of limitations applied did not analyze whether the bulk of Kansas oil and gas implied covenants have been derived from factual analysis or instead implied by law. *See Smith v. Amoco Prod. Co.*, 31 P.3d 255, 264–68 (Kan. 2001). Ironically, when the *Smith* court later discussed the substance of the best-price portion of the duty to market, it cited a variety of cases that do apply that duty as a matter of law, but without discussing the reasoning of those courts. *See id.* at 268–71.

114. In the Kansas cases, as an example, one finds such totally nonfactual, across-lease statements of the general rule governing the deduction cases as *Gilmore*’s statement that “Kansas has always recognized the duty of the lessee under an oil and gas lease not only to find if there is oil and gas but to use reasonable diligence in finding a market, . . . .” *Gilmore v. Superior Oil Co.*, 388 P.2d 602, 606 (Kan. 1964); *see also Sternberger’s articulation of when the lessor has to bear a share of costs, Sternberger v. Marathon Oil Co.*, 894 P.2d 788, 799–800 (Kan. 1995), as well as its general rule that the “lessee has the duty to produce a marketable product, and the lessee alone bears the expense in making the product marketable,” *id.* at 799; and *Coulter’s summary of the substantive principles underlying the settled class claims, Coulter v. Anadarko Petroleum Corp.*, 292 P.3d 289, 305–06 (Kan. 2013). The same approach characterizes the other Kansas implied covenant cases (as it does approaches in other states), for instance the leading Kansas development cases of *Myers v.*

implied at law, not induced in fact. This is what made it proper for the *Fawcett* court to discuss the deduction issues on a common basis.

Arguments for “factual” covenants rather than covenants implied in law appear most often in class cases. Defendants hope that if a court will hold that an implied duty is factual, it will conclude that the jury has to look at the particulars of each lease and that the case cannot possibly be tried as a common dispute. The New Mexico Supreme Court recently addressed this very issue and rejected the inherently factual argument as too simple by considering principles that guide implication under American contract law generally.<sup>115</sup> It noted that American courts have the power to imply contractual covenants for two independent reasons, not just one: *either* as a matter of law when needed to effectuate the parties’ purposes *or* as a fact matter based on evidence of what the particular parties intended.<sup>116</sup> The primary oil and gas implied covenants, including the duty to market and its more than fifty year reign in Kansas over marketable-product issues, are rights Kansas courts have adopted to effectuate the purpose of the lease. One will look in vain in *Gilmore*, *Schupbach*, *Sternberger*, *Coulter*, *Hockett*, and even *Fawcett* for a sign that lessors have to prove the duty to market individually, lease by lease.

#### G. Fawcett Confirmed Again that Determining When Gas Is Marketable Is A Fact Issue.

Finally, even if the existence of implied covenants in a group of leases is not a fact question, but one of law, *Fawcett* held that the determination of when marketability is achieved remains a fact issue in Kansas, not a categorical question that ordinarily can be decided as a matter of law. *Gilmore* and *Schupbach* could be read as holding that

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*Shell Petroleum Corp.*, 110 P.2d 810, 816 (Kan. 1941) and *Temple v. Continental Oil Co.*, 320 P.2d 1039, 1046 (Kan. 1958); the common-drainage case of *Culbertson v. Iola Portland Cement Co.*, 125 P. 81, 83 (Kan. 1912); and, of course, the Eighth Circuit’s Kansas-based decision *Brewster v. Lanyon Zinc Co.* itself, 140 F. 801 (8th Cir. 1905), in which the duty to develop is derived from features of the *Brewster* lease common to all ordinary oil and gas leases, not from individual facts about the parties.

For an explanation of how *Brewster* derived the duty to develop from the general nature of American oil and gas leases, not particular aspects of the relationship that would apply only to *Brewster* and *Lanyon Zinc* in unique aspects of their own contract setting, see MCARTHUR, *supra* note 4, at 26–27 & nn.17–20.

115. See *Davis v. Devon Energy Corp.*, 218 P.3d 75, 86 (N.M. 2009). For an in-depth analysis of *Davis*, the case from which this discussion is drawn, see MCARTHUR, *supra* note 4, at 264 n.156.

116. *Davis*, 218 P.3d at 85.

compression costs are categorically not deductible as a matter of law.<sup>117</sup> The older Kansas cases holding that the costs of “transportation,” at least if “to a distant market,” *are* deductible, also could be read to use a categorical analysis.<sup>118</sup> But *Sternberger* rejected categorical analysis by its broad statement about marketability being the hinge upon which deductibility turns. That meant that all service costs, including gas movement, must be borne by the lessee regardless of where they are provided as long as the services are needed to make gas marketable, and makes determining marketability the key challenge in the analysis. There is nothing ambiguous about the following:

The lessee has the duty to produce a marketable product, and the lessee alone bears the expense in making the product marketable. . . .

. . . [A]bsent a contract providing to the contrary, a nonworking interest owner is not obligated to bear any share of production expense, such as compressing, transporting,<sup>119</sup> and processing, undertaken to transform gas into a marketable product.

Under any reading, one still can say that in Kansas compression, dehydration, and processing costs—classic physical transformation costs—will almost always be barred from deduction unless the lease expressly authorizes deduction of those specific costs or a service arrangement with title and sales features like the ones in *Fawcett* exists. Hence the Oklahoma Supreme Court’s finding of “common knowledge” that field services are needed to make gas marketable,<sup>120</sup> and a Colorado trial judge’s discussion of producers describing traditional field services as needed to make gas marketable.<sup>121</sup> Gathering, dehydration, treatment, processing, and most compression usually will be required for marketability under the existing standard unless a *Fawcett*-type service arrangement exists, while transportation after the plant almost always will be deductible. And, in spite of *Fawcett*, in general the broad

117. It was because deductions in Colorado turn on marketability that the Colorado Supreme Court—which treats marketability as a factual matter—criticized what it thought was the categorical rule in Kansas. *Rogers v. Westerman Farm Co.*, 29 P.3d 887, 905 & n.21, 906 (Colo. 2001) (en banc). Yet given the nature of the market, even the factual test should point to pipeline ready gas in most circumstances. *See id.* at 905 (“It may be, for all intents and purposes, that gas has reached the first-marketable product status when it is in the physical condition and location to enter the pipeline.”).

118. *See infra* Part III.E (discussing early Kansas cases on the treatment of transportation to a “distant” market, as deductible under typical oil royalty clauses).

119. *Sternberger*, 894 P.2d at 799–800.

120. *See supra* notes 103–04 & accompanying text.

121. *See supra* note 105 & accompanying text.

*Gilmore-Schupbach-Sternberger* rule still governs and suggests that marketability determines the fate of all field costs. That this outcome may appear categorical is a consequence of the commonality of gas market facts, not part of the marketability principle as a matter of law.

This then leaves open the question of the nature of marketability. In *Fawcett*, OPIK moved below for a summary judgment holding that its supply arrangements were third-party sales and that it had complied with the leases by paying 100 percent of the proceeds of those “sales.”<sup>122</sup> The plaintiffs, who also sought summary judgment, responded that the first “sale” came when the service companies resold the gas (generating the base price upon which the service companies computed their payments to OPIK, the same price behind OPIK’s royalty payments). They argued for a dispositive order holding that gas is only in a marketable position when it is in a physical condition to be delivered into interstate pipeline systems, a rule that would include a stronger locational requirement in the Kansas rule.<sup>123</sup>

The plaintiffs also argued that the services that are not deductible are those that physically transform the gas.<sup>124</sup> In retrospect, plaintiffs would have been better off fighting for marketability to be left as a fact issue, not couched as the legal issue that they erroneously thought would let

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122. *Fawcett*, 352 P.3d at 1036.

123. *Id.* at 1036–37.

124. See, e.g., Brief of Appellee Class at 1, *Fawcett v. Oil Producers, Inc. of Kan.*, 306 P.3d 318 (Kan. Ct. App. 2013) (No. 108666-A), 2013 WL 360450 [hereinafter *Fawcett* Brief of Appellee Class] (arguing that in Kansas lessees must “produce the raw gas and transform it into marketable products”); *id.* at 28 (interpreting *Sternberger* holding as explained by fact that “nothing was done that would physically ‘transform’ the gas”); *id.* at 44 (claiming that “[a] marketable gas product is not determined by a paper sale, but by a physical transformation” (citing *Sternberger*, 894 P.2d at 788)); *id.* at 49–50 (“lessee must also bear the entire cost of putting the gas in condition to be sold pursuant to the court-made ‘marketable condition rule’” (citing *Coulter*, 292 P.3d at 306)).

One sign that physical transformation was not likely to be the test is that even the *Fawcett* plaintiffs seemed to concede that only certain kinds of transformations should generate the shield of non-deductibility. They went out of their way to argue that the services at issue did not change the “quality” or “chemical composition” of the gas, but only made it marketable, or, in another phrase, “condition[ed]” it for sale. *Id.* at 15, 40. Whether they drew this distinction to make a point in response to OPIK’s timber analogy or from an intuitive concern that chemical transformation is too much like manufacturing and too little like a field service, it is hard to explain why some physical transformation services should generate lessee-only costs but too much physical transformation and the costs become a shared expense. See *infra* note 187 & accompanying text; see also *In re Am. Warrior*, 43 P.3d 828, 831 (Kan. Ct. App. 2002) (finding pressurizing natural gas to split “unmarketable natural gas into marketable helium, nitrogen, and marketable natural gas” to be a manufacturing process for purposes of Kansas ad valorem ten-year tax exemption for companies engaged in “transforming, refining or combining materials and labor to convert tangible personal property from one form to another”). The answer to the transformation puzzle should be that it is not physical transformation in the abstract, but physical transformation in relation to where gas is marketed, that determines the nature of the charge for royalty purposes.

them prevail.

The trial court granted the plaintiffs' Motion and thus defined marketable gas as (mainline) pipeline-ready gas. The Kansas Supreme Court accurately characterized the plaintiffs' position as "that natural gas, *as a matter of law*, is not marketable for purposes of these oil and gas leases until it enters an interstate pipeline."<sup>125</sup> The issue up for decision on appeal was whether the trial court was correct in deciding *as a matter of law* that the gas was not marketable at the well, but instead only when it entered interstate pipelines.

One of the clear holdings in *Fawcett* is that it rejected this categorical standard. "Notably absent" in prior Kansas Supreme Court cases, according to the decision, "is any discussion of a precise quality or condition" at which gas becomes marketable.<sup>126</sup> The factual nature of this question did not change in *Fawcett*; here, too, "[w]hat it means to be 'marketable' remains an open question."<sup>127</sup> The court held that "the answer is not simply, as *Fawcett* would have us hold, interstate pipeline quality standards or downstream index prices."<sup>128</sup> It did not say more, other than announcing that the service arrangements in the record looked like sales to it and so should be treated as demonstrating the marketability of the particular *Fawcett* gas. In general, marketability remains a fact issue in Kansas.

### III. BUT FAWCETT NARROWS APPLICATION OF THE KANSAS MARKETABLE-PRODUCT RULE.

*Fawcett* did work one major change in Kansas law: the court's decision to transmute a service-arrangement-with-sales-aspects into a sales agreement. With no discussion of the implications of its decision, the court allowed a lessee to create a wellhead location for valuation merely by entering service arrangements with some characteristics of wellhead sales contracts.

*Fawcett* also suggests that if the Colorado marketable-product rule would bar deduction of transportation costs on *Fawcett*'s facts (yet Colorado, too, would not bar deduction if its courts agreed with the

125. *Fawcett*, 352 P.3d at 1036 (emphasis added); *see also id.* at 1039 ("Fawcett claims raw natural gas sold at the well is not marketable as a matter of law or fact until it is processed and enters an interstate pipeline, . . ."); *id.* at 1041 ("[marketability] is not simply, as *Fawcett* would have us hold, interstate pipeline quality standards or downstream index prices").

126. *Id.* at 1041.

127. *Id.*

128. *Id.*

Kansas Supreme Court's novel holding that OPIK's wellhead arrangements are true sales), then Kansas law would not agree. This seemed to be a signal that the court is abandoning its recent hint that Kansas, like Colorado, will require the lessee to bring gas to a marketable location at its own expense even if the gas already is in a physical condition suitable for final sale. Given that the court did not care to give its opinion on what the Colorado rule actually would require in this situation (if a Colorado court determined that gas was marketable under a service-cum-some-sale-aspects arrangement at the well), it is impossible to decide how much of a change this dictum might foretell.

A third area of possible change is the *Fawcett* court's dictum on "at the well" terms. Part II.B has argued that the court did not provide the reasoning that would be needed to abandon Kansas' existing standard on such terms, including their subservience to the lessee's duty to first produce a marketable product.

#### *A. Fawcett Rejected Plaintiffs' Pipeline-Quality Theory.*

A new principle in *Fawcett*, but one not at all surprising under prior Kansas law, is that marketable gas will not be equated with pipeline-quality gas as a matter of law. As discussed in Part II.G *supra*, plaintiffs argued that marketable gas is synonymous with gas brought into interstate-pipeline quality; the court held instead that marketability remains a fact issue. In hindsight, the class would have been better off to fully develop a record of why OPIK's service arrangements are not really sales, rather than trying to get the court to treat qualification for any particular sales point as synonymous with marketability in all cases as a matter of law. But the law existing at the time of *Fawcett* suggested that the case would be decided by requiring payment on the gross proceeds of the service-and-sales arrangements, so the need to question the nature of the service arrangements in detail is only plain in hindsight, as is, of course, often the case when a court changes the law.

#### *B. Fawcett Accepted a Wellhead Service Arrangement With Sales Aspects As An Ordinary Sale for "Proceeds" Purposes.*

The most significant and controversial holding in *Fawcett* concerns its treatment of the service-and-sales arrangement between OPIK and the four service companies. The leases at issue were "proceeds" leases with

“at the well” or “well mouth” references.<sup>129</sup> Unfortunately, the true nature of the agreements may never be fully public. While the contracts are summarized in the briefs and decisions, they themselves are confidential.<sup>130</sup> The full details of characterization are thus unavailable.

The contracts’ substance, though, is largely known, even if not all of the specific terminology, headings, exceptions, and other terms that a lawyer also would want to consider if asked to fully analyze the arrangements. The lessee, OPIK, transferred the gas at the well to various third party “midstream” companies that provided field services to alter and move the gas, and these third parties passed on to OPIK the great bulk of what they received when they later sold the gas downstream.

The service companies charged OPIK for rendering field services that the industry ordinarily views as marketability services. Indeed, the payments and purpose of the arrangements are almost certainly tied to their field services, not sales services. The price began with a gross price received when the midstream companies sold the gas in downstream markets after the gas was processed to separate the liquids from dry gas. The companies deducted costs for a variety of field services and thus reduced the revenues paid to OPIK.<sup>131</sup> Each purchaser deducted some amounts for the marketability services it provided OPIK, including deducting costs for services that one purchaser called “gathering” and another called “transportation.”<sup>132</sup> Depending upon the purchaser, the costs were deducted by a proportionate reduction in the base downstream price (one based upon a percentage-of-index (POI) downstream value, a downstream proceeds (POP)), or a reduction in base volumes, as well as

129. The *Fawcett* leases are called “Waechter” or “two-prong” leases. The defendants alleged that 48 different lease forms existed in *Waechter v. Amoco*, 537 P.2d 228, 240 (Kan. 1975), but the case has given its name to one of these many lease forms: two-prong leases are now described in Kansas as “Waechter” leases. See *Smith v. Amoco Prod. Co.*, 31 P.3d 255, 268 (Kan. 2001).

These *Waechter* leases provided for payment on “proceeds” or “proceeds thereof at the mouth of the well” if the sale occurred at the well, and “market value at the well” if away from the well. The court of appeals described the two proceeds variants cited in text as representative of the 25 pertinent leases. *Fawcett*, 306 P.3d at 319–20. OPIK argued that because it transfers title at the well, the sale is at the well, and that because it pays royalty on all the money—the “proceeds”—it actually receives, it has satisfied its lease obligation. It pointed out that it pays the royalty share on all proceeds it receives from the “first purchasers.” For OPIK’s first-purchaser argument, see *infra* notes 263–66 & accompanying text.

130. E-mail from Barbara Frankland, one of *Fawcett* Plaintiffs’ counsel, to author (July 27, 2015) (on file with author).

131. *Fawcett*, 306 P.3d at 319–20.

132. See *supra* notes 31–35 & accompanying text.

certain fixed-fee deductions.<sup>133</sup>

*Fawcett* thus presented the Kansas Supreme Court with a twist on the normal marketable-product case because OPIK, which calls itself “primarily a contract operator,”<sup>134</sup> was delegating its marketability responsibility when it transferred title on the lease to the field-service companies who made the gas marketable even as they appeared to “buy” the gas. The arrangement let OPIK claim that outsourcing marketability services made the related costs deductible. Accepting this argument, as the court did, means that in this market configuration, at least when leases have “at the well” terminology, deductions can be taken back to the well in Kansas just as in Texas. Yet the exchanges that OPIK claimed as sales were transactions in which OPIK retained most of the risk and most of the potential gain surrounding the downstream sales price.

OPIK argued that its at-the-well transactions with the service companies were sales and that the price it received should be treated as ordinary sale “proceeds.”<sup>135</sup> The plaintiffs disagreed, claiming that the wellhead contracts actually incorporated a first arm’s-length price at the point of downstream sale, not at the well. To the plaintiffs, the agreements were built around payments for the field services that typically establish marketability, even if the agreements were structured in some ways as sales, and the gas did not find a true buyer until sold downstream. Plaintiffs therefore argued that payment had to be on the gross (downstream) price in the sales agreements without deduction of marketability costs.<sup>136</sup>

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133. See *Fawcett*, 306 P.3d at 320. The briefs discuss the service arrangement payments as based upon a “Percentage of Proceeds” basis, which means, not surprisingly, payment was on an agreed share of the proceeds, 8 HOWARD R. WILLIAMS & CHARLES J. MEYERS, MANUAL OF OIL AND GAS TERMS 751 (Patrick H. Martin & Bruce M. Kramer eds., 13th ed. 2006), or on a “Percentage of Index,” which is a percentage off a published index price. *Fawcett* Brief of Appellant, *supra* note 31, at 5–6. In addition, at least some purchasers also deducted a fixed fee for certain services. *Id.* at 5 (describing in addition to percentage of proceeds reduction “certain adjustments, for instance for ‘Gathering and Compression Fees’”). The Appellee class listed four ways in which they claimed OPIK agreed to let one or more of the purchasers reduce the gas sales price. *Fawcett* Brief of Appellee Class, *supra* note 124, at 10 (percentage of proceeds reduction, percentage of index reduction, volumetric deductions for fuel use or loss, and keeping products like drip condensate or helium); see also *id.* at 11 (listing ONEOK plant statement showing 8% reduction in residue and liquids recovery as well as gathering fee). For added discussion of the wellhead arrangements, see *supra* notes 31–35 & accompanying text.

134. *Fawcett* Brief of Appellant, *supra* note 31, at 11.

135. *Id.* at 3 (OPIK claiming that any sale to “first purchasers” satisfies duty to market).

136. *Fawcett* Brief of Appellee Class, *supra* note 124, at 9–11, 41–42, 46–47. Appellees even cited excerpts from 10-K reports of three of the four “purchasers” in which these companies described the kind of services they provided as necessary to make gas marketable or at least pipeline

OPIK's sales contracts transferred title "on the lease," but the prices were not set there. Instead, they came from the downstream market after processing, a point after the gas had been subjected to the physical services that make it marketable.<sup>137</sup> In the context of the lease and the ordinary Kansas duty to market, the marketability services reflected in the deductions were OPIK's responsibility. OPIK used a service-plus-sales structure to shift performance to the gas buyers. Therefore, the question as the plaintiffs saw it became whether a lessee can make the lessor pay for marketability services by delegating its responsibility to someone else.

When the trial court granted partial summary judgment for the class, it rejected OPIK's position as one that elevated form over substance. To the court, OPIK was not free to deduct the cost of services needed to produce a marketable product under a lease requiring it to pay royalty on "proceeds . . . at the well" even though the gas may nominally have been sold at the well.<sup>138</sup> The sales price paid to OPIK and used in royalty computations still was the downstream, after-plant index price, from which the purchaser deducted the costs of making the gas pipeline ready.<sup>139</sup> In other words, even this purported at-the-well price was based as a starting point on the sales prices received at points beyond the gas plant, after all marketability services had been performed, not at the well.

The Kansas Court of Appeals agreed that the challenged deductions were impermissible given the lease language and Kansas' marketable-product precedent. It found that "no express provision was made for deductions in the leases in question."<sup>140</sup> It too rejected the argument that a lessee can avoid bearing marketability costs by structuring a service contract to have a sales aspect so that the buyer, instead of the lessee,

ready, *id.* at 33–34, although only one of the three companies, ONEOK, expressly used the term "marketable" in the cited language. See *supra* note 29 for citation to a summary arguably reflecting an industry consensus on field services needed to create marketable natural gas and liquids (table prepared by Oklahoma engineer Dan Reineke, a frequent expert on the plaintiffs' side in deduction cases).

137. For OPIK's description of how its sales contracts operate, see *Fawcett* Brief of Appellant, *supra* note 31, at 5–6, 12–14.

138. For the lease language and granting of summary judgment, see *Fawcett*, 306 P.3d at 319–20.

139. *Id.* at 320. The deductions varied slightly, at least in description, by purchaser: one company attributed its deductions to gathering, compression, and dehydration costs; a second called them "a gathering fee, a conditioning fee, and a fuel reimbursement fee;" a third "all third-party costs, fees, and charges incurred that were associated with selling the gas, including treating, gathering, transporting, and compressing fees." *Id.* The court of appeals' decision does not specify the costs deducted by the fourth purchaser. *See id.*

140. *Id.* at 322–25.

deducts service costs from the selling price.<sup>141</sup> The court of appeals couched the fundamental issue as whether OPIK “can avoid its obligations under the implied duty to market the gas by negotiating and contracting with a gas purchaser for a gross sale price of the gas sold at the well and then allow the gas purchaser to deduct from that gross sale price any amount used to compress, dehydrate, treat, and gather the gas.”<sup>142</sup> Like the trial court, it viewed the issue as whether OPIK could do indirectly what it could not do directly,<sup>143</sup> a key question that, somewhat bizarrely, the Kansas Supreme Court did not even mention.<sup>144</sup>

The Kansas Supreme Court, reversing, ignored the service aspects of OPIK’s wellhead arrangements, and thus all issues of form over substance. It never mentioned the questions raised as to when a responsibility can be extinguished merely by changing the form of a service agreement. Instead, it treated the wellhead exchange as if it was

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141. *Id.* at 325–26. A case in the Western District of Oklahoma also considered whether a lessee should be able to offload its responsibility by negotiating a lower sales price with a third party who agrees in turn to bear a cost the lessee is supposed to pay vis-a-vis its royalty owners. *Naylor Farms, Inc. v. Anadarko OGC Co.*, No. CIV-08-0668-R, 2011, WL 7053787 (W.D. Okla. July 14, 2011). In *Naylor*, lessee QEP sold raw gas at the well to a third party, DCP Midstream (one of the service companies in *Fawcett*, too; see *supra* note 31 & accompanying text), a company that extracted a percentage of the liquids and dry gas as its processing charge. *Id.* at \*1. QEP paid royalty on the volume-reduced revenue stream. It moved for summary judgment, arguing it was entitled to pay royalty on these lower volumes. Some of the leases provided for pricing “at the well,” and the court granted the motion on those leases, because it believed they did allow deductions for costs incurred away from the well and so preempted the general Oklahoma marketable-condition rule. *Id.* at \*3. This assumption that the term “at the well” allows deductions of post-production costs is incorrect under Oklahoma law, as *Naylor*’s author, Judge Russell, concluded the following year in *Hill v. Kaiser-Francis Oil Co.*, No. CIV-09-07-R, 2012 WL 4327665, at \*2 (W.D. Okla. 2012). But even in *Naylor*, Judge Russell agreed with the plaintiffs that on leases without an at-the-well reference, the lessee could not shirk its duty to pay for making gas marketable by selling the gas as raw gas and letting the buyer perform those services:

While a lessee may hire a third party to perform the processes necessary to make gas marketable . . . , the lessee may not deduct the costs incurred for such third party’s services from amounts paid the lessor(s) or royalty owner(s) but must compute the royalty interest(s) based upon the amounts paid by the interstate pipeline for the residue gas and NGLs unreduced by the amount or percentage of proceeds paid to the third party.

*Naylor*, 2011 WL 7053787, at \*3. In other words, a lessee cannot structure its marketing to avoid its duty to bear the costs of making gas marketable in marketable-product jurisdictions.

Federal regulations prevent price reductions (for royalty purposes) that offload the cost of field services into the sales contract. They require increasing gross proceeds by any amount by which the buyer has reduced the price to compensate it for services it undertakes to make the gas marketable. 30 C.F.R. § 1206.152(h)(i) (2013) (unprocessed gas); *id.* § 1206.153(h)(i) (processed gas and liquids (“plant products”)).

142. *Fawcett*, 306 P.3d at 325.

143. *Id.* The court of appeals also relied heavily on the Kansas Court of Appeals decision in *Davis v. Key Gas Corp.*, 124 P.3d 96, 106 (Kan. Ct. App. 2006), discussed *infra* note 159.

144. The Kansas Supreme Court did mention the court of appeals’ reliance upon *Key Gas*, but it did not address that case further, either. *Fawcett*, 352 P.3d at 1037–38.

an ordinary sale and repeatedly called the service companies “third-party purchasers,” their activity “purchases,” the proceeds “sales” “proceeds,” and the expenses “post-sale” expenses. It never addressed the argument that the sales aspects were really just the surface covering of a service arrangement.<sup>145</sup> It tried to bolster its assumption that these were just sales and that it was dealing with ordinary third-party buyers by noting that “the [court of appeals] panel agreed that the gas was sold at the well,” under leases requiring royalties to be paid on “proceeds from wellhead sales,”<sup>146</sup> and that the panel “concluded: ‘As a result, the geography of the sale of gas was at the well and the geography for calculation of the royalty was at the well.’”<sup>147</sup> To further emphasize the point, it added that “[t]he parties [by which it really meant plaintiffs, because obviously OPIK wasn’t going to object] have taken no exception to the panel’s conclusions in this regard.”<sup>148</sup> But surely no one involved below had reason to believe that the court of appeals’ nominally discussing the wellhead transactions as sales meant that it thought the arrangements were sales in substance. The court of appeals clearly understood that these were not ordinary sales, that the arrangements had other overriding purposes, and it treated the arrangements as primarily about marketing services, not sales. In other words, unlike the trial court and the court of appeals, the supreme court refused to look beyond the form of the arrangements to their substance. Once it made this decision, everything else it wrote was a foregone conclusion.

Moreover, although its narrow holding only reverses the summary judgment granted to the class, the supreme court categorically treated the service-sale agreements as sales. It could have simply stated that the case would be remanded for resolution of any issues involving good faith and the duty to market—a remand that would have been consistent with the supreme court’s emphasis upon marketability being a factual

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145. These terms and minor variants of “purchase” and “sale” appeared over 50 times in *Fawcett* as the court described the facts and its decision. It cited the court of appeals three times for the proposition that the wellhead arrangements were sales. *Fawcett*, 352 P.3d at 1034, 1037, 1039. It did also mention the trial court’s holding that OPIK could not avoid its duty to bear marketing costs by contracting with third parties to provide the services, *id.* at 1037, and the court of appeals’ similar conclusion, *id.*, but it never really dealt with those parts of the lower-court decisions. The Kansas Supreme Court did not give any weight to the service aspects of the wellhead arrangements, instead being content to just classify the overall arrangement as a sale arrangement. It thus avoided serious discussion of the very issue that proved determinative for the lower courts.

146. *Id.* at 1037, 1039.

147. *Id.* at 1039.

148. *Id.*

matter.<sup>149</sup> Instead, it labeled one particular kind of marketing arrangement as a true sale without explaining why it gave no weight to the numerous nonsale aspects of the arrangement.

The outcome in *Fawcett* is surprising not only because the Kansas Supreme Court failed to address the true substance of the agreements (the very issue that drove both lower court decisions), but also because it is so contrary to the court's recent decision in *Hockett v. Trees Oil Company*.<sup>150</sup> A core holding in *Hockett* is that when a lessee with a "proceeds if sold at the well" lease enters a gas sale agreement that allows the buyer to take deductions from the gross sales price, the lessee nonetheless has to pay royalties on the gross sales price, not the net price, and the lessee cannot use the buyer's reductions in the sales price to reduce royalty payments as well. *Fawcett* seems to have discarded this holding without acknowledgement, resulting in its death (or at least large loss of vitality) without a burial.

The *Hockett* dispute concerned primarily whether the Kansas severance tax covers helium and who bears a statutory conservation fee, but it included a lease issue as well.<sup>151</sup> The trial court and court of appeals held that the lessee is supposed to bear the conservation fee.<sup>152</sup> Having lost on its argument that the pertinent statute envisions lessors sharing the fee, Trees Oil Company claimed that the lease gave it a contractual right to deduct a share of the fee from the royalty interest. The company argued that it sold its gas at the well and that the "'one-eighth of the proceeds if sold at the well'" royalty clause in the 1941 lease embodied an agreement that conservation fees could be deducted because, after all, Trees Oil did not get to keep the money reflecting those deductions.<sup>153</sup>

Just as OPIK later would argue in *Fawcett*, so Trees Oil argued that

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149. The Kansas Supreme Court several times phrased the issue in *Fawcett*, and the context of its holding, as whether gas had to be pipeline-ready to be marketable as a matter of law. See *supra* notes 125, 128 & accompanying text. But at other points, as when it noted that the court of appeals panel found the arrangement a sale and that no one challenged that conclusion, and when it rejected in at least one sense the idea that Kansas requires more than a sale to prove marketability, see *supra* notes 145–48 & accompanying text, the court seemed to be finding the arrangement adequate to prove marketability as a matter of law. It will require remand to know whether the class will challenge the four wellhead service-and-sale arrangements under the duty of good faith and the duty to market. (The Kansas Supreme Court found no such challenge in the record. *Fawcett*, 352 P.3d at 1042.).

150. 251 P.3d 65, 72 (Kan. 2011).

151. *Id.* at 67.

152. The court held that complaints about the severance tax extending to helium had to be addressed to the Kansas Department of Revenue. *Id.* at 68–69.

153. *Id.* at 71.

“proceeds” means “money . . . actually receive[d],” the “amount of cash-in-hand it receive[d] from the first purchaser . . . .”<sup>154</sup> Because its sales agreements allowed deduction of the conservation fee to compute the sales price it was paid, said Trees Oil, the resulting net value was the proper basis for its royalty payments under its lease as well.<sup>155</sup> And, claimed Trees Oil, because the purchasers deducted the conservation fees before paying Trees Oil, it did not receive any “proceeds” embodying conservation costs.<sup>156</sup> In other words, its “proceeds” were the net price. With the sales contract leaving it to the purchasers to deduct those fees, Trees Oil argued that the only proceeds it actually received was the net amount after deduction of the conservation fees from the gross contract price.<sup>157</sup>

The Kansas Supreme Court rejected this argument. It held that because royalty owners cannot be assessed the conservation fee directly (per the statute), lessees could not take the deduction indirectly via the lease.<sup>158</sup> The court refused to read an unexpressed deduction into proceeds leases. In spite of the applicable “at the well” language, “proceeds” in application meant:

the **gross sale price in the contract** between the first purchaser and the lessee/producer/seller . . . If the lessee claims that it is entitled to compute and pay royalties based upon an amount less than the gross sale price, **it must find the authority to do so somewhere other than in the lease’s royalty clause.**<sup>159</sup>

154. *Id.*

155. *Id.* at 68–69, 72.

156. *Id.* at 67.

157. *Id.* at 71.

158. *Id.* at 70–71.

159. *Id.* at 72 (emphasis added). Thus in Kansas, the unadorned term “proceeds” means the “gross sales price,” true gross proceeds, and not a net price. The key issue in *Hockett* turned on who bears the imposition of a conservation fee and the tax issue, but the court also articulated the meaning of “proceeds . . . at the well,” as the cited text shows.

In 2006, a Kansas Court of Appeals case similarly rejected a lessee’s effort to reduce the royalty payment by shifting marketability services and their costs to the gas buyer in a lease with an express no-deduction clause. *Davis v. Key Gas Corp.*, 124 P.3d 96 (Kan. Ct. App. 2006). The buyer had reduced the sales price as compensation for providing these services. *Id.* at 106. The lease specified that “[l]essor shall bear no costs of gas treatment, dehydration, compression, transportation or water hauling.” *Id.* at 100. It provided as well that the lessor would receive its “proportionate royalty share of all monies received . . . including any premiums, rebates and refunds of any kind or nature . . . .” *Id.* Key Gas sold the property’s output to ONEOK for 98% of a downstream index price minus (in addition to the discount) seven fees, including those for compression, gathering, dehydration, treating, and “conditioning.” *Id.* Key Gas argued, like OPIK in *Fawcett*, that it was paying on the full proceeds it received. *Id.* The court required Key Gas to pay royalties on the full, undiscounted price without the deductions. *Id.* at 104–06. It made this decision by relying both on

In other words, Trees Oil could not by contract or arrangement with its purchasers convert deductions not otherwise authorized into legitimate deductions from royalties and could not try to use sales arrangements to make costs not otherwise deductible suddenly acceptable. There had to be authorization for the deduction “somewhere other than in the lease’s royalty clause”<sup>160</sup>—somewhere beyond the classifications in the purchase-and-sale contract, too—authorizing any reduction in royalty. Nothing the court said suggested it intended this principle to apply only to the legislatively mandated conservation fee.

Another notable aspect of *Hockett* for the line of marketable-product authority that began with *Gilmore* is that the Kansas Supreme Court once again did not let the term “at the well” authorize deductions that were not specifically authorized in the lease, even though the lease provided for royalty payment on “one-eighth of the proceeds if sold at the well.”<sup>161</sup> *Hockett* thus confirmed that in Kansas, as in other marketable-product jurisdictions, the term “at the well” is not sufficient to alert royalty owners to the fact that specific deductions will be taken and thus to authorize such deductions.<sup>162</sup> As discussed in Part II.B, this rule should be unchanged by *Fawcett*, in spite of its too-casual language about the term “at the well.”

*Hockett*’s most notable aspect, though, is that the form of the lessee’s gas sales arrangement was not allowed to reduce lessor rights. The lessee of course is always free, within the economic constraints between it and the buyer and the boundaries of the law generally, to structure a sales contract any way it wants. One of the lessons of *Hockett*, though, is that even when applying a proceeds principle, a lessee cannot reduce the lessor’s right to payment on a marketable product by having certain costs

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the “bear no costs” deduction language and also on the payment language, which it read to mean payment “which included any payments that were disguised as something other than oil and gas production payments.” *Id.* at 104. When Key Gas entered its sales contract with ONEOK, it “surrendered control of the transportation costs and other expenses,” even though Key Gas had agreed to protect the plaintiffs from bearing those costs. *Id.* The court treated Key Gas’ elimination of the lessors’ protection against deductions as an unjust thwarting of a contractual condition. *Id.* at 105. Although in *Davis* the ban on deductions is an express contract term, the court of appeals’ focus on substance, not form, seemed another sign that OPIK was likely to lose in *Fawcett*.

160. *Hockett*, 251 P.3d at 72.

161. *Id.* at 71–72.

162. The rejection of the argument that merely stating “at the well” is sufficient to authorize deductions is a common thread through the leading royalty-deduction marketable-product decisions as issued by the supreme courts of Colorado, West Virginia, and Oklahoma as well as Kansas. See *supra* note 21 & accompanying cases. In states that have reached the opposite conclusion, Texas particularly, “at the well” is given strong weight as a term authorizing all deductions away from the well. See *infra* note 223 for a discussion of a case embodying the current Texas standard.

the gas purchaser takes in computing the price paid to the lessee treated as deductions just because they may be deducted in whatever sales contracts the lessee chooses to enter.<sup>163</sup>

*Hockett* rejected the attempt to shift a lessee obligation onto the lessor using the form of the gas purchase agreement.<sup>164</sup> Yet in *Fawcett*, the court let OPIK do just that. Unless lessees can show bad faith or breach of the duty to market, Kansas lessees now can gain substantial monetary advantages through reduced royalty payments if they outsource field service operations and cloak their outsourcing with a sale-like structure.

Under *Hockett*, as under prior Kansas law, the lessee should bear all marketability costs unless the lease expressly says otherwise. The proceeds leases in *Fawcett*, though having “at the well” limitations, did not authorize specific deductions and under Kansas law did not negate its marketable-product rule. *Hockett* required payment on the gross price, not a price whose computations net out the cost of making gas marketable. Taking the leading Kansas case *Sternberger v. Marathon* to mean what it says, namely, that no service costs are deductible until the gas is marketable,<sup>165</sup> one would have expected *Fawcett* to parse form for substance and at least allow the class to proceed to trial with marketability a disputed fact, or even to affirm as a matter of law.

With or without any guidance from *Hockett*, there certainly was a factual basis for treating the *Fawcett* service agreements as mere service arrangements and not true sales. The economic reality looming through OPIK’s sales contracts is that the “purchasers” are more service providers than true buyers. If downstream prices fell, OPIK and the royalty owners would suffer most of the pain. If the prices rose, they would enjoy most of the pleasure. The *Fawcett* trial court noted that the “parties sometimes refer to the contracts as gas purchase contracts, gas conditioning service contracts, or both.”<sup>166</sup> It is easy to see why the trial court felt that one important legal principle was that the “[d]efendant can’t do indirectly what it can’t do directly.”<sup>167</sup> Yet the Kansas Supreme Court paved the way for it to do just that.

The new rule can create a variety of irrational distinctions. Had

163. See *Hockett*, 251 P.3d at 72.

164. See *id.*

165. See *supra* notes 61–62 & accompanying text. The quirky setting in which *Sternberger* arose is discussed *infra* note 225.

166. *Fawcett* Partial Summary Judgment Order, *supra* note 36, at 4, ¶ 18.

167. *Id.* at 10, ¶ 55.

OPIK itself prepared its gas for sale at the downstream location that provides the gross price in its sales contract and sold it there, it would have to pay royalties on the full proceeds and absorb the marketing costs. Had it hired an independent third-party service company to do so, but only paid it a fee while itself selling the dry gas and liquids, it would have had to pay royalties on the full proceeds and absorb the marketing costs. Thus had it kept title and sold the gas, but paid the four midstream companies on exactly the same basis, it still would have owed royalties on the full downstream prices. It is merely because OPIK hired a company to provide those services but transferred title to the gas at the well—even though retaining the great bulk of the economic value for itself—and used a partial sale structure in an agreement in which the services the buyers provided were field services, that it was allowed to deduct a share of the service costs from the royalty interest.

The *Fawcett* court tried to surmount *Hockett*'s requirement of payment on a gross price under a proceeds lease by claiming that *Hockett* only concerned a "state-assessed conservation fee," and to contrast *Fawcett* as concerning a net value that "more clearly represent[s] a negotiated sale price for the gas."<sup>168</sup> But this is hardly a persuasive distinction. What the parties negotiated in *Fawcett* was an arrangement in which they traded a variety of field services for some fees and a small portion of the sales price or volumes, the great bulk of the revenues for which went back to OPIK. The arrangements were service arrangements that used a small part of the sales price to pay for services rendered by the supposed buyers.

*Hockett* discouraged trying to use a sales strategy to undermine proceeds leases. It stands for the principle that even in proceeds leases, the court will parse form for substance in order to protect legitimate lessor interests. *Fawcett* elevates form over substance at the expense of lessor interests.

### C. Fawcett Included Inapplicable Dictum on Gas Movement Costs.

Until *Fawcett*, it appeared that the Kansas Supreme Court was ready to add gas movement to the list of services that the lessee must provide at its sole expense as part of the duty to market, even if no other services were provided. Such a rule would reverse the holding in *Sternberger*. Instead, in one of the strangest aspects of the *Fawcett* decision, it discussed the Colorado standard, which does treat gas movement costs to

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168. *Fawcett*, 352 P.3d at 1039.

the point of marketability as an independent lessee responsibility, as if the court was rejecting that gas movement part of Colorado's rule, but did so in a context in which Colorado, too, would have allowed deductions if it shared *Fawcett*'s interpretation of the wellhead arrangements.

Early Kansas cases, almost entirely oil cases, did treat "transportation" to "distant" markets as deductible.<sup>169</sup> In spite of a certain carelessness in separating gathering from transportation, by the time of *Sternberger* it was clear that the cost of moving gas to locations where marketability services are provided generally is not deductible. The lessee bears the sole expense of making the product marketable, and unless the lease says otherwise, the royalty owner "is not obligated to bear any share of production expense, such as compressing, transporting, and processing, undertaken to transform gas into a marketable product."<sup>170</sup> The movement costs in *Sternberger* were deductible only because of the quirky fact that the gas, though sold downstream, apparently was not changed in any way other than movement between the wellhead and the downstream point of sale.

In a judicial universe in which marketable-product jurisdictions have been highly conscious of each other's decisions, the Colorado Supreme Court went on record in *Rogers v. Westerman Farms Co.* as holding that the duty to market includes moving gas to the market location as well as physically putting the gas in a condition for sale.<sup>171</sup> Had the *Sternberger* dispute arisen in Colorado under that rule, Marathon Oil would have had to bear the cost of moving the gas on which it paid royalties to the Sternbergers to the point of sale. The broad standard of the West Virginia Supreme Court makes it likely to reach the same conclusion.<sup>172</sup>

In 2013, the Kansas Supreme Court suggested that it would take the same approach, too. In *Coulter v. Anadarko Petroleum Corp.*,<sup>173</sup> the Kansas Supreme Court cited *Sternberger*'s equation of Kansas law with Colorado law and acknowledged that Colorado now required the lessee not only to put gas into a marketable physical condition but also *to bring*

169. See *infra* Part III.E.

170. See *Sternberger*, 894 P.2d at 799–800.

171. *Rogers v. Westerman Farm Co.*, 29 P.3d 887, 905–06 (Colo. 2001) (en banc).

172. In West Virginia, unless a proceeds lease very clearly says otherwise, the lessee has to bear "all costs incurred in exploring for, producing, marketing, and transporting the product to the point of sale." *Wellman v. Energy Res., Inc.*, 557 S.E.2d 254, 265 (W. Va. 2001). To deduct costs, the lease must "provide that the lessor shall bear some part of the costs[,] . . . identify with particularity the specific deductions the lessee intends to take[,] . . . and indicate the method of calculating the amount." *Estate of Tawney v. Columbia Nat. Res., L.L.C.*, 633 S.E.2d 22, 30 (W. Va. 2006).

173. 292 P.3d 289 (Kan. 2013).

*the gas to a location where it can be sold.*<sup>174</sup> The *Coulter* court mentioned Colorado law favorably, stating that *Sternberger*, “[n]otwithstanding some inconsistencies in prior [Kansas] holdings,” adopted Colorado law as that law then existed via its articulation in *Garman v. Conoco, Inc.*<sup>175</sup> (decided the year before *Sternberger*).<sup>176</sup> *Garman* held that if the lease is “silent as to how post-production costs are to be borne,” the royalty owner (in *Garman*, owner of an overriding royalty) does not have to bear a proportionate share of “post-production” costs, “such as processing, transportation, and compression [costs] . . . .”<sup>177</sup>

*Garman* was a 1994 *en banc* decision of the Colorado Supreme Court—*Sternberger*, a 1995 decision of its Kansas counterpart. In 2001, over a decade before *Coulter* but after *Garman*, the Colorado Supreme Court explicitly held that in Colorado marketability does indeed require bringing gas to a marketable location, not just putting it in a marketable condition, and criticized what it took to be Kansas’ contrary position.<sup>178</sup> Thus in Colorado, even if gas is in a physical condition to be marketed (say, at an upstream location), the lessee still must pay all costs of getting the gas to market. In Colorado, contrary to *Sternberger*, the lessee has to move gas that may already be physically marketable to the marketplace at its own expense.

The *Coulter* court seemed to be signaling its readiness to amend the Kansas rule to track Colorado’s updated rule, thus independently requiring the lessee to pay to get gas to market. It admitted that its sister court in Colorado “ha[d] subsequently disapproved” of what it had taken as *Sternberger*’s marketability holding, which refuses to treat transportation services as part of marketing expenses when the gas is physically marketable at the well.<sup>179</sup> (*Sternberger*’s at-the-well

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174. *Id.* at 305–06 (stating that, on the connection between Colorado and Kansas law, *Sternberger* “discerned that the law in Kansas was the same as that stated by the Colorado Supreme Court in *Garman v. Conoco*”). In 2001, twelve years before the Kansas decision in *Coulter*, the Colorado Supreme Court held that marketability requires gas to be (1) physically marketable and (2) moved to a location where it can be sold. *See Rogers*, 29 P.3d at 905. In the Colorado Supreme Court’s pragmatic holding, gas must be in a physical condition “acceptable to be bought and sold in a commercial marketplace,” but marketability concerns “location” as well as “condition.” *Id.* Under this test, “[i]t may be, for all intents and purposes, that gas has reached the first-marketable product status when it is in the physical condition and location to enter the [mainline] pipeline.” *Id.*

175. 886 P.2d 652 (Colo. 1994).

176. *Coulter*, 292 P.3d at 305–06 (citing *Sternberger*, 894 P.2d at 800).

177. *Garman*, 886 P.2d at 661 (emphasis added).

178. *Rogers*, 29 P.3d at 899, 905.

179. *Coulter*, 292 P.3d at 305–06. The *Coulter* court noted that Kansas courts previously had adopted the Colorado rule, and that in *Rogers*, the Colorado Supreme Court rejected what it called

marketability is quite a metaphysical phenomenon, given that there was no market at the well). *Coulter* suggested that *Sternberger*'s isolation of gas movement from other marketability services soon would disappear from Kansas law.

In *Coulter*, the court only was required to determine whether the trial court had abused its discretion by approving a settlement. It therefore did not need to actually decide questions of substantive royalty law. But it did discuss substantive law, and when it did, it expressed doubt about the part of *Sternberger* that allowed deductions for getting gas to market. It conceded that under the Colorado standard, *Sternberger*'s "holding that gas can be in marketable condition at a point at which no market exists may be questionable."<sup>180</sup> The *Sternberger* holding is not just questionable under Colorado law: it is wrong. This phrasing suggested that the Kansas court was ready to join its Colorado counterpart.

In *Fawcett*, though, the Kansas Supreme Court discussed the Colorado rule as if it disagreed with it. When one looks at the setting the court was discussing, though, it is one in which the two rules should not disagree. As the Kansas high court interpreted it, *Fawcett* did not present a *Sternberger* situation in which gas was physically marketable at the well but needed to be moved to a market location. The court instead found that gas was marketable *and sold* at the wellhead, so under the court's reading of the facts there was no separate question about gas movement or location at all. Yet the court held that "[t]o the extent *Rogers* concerns the royalty due on gas sold at the well under a proceeds lease, it is at odds with our Kansas caselaw interpreting such provisions,"<sup>181</sup> caselaw the court claimed gave effect to "at the well." While one hopes that Colorado would indeed disagree with the way *Fawcett* classifies a service arrangement as a sale, there is no reason to believe that Colorado would disagree with *Fawcett* if it ever entered *Fawcett*'s world, one in which a true sale is assumed to exist at the well. Even in Colorado under *Rogers*, if a cognizable sale (one that indicates

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Kansas' "at the well" interpretation in *Sternberger*. *Id.* The court further noted that under the Colorado standard, "*Sternberger*'s holding that gas can be in marketable condition at a point at which no market exists may be questionable." *Id.* at 306. This was a great understatement. But at the same time, the Colorado Supreme Court reads *Sternberger* far too broadly if it thinks that in Kansas, the term "at the well" is enough to set the point of royalty valuation, *see Rogers*, 29 P.3d at 899. That issue only came up in *Sternberger* in an unusual posture, because there the wellhead gas was sold downstream in physically unmodified shape, at least, as far as the decision indicates. *Sternberger*'s general language made very clear that marketability is required before deductions can be taken, regardless of "at the well" language. *See Sternberger*, 894 P.2d at 800.

180. *Coulter*, 292 P.3d at 306.

181. *Fawcett*, 352 P.3d at 1042.

marketability, unlike, say, an affiliate transfer, or a service arrangement masquerading as a sale), does occur, costs that someone incurs to thereafter “enhance” the gas are deductible.<sup>182</sup> Moreover, in *Rogers*, the jury found gas sold at the well marketable there, but other gas sold downstream only marketable at that point, a rational conclusion from the limited demand for natural gas at most wellhead locations.<sup>183</sup>

The *Fawcett* dictum on movement costs is odd because, first, when the Kansas Supreme Court held that the *Fawcett* gas was marketable at the well, it removed any need to address gas movement. The court already had decided that the transfer at the wellhead was a sale and that it established marketability. Second, the appeal was not pitched to raise a discrete transportation issue. The issue below was that in order to be marketable, gas had to be pipeline ready as a matter of law, an issue that did not single out gathering or transportation from other marketability services. All the court needed to do was remand for a factual determination of marketability (which is how *Rogers* was decided the first time, with the jury deciding marketability). Third, the court’s statement that it disagreed with *Rogers* “[t]o the extent” that it concerns gas sold at the well under a proceeds lease<sup>184</sup> only makes sense if one assumes that *Rogers* held that deductions could not be taken on such gas. Yet *Rogers* did not deny deductions for gas truly made marketable and sold at the well; instead, it reversed the jury because of what it viewed as error in the jury instructions and remanded.

The place where *Rogers* is important is the *Sternberger* situation, in

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182. In *Rogers*, the lessees claimed that the gas was “directly usable” at the well and that gas (at least in general) was used by local consumers and by lessors themselves. *Rogers*, 29 P.3d at 892. *Rogers* concerned two categories of gas; gas sold at the wellhead, but allegedly to affiliated or at least “closely linked” companies, and gas sold downstream. *Id.* at 893–94. The trial court left marketability to the jury, which found that gas sold at the well was marketable there, but gas sold downstream was not marketable at the well. *Id.* at 894. To submit the issue to the jury, the trial court had found that the implied duty to market “supersedes” the “at the well” language in the lease. *Id.* The court of appeals determined that “at the well” set the point of valuation, and therefore agreed that gas sold at the well was marketable there, but reversed the judgment on downstream sales because it held, “[r]elying on a commentator’s article,” that this gas, too, should be valued as if marketable at the well. *Id.* at 895. When both sides appealed, the Colorado Supreme Court found the “at the well” language silent on deductions. *Id.* at 897–900, 902. Deductibility was part of the larger issue of marketability. *Id.* at 900–01. The court then formally held that marketability concerns the location of gas—getting it to market—as well as its physical condition. *Id.* at 903–05. The court remanded the case for further proceedings after finding prejudicial error in a jury instruction that combined the duty to market and the duty of good faith, rather than requiring separate treatment of each. *Id.* at 908–13.

183. As explained above, *supra* note 182, *Rogers* was remanded for trial under a revised jury instruction.

184. *Fawcett*, 352 P.3d at 1042.

which gas at the well is in a physical condition where it could be marketed somewhere else, but no market exists at the well, and the only activity undertaken “to market” after the wellhead is gas movement, whether one calls that service gathering or transportation. In this situation, *Rogers* makes the lessee bear the resulting costs, and *Coulter* clearly suggested that Kansas might, too. For courts that take a marketable-product position, this is the only reasoned position. The idea that moving gas to a true market is *not* part of marketability services in marketable-product jurisdictions, even though all other “physical” services are, always has been unrealistic. If the lessee has a duty to bear the costs of making gas marketable, what separates the physical services of getting the gas to an appropriate market from the physical services of putting gas into a physical condition where buyers are willing to buy it? The irrationality of this position can be seen from several perspectives.

First, all jurisdictions, whether marketable-product jurisdictions or not, accept that the lessee has to bear the costs of production and that this means doing *everything* that is required—including gas movement—to get oil and gas to the wellhead on the surface of the lease. To the extent that any duty exists over production, it encompasses all services and their related cost. A substantial part of total production expense is providing the pipe and at times compression and other services, including fracking, to let oil and gas flow to the wellhead. The gas may or may not be transformed physically by these services. For instance, liquids can drop out of the gas stream as it is decompressed when moving to the surface. This changes the physical nature of the gas stream in one way, but does it really change the dry gas or just help separate liquids that have solidified in the lower pressure of the atmosphere when the gas emerges from the well? Other gas emerges at the wellhead very similar to its condition *in situ*, yet production costs still all fall on the lessee even though it may not have taken any steps to physically “change” the gas before it emerges from the wellhead. So why, if physical transformation is not required to make the lessee bear *all* “production” costs including underground gas movement, would the cost of movement above ground only be covered when related to an undefined physical transformation of the gas?

Some will respond that the answer is that “production” is a “wellhead” concept, but that is not true in marketable-product jurisdictions. There, “production” means producing a marketable product and obviously is not limited to the wellhead. So, again, why would Kansas classify all services including transportation *to* the wellhead as nondeductible but after that point only shield physical transformation services and allow deduction of the often equally or more expensive physical activity of gathering gas *after* the well when

movement is the only service applied to the gas?

Second, conversely, if there is to be something different about transportation from physical transformations after the wellhead in marketable-product states, why are any gas movement costs ever deductible, even costs incurred moving gas to the surface during production?

Third, there is a difference between “gathering” and “transportation” in industry custom and usage. The Kansas Supreme Court sometimes distinguished between these terms in its descriptions in *Sternberger*,<sup>185</sup> and it is a dividing line that separates field services from interstate pipeline services. If this is so, why is gathering transmuted to “transportation” and deductible under the rule in *Sternberger* if it is the only service applied, but left as “gathering” and not deductible if even one “physical transformation” service, no matter how minor and inexpensive, is applied to the gas after it is moved?<sup>186</sup>

Fourth, and finally, not all of the services typically deducted involve physical transformation at all, or, at least, “transformation” has to become an almost metaphysical concept for them to always arguably do so. So how can physical transformation, as opposed to how a service relates to actual marketability, be a distinguishing factor? Dehydration changes the quality of the product stream, as does gas treatment (or removing sulfur from oil), but it does not change the chemical composition of the hydrocarbons. Compression does not change the molecular structure of gas. This underlines the irrationality of any distinction between physical transformation and movement. Both are industrial-type processes that require investment in capital equipment and application of labor, and both generate costs. Sales, at least sales at a price that can satisfy the duty to market, often cannot occur without both

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185. In *Sternberger*, the court described the gas movement as involving gathering on an initial line and transportation on a pipeline before getting the gas to the purchaser. *Sternberger*, 894 P.2d at 792. Yet, just when one expected that the court had made this careful distinction in order to separate deductibility for these two services, barring deduction of gathering costs but allowing transportation costs, the court announced that it was allowing deduction of *all* gas movement as “transportation” without such a distinction. *Id.* at 796 (stating narrow holding in seemingly categorical terms of “transporting the gas or oil to a distant market” without distinguishing the two aspects of the gas movement).

186. The failure to grapple with differences between gathering and transportation can be seen in the inconsistent use of these two terms in *Sternberger*. See *supra* note 185; see also *infra* note 225, ¶ 4. The failure to make this distinction has something of a history in Kansas cases; it can be found in *Matzen*, too. See *infra* note 261. The *Williams and Meyers* treatise defines gathering lines as “[p]ipes used to transport oil or gas from the lease to the main pipeline in the area.” WILLIAMS & MEYERS, *supra* note 1, at 436.

sets of processes.<sup>187</sup>

For all of these reasons, if the Kansas Supreme Court had a good reason to address the issue at all, it would have made a pragmatic decision suited to industry realities had it stated that gas movement is just as eligible to be a marketability service as compression, dehydration, gathering, treatment, and processing when those services are needed to market gas. There is nothing inconsistent with that position and the court's conclusion, once it found the service agreement to be a sale, to holding that a real sale establishes marketability.

As it is, the court's “[t]o the extent” comment on Colorado's rule<sup>188</sup> is a distinction that does not distinguish, because in both states a sale that does indicate marketability means that gas movement costs after that point are deductible. *Fawcett*'s comment on Colorado law, therefore, should be much less than it seems.

#### D. Fawcett's Erroneously Tried to Limit Gilmore and Schupbach to On-Lease Services.

In addition to opening a service-and-sale exception to the marketable-product rule, deviating from *Hockett* in at least one circumstance, and ending its recent friendliness with the location principle in the Colorado marketable-product rule, the Kansas Supreme Court produced a revisionist discussion of two leading Kansas cases, *Gilmore v. Superior Oil Company* and *Schupbach v. Continental Oil Company*. Its discussion suggests a narrower geographic scope for the implied duty in those cases than the duty they actually established and thus tends to minimize the change represented by *Fawcett*.<sup>189</sup> It provides

187. One factor that separates “physical transformation” services from movement services is that the former at least theoretically could have been performed, albeit often in a less efficient manner, at the well. Field gas movement may begin at the well but by definition the activity ends away from that point. The fact that lessees have moved core production services into larger, more efficient downstream locations does not provide a reason to suddenly make them deductible. If “production” is viewed only as a physical process that involves getting gas into a condition in which it theoretically might be sold to someone in some market in some location, without regard to where actual markets are located, then gas movement might not be part of production. But when, as in the logic of marketable-product rules, the idea of production includes putting gas in a place where it can be sold for an adequate price (giving the lessor something it actually can sell, not just might sell in a market that may not even exist anywhere near the lease), this function is not fulfilled when the gas is at a location, as in *Sternberger*, where there is no market. Part IV *infra* argues that there surely has to be more than just any “market,” and that marketability should exist only if the gas is in a location that yields a price that qualifies as acceptable under the duty to market.

188. *Fawcett*, 352 P.3d at 1042.

189. If the court restricted a rule that did not extend very far anyway, it should make less difference than restricting a rule with the actual breadth of the Kansas rule.

a more restrictive—but also incorrect—reading than justified by those leading cases.

### 1. *Gilmore v. Superior Oil Company* Did Not Turn On Lease Boundaries.

*Gilmore* is the foundation for the Kansas rule. In the more than fifty years since *Gilmore*, Kansas generally has not allowed deductions “at the well” even under “at the well” leases if gas was not marketable there. As Part II.A demonstrates, that remains the Kansas rule.

In *Gilmore*, the Kansas Supreme Court held that compression costs incurred after production to make oil and gas marketable generally cannot be deducted from the royalty share.<sup>190</sup> Fawcett describes *Gilmore* as if it represents a limited geographic rule. The court singled out the “only purpose” of the challenged compression in *Gilmore* as moving gas to a pipeline “which was on the lease,” and noted that a purported “common thread in *Gilmore* [and its successor decision, *Schupbach*] is that the compression expenses were necessary to deliver the gas production, on the leased premises, to the purchaser.”<sup>191</sup> Yet *Gilmore* was most significant not for any geographic limitation but, instead, because it breaks the geographic link between “at the well” terminology (in *Gilmore*, “at the mouth of the well”) and the valuation point.<sup>192</sup> *Gilmore* set Kansas on the path that other leading marketable-product states followed. It was the first major state court gas marketable-product decision in the United States. Its influence radiated outwards into many other states.<sup>193</sup>

The governing lease in *Gilmore* required payment on proceeds “at

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190. *Gilmore*, 388 P.2d at 605–06. The *Gilmore* court cited the *Summers* treatise for the principle that “the duty to market oil and gas rests constantly on the lessee.” *Id.* at 606 (citing 2 W.L. SUMMERS, THE LAW ON OIL AND GAS § 415, at 631 (perm. ed. 1958)). This is hardly an innocent citation in the context of the case, and neither is *Gilmore*’s citation to Maurice Merrill for the principle that the costs of preparing product for market fall on the lessee. *Id.* at 607 (citing MERRILL, *supra* note 1, § 85, at 214–15).

191. Fawcett, 352 P.3d at 1040–41.

192. *Gilmore*, 388 P.2d at 606.

193. The Oklahoma Supreme Court cited *Gilmore* and *Schupbach v. Continental Oil Co.*, 394 P.2d 1 (Kan. 1964), in its first marketable-product case, a case in which it chose to follow “the holdings of the Kansas and Arkansas courts” over the pro-deduction principle it described as emanating from Texas, Louisiana, and Mississippi. *Wood v. TXO Prod. Corp.*, 854 P.2d 880, 881–82 (Okla. 1993). The Colorado Supreme Court discussed *Gilmore* in its leading decision, *Garman v. Conoco*, 886 P.2d 652, 658 n.15 (Colo. 1994). And the West Virginia Supreme Court of Appeals, which is the third of the three leading courts (besides the Kansas Supreme Court) to issue marketable-product decisions, cited *Gilmore* in *Wellman v. Energy Resources, Inc.*, 557 S.E.2d 254, 264 (W. Va. 2001).

the mouth of the well,” but the gas emerging at the mouth of the well was not marketable until it was compressed.<sup>194</sup> The trial court found there was no market for the gas until Superior Oil’s compression station was in operation.<sup>195</sup> The gas had been flared as an unwanted byproduct of oil production until Superior installed a “compressor station” in November 1956.<sup>196</sup>

Compression is an increasingly important factor in states with older fields because reservoir pressure tends to decline as production continues. Increasing amounts of compression can be required if old fields are to produce at all. In the Hugoton field, for instance, pressure has declined sharply since the early days of production in the 1920s.<sup>197</sup> Compression also plays an unusually early and important role in shale fields; a distinguishing feature of gas shale wells is their rapid decline pattern in the first few years of production but long tails thereafter.

The compression station that Superior Oil established on the *Gilmore* lease was placed away from the mouth of the well—the geographical reference point in the lease.<sup>198</sup> The supreme court agreed with the trial court that the compression costs incurred *after* the well mouth were not deductible from the royalty interest, in this case in which the lease had “at the mouth of the well” language, because the compression was needed to make the gas marketable.<sup>199</sup> Compression was not only provided near the well mouth; the trial court’s compression discussion included a compressor into which gas flowed “immediately” from the

194. *Gilmore*, 388 P.2d at 605–06.

195. *Id.* at 604.

196. *Id.*

197. An estimate of ultimate recovery for the Hugoton as of 2011, including Oklahoma and Texas production as well as production in Kansas, was 39.55 tcf, fully 12.55 tcf more than the next largest natural gas field in the United States, the Pinedale field in western Wyoming. Information provided by Washington Lem, Consultant at Econ One, Los Angeles, and drawn from M.K. Horn, *Estimated Ultimate Recovery—Top United States Gas Fields*, AAPG DATAPAGES. See also Timothy R. Carr. et. al, *Use of Information Technology for Integrated Reservoir Characterization of Permian Gas Fields of the Hugoton Embayment*, KAN. GEOLOGICAL SURV., <http://www.kgs.ku.edu/PRS/publication/2003/ofr2003-29/P1-03.html> (last updated May 2003) (including chart of average reservoir pressure versus gas production showing decline from over 400 psi in 1935 to less than 40 psi in 2003).

198. *Gilmore*, 388 P.2d at 604. There apparently was a compressor away from the well mouth, but nearby, and another compressor—a gathering compressor—“farther out in the field.” *Id.* The more distant compressor presumably was the “large compressor station” installed in November 1956 to serve multiple wells, an alternative to “installing small compressors at the mouth of each well,” because gas either went “immediately” into a compressor or into the gathering compressor. *Id.*

199. *Id.* at 604–06. “[The] only purpose for the compressing station was to put enough force behind the gas to enable it to enter the pipeline *on the lease*. This made the gas marketable . . . .” *Id.* at 606 (emphasis in original).

well mouth and also “a gathering compressor farther out in the field.”<sup>200</sup> It was only after treatment in the compression “system” that the gas became marketable.<sup>201</sup> Moreover, the *Gilmore* claims were brought by multiple royalty owners in more than one lease, and presumably they did not all own part of the lease on which the gathering compressor sat, yet the court found the compression necessary to produce marketable gas without distinguishing well-site compression and the central gathering compression.<sup>202</sup> Thus when one reads it closely, *Gilmore* represents the supremacy of the lessee’s duty to make gas marketable over lease terms of location.

*Fawcett* ignores the clear break *Gilmore* makes between the function of making gas marketable and any geographical terms of reference in the lease. It says nothing to upset *Gilmore*’s central holding that if the gas is unmerchantable, the lessee must prepare it for market at no cost to the royalty owner.<sup>203</sup> The *Fawcett* decision treats the distance between the well mouth and the compressor station as minor because it is written as if both compression units were “on the lease” and this was a distinguishing fact, even though the lease premises were not relevant to *Gilmore*. Moreover the court formally rejected on/off lease distinctions not many months later in another 1964 decision, *Schupbach v. Continental Oil Co.*<sup>204</sup>

In *Gilmore*, in another sign of the decision’s breadth, the court favorably cited the leading theorist behind the marketable-product duty, Professor Maurice Merrill, and his oft-cited conclusion:

If it is the lessee’s obligation to market the product, it seems necessarily to follow that his is the task also to prepare it for market, if it is unmerchantable in its natural form. No part of the costs of marketing or of preparation for sale is chargeable to the lessor. This is supported

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200. *Id.* at 604.

201. *Id.*

202. The nature of the “leased premises” in *Gilmore* is unclear because there were two plaintiffs, Faye Gilmore and Ruth Chapin, who with their husbands executed “A” and “B” leases. *Id.* at 604. In theory, the two leases could have been fractional shares of the same land, but if so one would expect the court to have mentioned that fact. The opinion ambiguously describes what seems to be the larger compressing station as being “on the Gilmore lease which was a part of the overall lease including the property of both plaintiffs,” implying that the leases did not cover the same land. *Id.* at 606 (emphasis added). It does not explain why the court called the larger area “the” overall lease, singular.

203. See *supra* Part II.A.

204. 394 P.2d 1 (Kan. 1964). For a discussion of *Schupbach*, and the *Fawcett* court’s misreading of its facts as far as on/off lease distinctions, see *infra* notes 215–18 & accompanying text.

by the general current of authority.<sup>205</sup>

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205. *Gilmore*, 388 P.2d at 607 (quoting MERRILL, *supra* note 1, § 85, at 214–15). In the 1940 edition of his treatise, Merrill cited three cases as support for the proposition that no part of marketing or preparation can be charged to the lessor. MERRILL, *supra* note 1, § 85, at 215 n.24. Of these cases, *Clark v. Slick Oil Co.*, 211 P. 496 (Okla. 1922), is an oil case that turns largely on contractual “free of cost” language. The case concerned how to handle a period in the Cushing field in 1914 and 1915 when massive production made it impossible to sell the oil—a situation Slick Oil handled by storing the oil in tanks and paying royalties on the field posted price. *Id.* at 497–98. The lease required Slick Oil to deliver the oil “free of cost, in the pipe line to which [lessee] may connect the well or wells.” *Id.* at 498. Under this language, the Oklahoma Supreme Court held that “[i]t was just as much a part of the duty of the defendant under the contract to prepare this oil for market so that it would be received by the pipe line company as it was its duty to pump the oil from the wells or drill the wells.” *Id.* at 501. Although the holding on the duty to prepare was not yet independent from the contract language, *Clark* carries the seed of the future implied duty.

In a Kentucky gas case cited by Merrill, *Warfield Natural Gas Co. v. Allen*, the Kentucky Court of Appeals came close to a modern statement of the duty, although again its statement was undergirded by contract language, specifically the term “[w]hatever price that you sell this gas for is what you owe me for my one-eighth.” 88 S.W.2d 989, 990 (Ky. Ct. App. 1935). The court held, on the one hand, that the defendant had as much duty to market the gas as to find it and, with nothing said about the expenses of either activity in the lease, that “[i]t must be presumed that the payment by the defendant of its expenses in doing both is the consideration it is to pay for its seveneighths [sic] of the proceeds, for it pays no other and it certainly gets the lion’s share.” *Id.* at 991. On the other hand, even though the gas language had no “at the well” term or other geographic limitation, the court held that, under then common practices, gas was measured and usually sold at the well in that locality, with “[n]othing . . . said in the lease about a sale elsewhere,” so lessee Warfield only had to pay the gross price at the well even if it sold the gas elsewhere for more. *Id.* at 991–92. The court did not address how it would interpret that lease if, as today, practices changed so that gas usually was sold downstream.

Finally, perhaps the most “modern” of Merrill’s early cases in its substance is neither an oil nor a gas case, but one over phosphate royalties, *Harlan v. Central Phosphate Co.*, 62 S.W. 614 (Tenn. Ct. Ch. App. 1901). The bulk of the decision concerned a convoluted title issue and whether one cotenant can bind the other tenants by a lease, but the court also authored a significant discussion of the duty to make phosphate marketable. Initially, under an “old” method, all of the rock was dug, dried in kilns or by the sun, broken by forks and thrown into wagons, and forked back into other wagons, removing waste in the process. *Id.* at 624. Small rock separated out from larger rock in this “old” method was the rock suitable for export. *Id.* For the new method, the lessee built a tramway; after drying, the rock was forked into wagons and moved by tram to a crushing plant. *Id.* The finest rock was screened out for export. *Id.*

The marketability dispute arose because initially the phosphate was sold only in the domestic market, but over time an export market developed for the higher quality portion of the rock that had been crushed and screened. *Id.* at 617. Once the rock was processed this way, 65% of it was higher-valued export grade, 30% was lower-valued domestic grade, and 5% was waste. *Id.* at 625. Central Phosphate insisted that the lessor “should not have the benefit of improved methods of treating the product (that is, by crushing and screening)” that did not exist when the lease was entered. *Id.* It noted that the lease provided for escalating payments per ton of phosphate “when mined and weighed,” with the escalated price depending upon the market price for phosphate. *Id.* The rock apparently was weighed both at the mine and at Mt. Pleasant, although the court found the record a little murky on this point. *Id.* at 624. The price was “f. o. b. Mt. Pleasant,” not at the mine. *Id.* at 615.

Faced with this record, the court agreed with the lessors that the defendant could not take the “finest grade of rock” but pay for it only on the lowest grade (and, of course, at the lowest price). *Id.* at 625. Even though the rock had not been separated at the mine, it was already known to be 65% export

This geographically unrestricted rule remains the general rule in Kansas.<sup>206</sup>

It is Merrill who emphasized that any right to take deductions must be stated very clearly in the lease: “[I]t is erroneous to read into the royalty clauses stipulations concerning the cost of marketing and preparation which are not specifically expressed.”<sup>207</sup> Under this approach, simply stating “proceeds . . . at the mouth of the well” or “proceeds . . . at the well” (as the leases in *Fawcett* stated)<sup>208</sup> would not be enough to entitle the lessee to deduct marketability costs from the royalty payment.

*Gilmore* did not have to address precisely how far beyond the “mouth of the well” its rule would extend. The court cautioned that it was not considering what would happen were the lessee put to “great expense in building miles of pipelines.”<sup>209</sup> But *Gilmore* unquestionably adopted the general principle that the lessee has an overriding duty to bear the cost of making oil and gas marketable.<sup>210</sup> And the court used this duty to transcend the locational term in the lease—its “at the mouth of the well” language.

*Gilmore* did sometimes appear in dictum to draw a distinction

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rock, 30% domestic, and 5% waste. *Id.* The court could not find that the parties agreed that royalty would be paid on a lower value than that received by the company; paying on the actual sales price for each grade was the “only practicable method, as it seem[ed] to the court, of doing justice,” and paying for all of the rock at the lowest grade “never could have been the understanding of the parties” unless such an intent “should be plainly expressed in the contract.” *Id.* The same logic, of course, can apply to dry gas and liquids that are known to be in an unprocessed gas stream that has not yet been processed for separate sale; the lessee must pay on the prices it actually receives for the separate components, which is the way a prudent company would value them.

On rehearing, the court rejected the idea that the lessee could deduct the cost of grinding and bagging the phosphate, one cost of the new process, in fixing the phosphate’s “market price.” *Id.* at 630–31. The court found “no principle upon which the lessor could be charged with the cost of preparing the product for market.” *Id.* at 630. This, of course, is the basic marketable-product principle.

206. The court’s syllabus provides perhaps the clearest statement of the *Gilmore* rule:

Under the facts and circumstances of this case the lessee, following the authorities cited in the opinion, has the duty of making the gas marketable and cannot recover from the lessors for the expense of installing a compressing station used to compress all gas produced on the leases because such installation was a necessary expense in the process of making such gas marketable.

*Gilmore*, 388 P.2d at 603.

207. MERRILL, *supra* note 1, § 85, at 216.

208. *Fawcett*, 352 P.3d at 1036.

209. *Gilmore*, 388 P.2d at 606. In denying deduction of the compression costs, the court noted that the purpose of the “compressing station” was to enable the gas to move “into pipelines already existing on the leases in question,” not into “miles of pipelines” that might require “great expense.” *Id.*

210. *Id.*

between the lease and activities beyond the lease. It called all gas movement beyond the lease “transportation,” a usage that could seem to fit its disclaimer that it did not need to consider a situation involving “miles of pipelines.”<sup>211</sup> But all *Gilmore* actually addressed was compression provided on the lease but away from the well mouth, and gathering compression in the field, when the lease contained an “at the mouth of the well” term.

If there could be any question about the geographic extent of *Gilmore*, a companion case issued the same year made undeniable that the Kansas Supreme Court did not envision an on/off lease distinction as a meaningful deduction barrier. The court meant what it said when it broke the geographic link in *Gilmore*.

## 2. *Schupbach v. Continental Oil Company* Found The Location of the Compressor “Of Little Consequence.”

In its same-year compression-cost decision in *Schupbach v. Continental Oil Co.*,<sup>212</sup> the Kansas Supreme Court refused to treat the lease boundary as consequential for the State’s deduction rule.<sup>213</sup> The lease boundary, like the term “at the well,” is not a determinative factor in the Kansas rule. While noting that where Continental chose to site the lease was not important, the court found *Gilmore*’s language about the lessee’s duty “controlling,”<sup>214</sup> confirmation that *Gilmore*’s principle was not intended to be limited to the lease.

*Fawcett* claims that *Gilmore* and *Schupbach* are “on lease” cases.<sup>215</sup> In doing so it ignores the break with geographic language in *Gilmore* and the language of *Schupbach*. The *Fawcett* analysis erroneously assumes that the Kansas Supreme Court barred deduction in *Schupbach* because Continental Oil’s compressor happened to be on the Schupbach’s “Newkirk” lease, when that court actually said that the location of the compressor did not matter.

The “compression and sales” of the *Gilmore* and *Schupbach* wells were in the same Rhodes field (indeed, the leases adjoined each other), the leases contained “identical” language, and both Superior Oil and

211. *Id.*

212. 394 P.2d 1 (Kan. 1964).

213. *Id.* at 4–5.

214. *Id.* at 5.

215. *Fawcett*, 352 P.3d at 1041 (“The common thread in *Gilmore* and *Schupbach* is that the compression expenses were necessary to deliver the gas production, on the leased premises, to the purchaser.” (citations omitted)).

Continental Oil separated gas at “centrally located separators” on the group of leases and transported it to a “central compressor station” built on one of a group of leases.<sup>216</sup> The *Schupbach* court held, in language ignored in *Fawcett*’s discussion of the case that the on- or off-lease location of compressing does not matter:<sup>217</sup>

Continental, like Superior, constructed its compressor station at a central location on one of its leases and commenced compressing the gas from its adjoining leases in the area . . . . [T]he fact that the compressor station was constructed under a business lease on the Newkirk section is of little consequence.<sup>218</sup>

That *Fawcett* misses the point of these cases is doubly surprising because both *Gilmore* and *Schupbach* contain an additional discussion of why the lease boundary should not be a significant deduction boundary. One reason that whether services were provided on the lease in *Schupbach* did not matter is that Continental did not consult the royalty owners on the location, size, or number of stations.<sup>219</sup> Profit-maximizing lessee decisions about where to put service facilities, including whether to concentrate them in a downstream location when that achieves economies of scale, should not make nondeductible costs suddenly deductible. Prudent steps to save the lessee money by lowering unit costs should not change deductibility of services vis-à-vis the royalty owner.

The Kansas Supreme Court made the same point about the irrelevance of where services occurred in *Gilmore*, in which it noted that Superior Oil could have installed a compressor at the mouth of the well but chose instead to put a large compressor station downstream to serve all wells on the lease from that one facility.<sup>220</sup> Superior Oil surely did this to lower costs through economies of scale. It made this decision unilaterally. It “did not consult with the lessor on any details pertaining to the location of the compressing station but [acted] on its own

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216. *Schupbach*, 394 P.2d at 5. The parties also agreed that the *Schupbach* decision would govern claims that *Gilmore* brought against Continental Oil. *Id.* at 2.

217. *Id.* at 5. The plaintiffs owned interests in the Newkirk lease, *id.* at 2, Continental also had “several adjoining leases in the area” whose gas flowed through the same compressor. *Id.* at 3. It would hardly be fair for the Newkirk lessors to be free of compression costs because Continental had chosen to put the compressor on that lease, while the royalty owners in the adjoining leases had to pay compression costs because Continental had not similarly favored their leases.

218. *Id.* at 5.

219. *Id.*

220. *Gilmore v. Superior Oil Co.*, 388 P.2d 602, 604 (Kan. 1964).

responsibility . . . .”<sup>221</sup> The importance of the court’s refusal to make the economic happenstance of facility location outcome-determinative often is lost in the *sturm und drang* of marketable-product debates.

The decision where to provide marketability services is similar in this regard to the decision of how to provide those services, whether internally or by contract with third parties, as well as where to do so, and how to structure the arrangement. A lessee always can provide the services itself as an integrated service, or outsource the activity to a third party. This is the “make or buy” decision that has attracted so much fruitful attention from economists as part of the focus on transactions costs sparked by Chicago School theorists.<sup>222</sup> In addition, when going into the market to hire third parties, a lessee can hire a company as a pure service company for a fee, or it can structure the arrangement as a sale in which the service company physically controls the gas through the point of sale, but need not take title to the gas, and the company still can give the great bulk of the value back to the lessee, which is just what happened with OPIK. None of these decisions are any more in the lessors’ control than the decision of where to site service facilities.

Theoretically, it is possible to perform most field services “at the well” and, for that matter, have services provided by the lessee itself; but economies of scale dictate that many will be performed in large facilities located in distant, often off-lease locations and comparative advantage sometimes will lead the lessee to outsource the services. These decisions about profit-maximizing behavior should not alter the non-deductibility or deductibility of the services. Superior Oil’s economic steps to increase efficiency, from which it of course benefitted, did not reduce its obligation to pay marketability costs. OPIK presumably could have provided field services for its leases, but one can deduce from its contracting out that it believed it more profitable and in its self-interest to hire third parties to provide those services. *Gilmore* and *Schupbach* indicate that these internal management decisions ought not vary the royalty obligation. *Fawcett* presented no reason to depart from this longstanding position, even though depart it did.

*Gilmore*’s holding that “at the mouth of the well”—a location that is a geographic subset of the more common “at the well”—did not

221. *Id.* at 606.

222. For the “make-or-buy” decision, the term famously used by Ronald Coase in his extended rumination on why firms sometimes provide goods and services internally and sometimes externally via the marketplace, see Ronald Coase, *The Nature of the Firm*, 4 *Economica* 386 (1937); see generally OLIVER WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM (1985).

authorize deductions, as well as *Schupbach*'s clear instruction that the lease line is not a relevant boundary, has been the rule in all marketable-product jurisdictions. On their face, terms like "at the well" do not mention deductions as a topic, much less specific deductions. Their lack of specificity prompted the Colorado Supreme Court, which finds "at the well" silent on deductions, to make its controversial pronouncement that companies have employed such vague language deliberately to "avoid directly stating their objectives in sharing costs."<sup>223</sup> The West Virginia Supreme Court of Appeals found "at the well" ambiguous rather than silent because the term does not say "*how or by what method* the royalty is to be calculated."<sup>224</sup> In an earlier decision, that court claimed that producers had been adopting the label "post-production costs" to

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223. *Rogers v. Westerman Farm Co.*, 29 P.3d 887, 897–900 (Colo. 2001) (en banc) (citation omitted). To get a sense of the irreconcilability between the marketable-product approach discussed in text and Texas-type jurisdictions on whether "at the well" is meaningful language on deductions, compare *Martin v. Glass*, 571 F. Supp. 1406, 1411–15 (N.D. Tex. 1983), *aff'd*, 736 F.2d 1524 (5th Cir. 1984), with *Rogers*, 29 P.3d at 897–900. *Martin* dealt with a "net proceeds at the well" lease. *Martin*, 571 F. Supp. at 1410. For general background on this term, see Randy Sutton, Annotation, *Sufficiency of "At the Well" Language in Oil and Gas Leases to Allocate Costs*, 99 A.L.R.5th 415, 422–23 (2002).

Texas is at an extreme even within "at the well" states, because its courts have at times shown implausible reluctance to enforce even clear language barring deductions. For instance, consider *Heritage Resources, Inc. v. NationsBank*, 939 S.W.2d 118 (Tex. 1996), in which a majority strained to overcome a clear prohibition on field service deductions and showed how one-sided the Texas approach can be. The leases in *Heritage* were "market value at the well" leases, but they added the qualification on deductions "provided, however, that there shall be no deductions from the value of Lessor's royalty by reason of any required processing, cost of dehydration, compression, transportation, or other matter to market such gas." *Id.* at 130. This plain and straightforward ban on deductions surely modified the general market value language. The no-deduction language is narrower than the more general market-value term, it follows the general language in the same sentence, and the clause even begins "provided, however," *id.*, thus indicating (not that an indication was needed) that it is intended to control what went before. Even though the *Heritage* court said it found the leases unambiguous, just as it should have given the "provided, however" clause, it inexplicably held that what was unambiguous and controlling was the phrase "market value at the well," not the no-deduction language. *Id.* at 121–23. The court further asserted nonsensically that all the prohibition on deductions meant is no deduction from value "at the well," *id.*, even though, of course, the language does not say that. Such a reading ignores the well-known industry fact that such activities as transportation and processing are going to occur far from most wells and thus cannot refer to well-site costs, and ignores as well the broad, unlimited nature of the deduction prohibition. The court did concede that its construction left the no-deduction clause "surplusage" whenever sales were off the lease. *Id.* at 123. This unfortunate, ill-grounded language did more than that—the court effectively wrote the very specifically negotiated language barring deductions out of the lease (or, one alternatively could say, it effectively added the term "but only up to the well" to the no-deduction clause, thus fundamentally rewriting the lease to serve its decision to allow all deductions). The plaintiff, NationsBank, could be excused if it was bewildered by this result, in which the court treated the plainest, most specific language intended to limit deductions as if it imposed no limit at all.

224. *Estate of Tawney v. Columbia Nat. Res., L.L.C.*, 633 S.E.2d 22, 28 (W. Va. 2006) (emphasis in original).

“escape” the general requirement that royalty be an interest free of costs.<sup>225</sup>

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225. *Wellman v. Energy Res., Inc.*, 557 S.E.2d 254, 264 (W. Va. 2001). For the other major jurisdiction, Oklahoma, not being limited by “at the well,” see MCARTHUR, *supra* note 4, at 254–56 and nn. 134–35.

*Fawcett* included three paragraphs discussing *Sternberger*, the third leading Kansas marketable-product case, after its discussion of *Gilmore* and *Schupbach*. *Fawcett*, 352 P.3d at 1040–41, but its treatment of *Sternberger* draws mainly from that case’s separation of physical marketability and “transporting the gas,” as well as dictum on the relationship between “at the well” and that rule.

*Sternberger* is an odd case for many reasons, starting with the fact that there was no market at the well yet, as far as the record showed, the wellhead gas had not been physically changed other than through transportation when sold downstream. *Sternberger*, 894 P.2d at 799 (“there is no evidence in this case that the gas produced by Marathon was not marketable at the mouth of the well other than the lack of a purchaser at that location”); *see id.* (“There is no evidence that Marathon engaged in any activity designed to enhance the product, such as compression, processing, or dehydration.”). Second, even though there was no buyer (“no market”) at the well, the plaintiffs never denied the gas was marketable there. Perhaps because of this failure to contest marketability, the court treated all gas movement from the well as “transportation,” and none of it as gathering. *Id.* at 792, 800. In describing the gas movement whose costs were at issue, the *Sternberger* court described the history as follows. TXO, the lessee, could not persuade anyone to build a line to its wells, even though the court was persuaded that “[h]istorically, about 85% of all gas purchasers paid the cost and built the lines necessary to gather and transport the gas to market.” *Id.* at 792. TXO therefore paid to build a “gas gathering system,” which connected to purchaser Kansas Gas & Supply’s pipeline. *Id.* The dimensions of the lines are not described, but TXO paid a “transportation fee” to ship gas through the KG&S line “to the purchaser.” *Id.* The case synopsis describes the *Sternberger* rule as requiring lessors to bear “their proportionate share of reasonable expenses of transporting gas in gathering pipeline system constructed by lessee to distant market,” even though TXO did not build a line to any *distant* market. The court generally called the disputed expenses “transportation” expenses, cited an earlier case about “transporting gas or oil” to a “distant market,” and claimed that because there was no evidence that Marathon tried to deduct any expenses for physical transformations that make gas marketable—“such as compression, processing, or dehydration”—the deductions “[t]herefore, . . . [were] properly characterized as ‘transportation’ rather than ‘gathering’ or other production costs.” *Id.* at 796–97, 799–800.

Third, an equal oddity is that the producer, Marathon, never contended that the gas was marketable at the well, the standard lessee position. Brief of Appellant at 6, *Sternberger v. Marathon Oil Co.*, 894 P.2d 788 (Kan. 1995) (No. 94-70990-AS) [*hereinafter Sternberger Brief of Appellant*] (“There was no market for the gas at the wellhead for the leases at issue.”). Given that *Sternberger* was litigated over a “market price at the well” lease, *Sternberger*, 894 P.2d at 792, most lessees would have looked for comparable nearby wellhead transactions of any sort and argued that they established general wellhead marketability.

Fourth, in spite of enjoying “at the well” language in its lease, Marathon downplayed the language, arguing that “[a] brief review of case law makes clear that the specific language, or lack of specific language, of the lease does not always control.” Reply Brief of Appellant at 12, *Sternberger v. Marathon Oil Co.*, 894 P.2d 788 (Kan. 1995) (No. 94-70990-AS). This is more a plaintiff’s normal position than a defendant’s.

Fifth, *Sternberger* nowhere mentions where the gas actually was sold, other than somewhere away from the well. The parties apparently did not tell the court where the sales occurred. *See Sternberger*, 894 P.2d at 806 (the court resorts to “assum[ing] that sales occurred] on the market price at a distant market”).

Sixth, the disputed “transportation” charges had been discontinued by time of trial, so the court may have thought the issue didn’t matter much anyway. *Id.* at 792–93, 806. Marathon claimed that Kansas royalty owners were only charged twelve cents per thousand cubic feet (MCF) to pay their share of the gathering line and that even that charge lasted only “approximately 12 months” (the

*Fawcett* does not hold that all costs are deductible just because a lease says “at the well.”<sup>226</sup> But its suggestion that the *Gilmore* and *Schupbach* rules might have been limited to on-lease services makes the allowance of deductions in *Fawcett* back to the well appear to be less significant than it really is. This is a misreading of both cases.

#### E. Fawcett Injudiciously Resurrected Old Oil Cases As Gas Deduction Precedent

Another unfortunate aspect of *Fawcett* involves the court’s treatment of a trio of early Kansas cases. In *Matzen v. Hugoton Production Company*, a price valuation case, the Kansas Supreme Court properly distinguished the trio as cases addressing “free of cost in the pipe lines to which he may connect his wells” language that is characteristic of oil royalty clauses but irrelevant to ordinary gas royalty standards because “the royalty provisions there involved provided for delivery of a specified portion of the oil or gas produced.”<sup>227</sup> Gas royalty clauses do

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charge and duration varied in other states), while Marathon’s absorbing the cost of the line allegedly led purchaser Kansas Gas Supply, Inc. to raise the price it paid to Marathon between ten and sixteen cents. *Sternberger* Brief of Appellant, *supra*, at 5–6. The court believed that “historically” most purchasers—“about 85% of all gas purchasers”—built gathering and transportation pipelines. *Sternberger*, 894 P.2d at 792. So it may have worried about penalizing a lessee for an investment that apparently might yield a net gain in royalty payments even after deductions, at least in all but the twelve-month period and at times even then. Nor did the gathering fee apply uniformly or continue by time of trial. *Id.* at 792–93. It did not apply to short lateral lines. *Id.* at 793. The class alleged that the charge had not been levied before 1984, that it did not apply to single well connections, and that it was terminated after Marathon acquired the properties from TXO because Marathon’s accounting system could not handle the deductions. Brief of Appellees at 3, *Sternberger v. Marathon Oil Co.*, 894 P.2d 788 (Kan. 1995) (No. 94-70990-AS).

Seventh, and finally, the case is odd because its holding is diametrically opposite to its most important statement of Kansas marketable-product law. The holding is that if wellhead gas is in the same physical condition in which it ultimately is sold downstream, lacking only purchasers at the well, the costs of transporting this physically marketable gas from the well to a buyer can be shared with royalty owners. *Sternberger*, 894 P.2d at 805. This, of course, is a holding that favors lessees. Yet the court’s phrasing of the Kansas rule was broad and very lessor favorable: “The lessee has the duty to produce a marketable product, and the lessee alone bears the expense in making the product marketable.” *Id.* at 799. This principle has no stated geographic limit, neither at the well nor the lease boundary. Absent express contrary language in the lease, the “nonworking interest owner is not obligated to bear any share of production expense, such as compressing, transporting, and processing, undertaken to transform gas into a marketable product.” *Id.* at 800 (emphasis added). This holding should mean that not even gathering or transportation—gas movement costs—can be deducted as long as they are part of services needed to put the gas into a marketable state *and bring it to locations where the gas will receive services needed to make it physically marketable*.

226. For a discussion of the role of “at the well” language in *Fawcett*, see *supra* Part II.B.

227. *Matzen v. Hugoton Prod. Co.*, 321 P.2d 576, 582 (Kan. 1958) (discussing *Scott v. Steinberger*, 213 P. 646 (Kan. 1923); *Voshell v. Indian Territory Illuminating Oil Co.*, 19 P.2d 456 (Kan. 1933); and *Molter v. Lewis*, 134 P.2d 404 (Kan. 1943)).

not ordinarily provide for in-kind deliveries. In *Sternberger*, however, the court cited these three cases, along with *Matzen*, as authorities holding that royalty owners do have to bear reasonable transportation costs if royalties “are paid (in oil or gas or in money) ‘at the well’ but there is no market at the well.”<sup>228</sup> And in *Fawcett* the court cited this aspect of *Sternberger*, and the three cases on which it relied, again.<sup>229</sup>

A closer look at these cases supports *Matzen*’s contrary analysis that these older cases are irrelevant to today’s gas royalty deduction issues and undercuts *Fawcett*’s interpretation. In the oldest case, *Scott v. Steinberger*,<sup>230</sup> decided at a time when gas generally remained an associated and often regretted, often costly byproduct of oil, the lease required the lessees to deliver oil “free of cost in the pipe lines to which he may connect his wells,” and provided on gas that lessees should pay as royalty “one-eighth of all gas produced and marketed.”<sup>231</sup> Although the gas language did not mention “pipe lines,” the court treated the oil and gas provisions as effectively the same in this respect, finding that “[e]vidently the parties contemplated that, if oil *or* gas . . . was found, some pipe line company would build into the field . . . .”<sup>232</sup> It concluded from this presumed expectation that buyers would extend pipelines to the well, and that the gas should be measured and priced where the wells were connected to pipe lines, which is what the language suggested for the oil point of valuation.<sup>233</sup>

The lessor, Scott, sued for the price paid at the terminus of the pipeline that took gas out of the field, one kind of downstream price.<sup>234</sup> The court rejected Scott’s argument. It conjectured that if it accepted such a position, lessors could require payment of the price being paid at such “distant” mainline-terminus markets as Kansas City and Chicago.<sup>235</sup> Because there was no market at the entering connection with the pipeline, the *Steinberger* lessees only had to pay a reasonable value at that point.<sup>236</sup> The opinion does not discuss marketable condition, implied

228. *Sternberger*, 894 P.2d at 797.

229. *Fawcett*, 352 P.3d at 1051.

230. 213 P. 646 (Kan. 1923).

231. *Id.* at 647.

232. *Id.* (emphasis added).

233. *Id.* at 647–48.

234. *Id.* at 647.

235. *Id.* (“If the pipe line had been built by defendants to Kansas City or Chicago, and the gas transported and marketed there at four or five times its value at the place of production, would it be contended that the price received at either of these distant markets should be the measure of defendant’s liability?”).

236. *Id.*

duties, or the relationship between there being no “market” at the pipeline connection and marketability, nor did it give signs of envisioning a world in which added acts in the field can be required to make gas marketable.

A decade later, in *Voshell v. Indian Territory Illuminating Oil Co.*,<sup>237</sup> a case involving another lease with the standard “free of cost” oil delivery language, the product was oil rather than natural gas, and depressed oil prices had extinguished demand at the field posted price. The lessee became unable to sell oil at that price into pipelines in the field. After a time, Illuminating Oil was able to connect the two producing wells to two pipelines that in combination brought the oil to a “distant” refinery in El Dorado, Kansas.<sup>238</sup> Voshell refused to accept royalties based on the distant sales price minus the cost of the dual pipeline transportation.<sup>239</sup> Instead, he claimed he should be paid on the posted price in the field (though buyers were not buying oil at that high a price at the time). And he argued that in the absence of a field market at the posted price, Illuminated Oil had to build enough storage tanks—a “tank farm”—to store oil in the field. The court disagreed, holding that the lease clearly envisioned pipeline transportation and treating the various provisions for connection to pipelines as applying “in the vicinity” of the wells as opposed to requiring free delivery to pipelines at more distant locations.<sup>240</sup>

Finally, another decade later, in *Molter v. Lewis*,<sup>241</sup> the Kansas Supreme Court interpreted the same oil royalty language narrowly in an oil case in which the lessees initially failed in their efforts to arrange a pipeline to the wells—instead trucking oil to nearby pipelines for a period of time, needing to keep the well producing to avoid reservoir damage—and the lessees wanted to deduct the cost of trucking. This situation continued for several years until a pipeline connection was secured.<sup>242</sup> The lessors cited the trial record for the parties’ having known when they entered the lease that there was no pipeline connected to the wells.<sup>243</sup> The court held that the lessees did indeed have a duty to market the oil, a “general” duty, but this duty did not include a duty to

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237. 19 P.2d 456, 458 (Kan. 1933).

238. *Id.* at 456–57.

239. *Id.* at 457.

240. *Id.*

241. 134 P.2d 404 (Kan. 1943).

242. *Id.* at 405.

243. *Id.*

pay the cost of transporting oil “to some distant place.”<sup>244</sup> It cited Merrill’s treatise for the principle that a lessee does not have a duty to arrange oil sales “to a distant point for sale” and held that there is “no authority” that the lessee would have to transport oil to a distant point and pay on the price available there without deductions.<sup>245</sup>

None of these cases presented an argument over the lessee’s implied duty to market and any resulting cost responsibility. All three turn on quite different oil language (the first case, *Scott*, incorporates the oil language as a likely standard for the gas under its lease). All predate the lead Kansas case, *Gilmore*, by decades. All predate significant gas regulation, gas deregulation, and the development of today’s gas market. None are authorities intended to address the proper gas deduction rule.

#### *F. Fawcett Misused Market Value/Proceeds Cases As If They Are Deduction Cases*

Another unfortunate aspect of *Fawcett* is its misuse of market value/proceeds cases. These cases concern a dispute over finding the proper price, not deductions. In *Gilmore*, the Kansas Supreme Court correctly noted that the *Matzen* decision, one of the leading Kansas opinions on the difference between “market value” and “proceeds” royalty terms, is not a relevant precedent on where the line should be drawn on gas deductions because the plaintiffs stipulated to the marketability of the gas at the well.<sup>246</sup> This *Matzen* case, a pre-*Gilmore*

244. *Id.* at 406.

245. *Id.* at 406–07. The *Molter* court pronounced, “[I]t seems impossible to conceive of any arguments in [that position’s] favor. The transportation to the distant point is no part of the legitimate operating expense of the lease.” *Id.* at 407. It also cited, in dictum, the *Summers* treatise for the oversimplification that “[i]t is quite uniformly held in cases involving the marketing of gas that the lessor or royalty owner must bear the expense of transportation of his royalty gas to the point at which it is actually sold,” *id.* (citation omitted), with the treatise citing *Scott*, even though *Scott*, as discussed above, applied the express oil clause language to its gas deduction dispute, used that express clause to make the pipeline connection the point of gas valuation, and did not articulate a general marketability principle. *See supra* notes 230–36 & accompanying text.

246. *Gilmore*, 388 P.2d at 605. The *Gilmore* court’s rejection of *Matzen*’s relevance to ordinary deduction cases could hardly have been clearer. The trial court had relied on *Matzen* as controlling law, although it twice stated that even under *Matzen* it found the question a close one. *Id.* The Kansas Supreme Court disagreed, holding, quite properly, that *Matzen* “is not applicable here for the very cogent reason the parties there had stipulated in court that the lessee could and had properly deducted costs of a large gathering system to transport the gas from the leased property to a far distant pipeline.” *Id.* In *Matzen*, the Syllabus recites that “lessors concede royalty is determined at the wellhead and that they should pay reasonable expenses of gathering, processing and marketing the gas . . .” *Matzen*, 321 P.2d at 578. The use of the term “gathering” rather than “transportation” in *Gilmore* is unfortunate. The pipeline may have started at the well, but the Kansas Supreme Court has a tradition of using a “far distant pipeline” to signify transportation, as it did in its Kansas

case, did not focus on general deduction issues.

In *Sternberger*, the Kansas Supreme Court disregarded its past analysis and discussed *Matzen* as if the plaintiffs' stipulation should not limit the case's precedential value for deduction disputes.<sup>247</sup> When it briefed *Fawcett*, OPIK relied heavily on a later decision also named for Carl Matzen, *Matzen v. Cities Service Co.*,<sup>248</sup> as well as several of the other market value/proceeds cases.<sup>249</sup> This later *Matzen* decision also addressed differences between market value and proceeds leases, not deduction issues, and is no more relevant than the first *Matzen* decision.<sup>250</sup> The *Fawcett* court cited this second *Matzen* decision and two other market value/proceeds cases, *Waechter v. Amoco*<sup>251</sup> and *Lightcap v. Mobil*,<sup>252</sup> as if relevant to its deduction dispute.<sup>253</sup>

The market value/proceeds cases are price disputes that do not turn on the deductibility issues in marketable-product cases. These cases arose during the regulated price era after the energy crisis pushed intrastate gas prices well above regulated interstate prices. This divergence, and the depressive effect of low interstate gas prices on exploration and development in fields committed to interstate commerce, was one of the major reasons that Congress and the Federal Energy Regulatory Commission deregulated the natural-gas industry in a series

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City/Chicago hypothetical in *Scott*, not gathering in or near the field.

247. *Sternberger*, 894 P.2d at 796–98. In contrast to its brief discussion of *Gilmore*, *Sternberger* spends six paragraphs in the heart of the opinion on *Matzen*, and only later dismissively mentions the *Matzen* plaintiffs' concession that deductions generally (just not on income taxes, but deductions generally) could be taken without any acknowledgement that the concession limits *Matzen*'s precedential value. *Id.* The reason for citing *Matzen* cannot be that, looking at *Matzen* through *Sternberger* spectacles, the court saw another example of an exception for raw gas that is never treated; in *Matzen* the dispute was over gathering, transporting, processing, and marketing, so the bulk of the gas was not sold as raw gas (a small part was, but the decision does not turn on the raw gas). See *Matzen*, 321 P.2d at 579–80. Thus, the bulk of the *Matzen* gas was transformed before sale. The *Matzen* plaintiffs' concession, though, may explain a certain casualness by the *Matzen* court in not really distinguishing between gathering and transportation. See *infra* note 261 (discussing *Matzen*'s use of "gathering" at end of note).

248. 667 P.2d 337 (Kan. 1983) [hereinafter *Matzen II*].

249. *Fawcett* Brief of Appellant, *supra* note 31, at 19, 25.

250. The *Matzen II* case consolidated sixteen class actions against a variety of producers. The court called the case a "sequel" to other market value/proceeds cases, *Matzen II*, 667 P.2d at 340, and was concerned with how regulated prices fit into market value, not particular deductions. In *Hockett*, which addressed in part whether royalties were due on the gross or net sales price, the Kansas Supreme Court found that the *Matzen II* decision, as well as two related market value/proceeds cases, "adds nothing to the question presented here." 251 P.3d at 72. *Fawcett* should have reached the same conclusion.

251. 667 P.3d 337 (Kan. 1983).

252. 562 P.2d 1 (Kan. 1977).

253. See *Fawcett* Brief of Appellant, *supra* note 31, at 7, 18–19, 24–25; see also *infra* notes 260–61 & accompanying text (discussing a set of cases OPIK relies on).

of steps from the mid-1980s to the mid-1990s.<sup>254</sup> Natural gas prices since have overcome their inter- and intrastate segmentation. For a time, though, when unregulated intrastate prices were materially higher than regulated interstate prices, landowners whose lessees had committed their gas to interstate commerce (usually under long-term contracts with a “maximum lawful price” that tracked the federally regulated price ceiling), received royalties based on a lower price than the “market value” they could see being paid for intrastate gas.

The result of these price divergences was a series of lawsuits filed by royalty owners whose leases had “market value” price terms that (they claimed) entitled them to be paid on the higher intrastate price and not be limited to their lessees’ “proceeds” under lessee sales contracts.<sup>255</sup> The disputes turned on whether the term “market value” in a natural gas royalty clause is intended to mean something different from “proceeds”—a question Kansas answered affirmatively in this series of leading cases,<sup>256</sup> though other states, including Oklahoma, have disagreed.<sup>257</sup>

In *Fawcett*, OPIK argued that these Kansas market value/proceeds cases established that, as long as a lessee pays the amount it receives from companies that purchase its gas (the classic proceeds argument), it satisfies its royalty-payment obligation.<sup>258</sup> Of course, because Kansas has given proceeds and market value leases separate meanings,<sup>259</sup> this would be true only, at most, for proceeds leases or if the proceeds prong of a *Waechter* two-prong lease applied. More fundamentally, though,

254. See McArthur, *Antitrust in the New [De]Regulated Natural Gas Industry*, *supra* note 81 (describing effects of natural gas deregulation generally); see also RICHARD VIETOR, *CONTRIVED COMPETITION: REGULATION AND DEREGULATION IN AMERICA* 91–166 (1994) (same); MARTHA DERTHICK & PAUL QUIRK, *THE POLITICS OF DEREGULATION* 207–36 (1985) (same).

255. See, e.g., *Holmes v. Kewanee Oil Co.*, 664 P.2d 1335, 1339 (Kan. 1983); *Lightcap v. Mobil Oil Corp.*, 562 P.2d 1, 5, 10 (Kan. 1977); *Waechter v. Amoco Prod. Co.*, 537 P.2d 228, 249 (Kan. 1975), *adhered to on reh'g*, 546 P.2d 1320 (Kan. 1976).

256. See *Holmes*, 664 P.2d at 1339 (holding that, in a regulated price regime, proceeds means the amount actually paid to the lessee under its sales contract while market value means the amount being paid in arm’s-length contracts for comparable natural gas); *Lightcap*, 562 P.2d at 5, 10 (same); *Waechter*, 537 P.2d at 249 (same).

257. For discussion of the market value/proceeds split across jurisdictions and the inconsistency between the structure of lease royalty clauses and the efforts to treat proceeds as if they are not “market value,” see McArthur articles cited *infra* note 259.

258. *Fawcett* Brief of Appellant, *supra* note 31, at 7, 18–19.

259. On this kind of distinction, see generally McArthur, *A Minority of One?*, *supra* note 79 (criticizing the Texas fruit of this poisonous tree); John Burritt McArthur, *The Precedent Trap and the Irrational Persistence of the Vela Rule*, 39 Hous. L. Rev. 979 (2002) (criticizing generally the *Vela* rule that distinguishes market value and proceeds royalty terms, and discussing cases in the two camps on this issue).

three of the four older market value/proceeds cases OPIK cited, all but *Matzen*, did not address deduction issues at all.<sup>260</sup> They are about what price applies, not what deductions can be taken. The fourth older case, the first *Matzen* decision, does have a deduction issue, but it only contains a discrete issue about the deductibility of income taxes. On deductions generally, the plaintiffs stipulated that value was to be set at the well, leaving the court nothing to decide on the point of valuation.<sup>261</sup>

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260. For OPIK's reliance upon these cases, see *Fawcett* Brief of Appellant, *supra* note 31, at 7, 18–19, 25.

261. *Id.* at 19 (citing *Matzen v. Hugoton Prod. Co.*, 321 P.2d 576 (Kan. 1958)). In *Matzen*, a natural gas case about a lease in the Hugoton field, the lease provided for payment on “one-eighth of the proceeds from the sale of gas,” gross-proceeds language that should be read (under *Hockett*) to bar any deductions unless specifically authorized by precise deduction language. *Matzen*, 321 P.2d at 578–79. But the lessees “conceded” that royalty value was to be determined at the well and “that they should pay reasonable expenses of gathering, processing, and marketing” of the gas in the gathering system. *Id.* at 578 (citing court syllabus). This was called the “proceeds-less-expenses” payment method. *Id.* at 580. Today it is often called a netback method. The Matzens’ argument was not that Hugoton Production could not take deductions, but that when there are no wellhead sales the royalty owners should be entitled to prove the “*fair value*” of gas at that point by any pertinent evidence. *Id.* at 581 (emphasis in original). Overall, their main worry was to exclude one particular expense, income taxes, that Marathon had included in its deductions. Given this position, they had no reason to focus on marketability generally or on the point of valuation.

The *Matzen* plaintiffs’ agreement that they did have to pay reasonable expenses and had to use the well as the anchoring valuation point may reflect the predominance of wellhead gas sales in the regulated era. The court emphasized the wellhead as the customary point of gas valuation when plaintiffs entered their leases. *Id.* at 582 (when leases were executed “it was the established custom and practice in the field to measure, determine the price, and pay royalty at the wellhead for gas produced”). With large pipelines providing field services in an integrated bundle of activities whose internal structure was invisible to most landowners, marketing seemed a simple thing because in so many areas there were active regulated markets at the well. Having the plaintiffs’ concession on point of valuation, the court held that when the gas was transported off the lease in Hugoton Production Company’s gathering system, the royalty should be calculated by a proceeds-less-expenses method, *id.*, a ruling that should not stand under today’s standard for a pure proceeds lease unless the gas truly was marketable on the lease. The *Matzen* decision distinguishes *Scott*, *Voshell*, and *Molter* as irrelevant because they were decided under lease language applying to in-kind deliveries, not to royalties computed as a “stipulated percentage of the proceeds derived from the sale of the gas.” *Id.*

Another casualty of *Matzen*’s emphasis on just one class of deductions, income taxes, and the stipulation on deductions generally, is that the *Matzen* court used the terms “gathering” and “transportation” largely indistinguishably. Neither term was going to affect the deductibility of income taxes. The initial lessee, Panhandle Eastern Pipe Line Company, entered an agreement to sell the gas to Kansas Power and Light Company and created Hugoton Production for purposes of “acquiring and developing the block” of 95,000 acres of leases. *Id.* at 578–79. Hugoton was to build facilities to “gather, transport, process and deliver gas to the power company.” *Id.* at 579. It built a “gathering pipeline system” of 184 miles of pipeline ranging from 4 to 24 inches in diameter, along with a processing plant and, at its outlet, a dehydration plant and an ultimate connection to the power company’s pipeline. *Id.* Hugoton sold liquids after processing to Warren Petroleum Company and also sold a small amount of interruptible surplus raw gas “as might be available after its contractual obligations to the power company” to Columbian Carbon Company; it delivered this remaining unprocessed gas somewhere “distant from the wellheads.” *Id.* at 579–80. For the insouciance of the court’s distinction between gathering and transportation, see also *id.* at 581–82

None of these cases embodied any principle about when deductions generally can be taken from proceeds. Furthermore, just four years earlier in *Hockett*, the Kansas Supreme Court read these market value/proceeds cases as generally supporting a reading that the lessee must pay royalties on gross, not net, proceeds,<sup>262</sup> a reading contrary to OPIK's claim that the cases support its proposed net, post-production royalty standard. These authorities do not add weight to *Fawcett*'s reasoning.

#### IV. WHAT SHOULD MARKETABILITY MEAN?

Although the Kansas Supreme Court stated in *Fawcett* that marketability remains an "open question," it did affirm certain limits on the concept. The court's statements, in *Fawcett* and before, help put some meat on marketability's bones.

One reading of *Fawcett* would be that any saleable gas is marketable. OPIK certainly took just this position in its *Fawcett* briefing, arguing that its gas was "saleable" at the well and that any sale was enough to prove marketability for a proceeds lease under the Kansas rule.<sup>263</sup> OPIK distinguished this rule from a "first marketable product doctrine,"<sup>264</sup>

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(discussing "a gathering system to transport and process the gas" and that the parties could not have contemplated that the lessee alone "would bear the expense of providing such transportation" and deduction expenses of "gathering, processing and marketing the gas"). The opinion gives no sign that the court thought about, or was trying to decide anything about, the differences between gathering and transportation.

262. *Hockett v. Trees Oil Co.*, 251 P.3d 65, 72 (Kan. 2011) ("In conclusion, what the cases cited by Oil Company teach us is that the term 'proceeds' in a royalty clause refers to the gross sales price . . . . If the lessee claims that it is entitled to compute and pay royalties [on a lesser amount] . . . it must find the authority to do so somewhere other than in the lease's royalty clause.").

263. *Fawcett* Brief of Appellant, *supra* note 31, at 3 (claiming sales were made to "first purchasers" at well); *id.* at 6 (accusing plaintiffs of trying to "deconstruct" gas sales contracts); *id.* at 7 (arguing that "proceeds" is the "amount of money obtained or realized by [the first] actual sale"); *id.* at 9 (discussing what it called the trial court's "fundamental misconception: that the implied duty to market existing in Kansas requires more from operators than producing a saleable gas product" and arguing that the Kansas rule has "only ever required operators to produce a saleable gas product" free of cost to royalty owner); *id.* at 14 (arguing that OPIK takes no deductions from "proceeds it receives"); *id.* at 16 (phrasing question as involving proceeds from sale to "first purchasers"); *id.* at 18 (title for section arguing that "Proceeds" means "Amount Actually Received by OPIK"); *id.* at 21 (accusing the district court of changing Kansas proceeds law); *id.* at 24 (claiming to "pay[] royalties based on 100% of the dollars it receives as proceeds"); *see also* Supplemental Brief of Defendant-Appellant at 4, *Fawcett v. OPIK*, No. 12-108666-A (Kan. Jan. 24, 2014) [hereinafter *Fawcett* Supplemental Brief of Defendant-Appellant] (claiming that "proceeds" will be "gross sale price in the contract between the first purchaser and the lessee/producer/seller" and citing *Hockett*); *id.* at 4-7 (general proceeds argument); *id.* at 10-11 (same); *id.* at 12 (again urging saleable product theory); *id.* at 15 ("This Court should clarify Kansas law so that the courts below know that the obligation to produce a 'marketable product' means the obligation to produce a 'saleable product' . . . .").

264. *Fawcett* Brief of Appellant, *supra* note 31, at 34 ("Although some commentators cite

which is certainly what *Gilmore*, *Schupbach*, and *Sternberger* apply. OPIK urged the court to adopt a “first purchaser”<sup>265</sup> rule rather than a “first marketable product” rule.<sup>266</sup> Its proposed rule would be an *ipso facto* rule. If a sale occurs, the product must be marketable. At least facially, this would allow *any* sale, whatever the price, whatever the condition of the gas, whatever its volume large or small, whatever the nature of the market including if there is only one buyer, to satisfy all lessee marketing duties.

One part of *Fawcett* would seem to adopt this position, if it were all the court said about marketability. Not only did the court treat the fact that OPIK and the service companies had a negotiated sale of some sort at the well as proof that the gas was marketable, but it criticized the argument that given the variety of points upon a demand curve, so that there is always demand for a product at some price (and often a little demand at almost any price, even if nowhere near market-clearing demand), it would be incoherent to hold that any price no matter how low can establish marketability.<sup>267</sup>

But the court said more than this. It specifically noted two strong standards that should reduce lessee manipulation of the gas price and help keep marketability disputes grounded in reality: the lessee’s duty to act in good faith and its duty to market.<sup>268</sup> These duties, particularly the duty to market, have proven quite potent in royalty cases.

The duty to market has been instrumental across the oilfield in invalidating two kinds of self-interested and, unfortunately, not uncommon enough lessee behaviors: use of a low price when the lessee could, or did, sell to third parties at a higher price and deduction of excessive costs. Two classic Texas cases illustrate the conflicts and self-dealing that can arise. In one, *Amoco v. First Baptist of Pyote*,<sup>269</sup> Amoco committed new leases to below-market prices because it received a *quid*

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Kansas as having already adopted the first marketable product rule, the rule in Kansas differs from the more commonly accept [sic] first marketable product doctrine, namely because Kansas law recognizes that gas can be marketed from the well.” (citation omitted)).

265. *E.g.*, *id.* at 12–14 (urging first-purchaser standard in section titled “OPIK’s Sales to First Purchasers at the Well”).

266. For OPIK’s distinguishing the first marketable-product rule by arguing that the rule only requires a first sale, any kind of sale, see *supra* notes 264–66 & accompanying text.

267. *Fawcett*, 352 P.3d at 1038 (citing views of Kansas Judge Patrick McAnany). Given *Fawcett*’s treatment of the service arrangement as a sale that *ipso facto* proved marketability, the Kansas Supreme Court obviously disagreed at least in the *Fawcett* context with Judge McAnany’s position.

268. See *supra* notes 76–77 & accompanying text.

269. 579 S.W.2d 280 (Tex. App. 1979), *writ ref’d n.r.e. per curiam*, 611 S.W.2d 610 (Tex. 1980).

*pro quo* on certain existing properties that already were locked into long-term sales contracts with low prices; Amoco and some of its other royalty owners received price increases on those properties in return for binding the just-signed lessors' gas to the now higher-priced, but still below-market, long-term Amoco sales contracts.<sup>270</sup> The Texas Court of Appeals and Texas Supreme Court found that Amoco had breached the marketing duty it owed to the lessors who issued the new leases.<sup>271</sup>

The other Texas case settled, but not before a Texas Supreme Court decision had exerted substantial influence on oilfield jurisprudence. The case, which is often cited as a classic example of conflicting interests and as a case in which the lessee did not pass on the full benefit it had received from the gas stream, is *TXO v. Hagen*.<sup>272</sup> TXO sold natural gas to a pipeline subsidiary, which re-sold the gas downstream for a significantly greater price and also received a separate payment for sulphur removed from the gas. TXO did not share the higher price or the payments for sulphur with its royalty owners. In a bench trial, the trial judge found the affiliate relationship a "sham," and the Supreme Court had affirmed based on the duty to market before the opinion was vacated for settlement.

The transactions that cloak self-dealing on revenues or costs often arise in affiliate cases, as was the case in *Hagen* with its pipeline subsidiary. Two large categories of affiliate cases have been the posted-price cases, in which lessees often "sold" oil internally to a marketing division or affiliate but that entity then sold or exchanged the oil for more on the open market, and gas-price cases that began to appear with frequency on the heels of natural gas deregulation and continue to be filed. The posted price cases were consolidated in an MDL case in federal court in Corpus Christi.<sup>273</sup> The natural gas deregulated price cases have been litigated company by company and have been resolved

270. *Id.* at 282.

271. *Id.* at 287. The Texas Supreme Court affirmed the court of appeals in an opinion that quickly honed in on the core duty-to-market issue:

It is implicit in the court's reasoning that there was evidence of a breach of the covenant to market in good faith in Amoco's marketing of the lessors' gas at a rate substantially lower than market value, where by doing so Amoco was able to obtain for itself the collateral benefit of increasing the price for gas from its other previously dedicated leases from third parties. 579 S.W.2d at 280. We agree. *First Baptist*, 611 S.W.2d at 610.

272. 683 S.W.2d 24 (Tex. App. 1984), *aff'd in part and rev'd in part*, No. C-3768, 1987 WL 47847 (Tex. 1987 Dec. 15, 1987) (affirming relevant opinion that lessee TXO had to disgorge profits made by reselling through affiliated company), *vacated after settlement*, 760 S.W.2d 960 (Tex. 1988).

273. *In Re Lease Oil Antitrust Litigation* (No. II), 186 F.R.D. 403 (S.D. Tex. 1999). For general background on these consolidated cases, see *id.* at 409–11.

over a much longer period of time.<sup>274</sup>

In addition to obvious self-dealing, courts have resisted accepting transactions that are not subject to market forces as competent to generate valid prices for royalty purposes. It has long been established that Kansas law accords with economic realities and that a “market” cannot necessarily be established by a single sale or a mere handful of sales. This issue cropped up in a slightly different context in the market value/proceeds cases, in which the court had to address what constitutes a market. In *Lightcap v. Mobil Oil Corp.*, the Kansas Supreme Court held:

[T]he “market” as the descriptive of the buyer or the outlet for the sale is not synonymous with its larger meaning in fixing price or value. For in that situation the law looks not to the particular transaction but the theoretical one between the supposed free seller *vis-à-vis* the contemporary free buyer dealing freely at arm’s length . . . .<sup>275</sup>

Although there are problems with distinguishing “market value” from “proceeds” in lease clauses,<sup>276</sup> one place where it is wise to make this distinction, and not always accept proceeds under either clause, is when there are reasons to question the adequacy of the underlying price.

Using a realistic screen can disqualify sales proposed for “market value” and sometimes disqualify a sales contract as a legitimate source of “proceeds.” An affiliate sale is not one between a “free” buyer and seller. A distribution for free use is not a sale. A small producer stuck on a single gathering system often has no buyer other than the gathering company and often is not dealing “freely.”

The requirement of comparability for market-value leases should

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274. For a discussion of the natural gas price cases, see MCARTHUR, *supra* note 4, at 219–20. On affiliate cases generally, see *Tara Petroleum Corp. v. Hughey*, 630 P.3d 1269, 1274–75 (Okla. 1981), in which, construing a “market price at the well” lease, the court held that the price the producer receives under an arm’s-length, good faith gas purchase contract with the best price and term available at the time is the “market price” in Oklahoma, but that if a lessee is paying royalty one on price, “but on resale a related entity is obtaining a higher price, the lessors are entitled to their royalty share of the higher price,” with one issue to show common control of the two entities. The plaintiffs lost their challenge to an allegedly related price because they had not shown common control. *Id.* at 1275–76. The Oklahoma Supreme Court cited the general affiliate principle from *Tara* with approval more than two decades later in *Howell v. Texaco*, 112 P.3d 1154, 1160 (Okla. 2004).

275. 562 P.2d 1, 5 (Kan. 1977) (quoting *J.M. Huber Corp. v. Denman*, 367 F.2d 104, 109–10 (5th Cir. 1966)); *see also Holmes v. Kewanee Oil Co.*, 664 P.2d 1335, 1339–40 (Kan. 1983); *Smith v. Amoco Prod. Co.*, 31 P.3d 255, 269 (Kan. 2001); *cf. Johnson v. Jernigan*, 475 P.2d 396, 398 (Okla. 1970) (“Market rate implies the existence of a free and open market of supply and demand where there are willing sellers and buyers.”).

276. On this market value/proceeds distinction, see *supra* note 259 & accompanying text.

further guide market analysis. The idea of marketability assumes some comparability. Markets themselves often involve a range of products sold at different prices. There is fresh bread and day-old bread. There are used cars with warranties and used cars without warranties. There is gas from which contaminants have been removed and there is unprocessed, untreated gas fresh out of the ground.<sup>277</sup> In today's gas market, producers with access to processing plants and downstream markets rarely consent to sell gas in captive wellhead transactions (although they are happy to buy gas there).

Cases discussing "market value" royalty clauses frequently talk about the requirement that like products be treated alike. In *Holmes v. Kewanee Oil Co.*,<sup>278</sup> the court discussed the trial court's use of "comparable sales" as a measure of market value. It cited other authority holding that "comparable" means comparable in "time, quality, quantity, and availability of marketing outlets."<sup>279</sup> In *Lippert v. Angle*, the Kansas Supreme Court held that comparable sales are sales made under "similar or under substantially similar conditions."<sup>280</sup> A sale of untreated surplus gas for local use is not the same as sales of processed gas into an interstate pipeline. Even the importance of comparability, however, though adding more detail to the idea of marketability, pales in comparison to the next consideration—the best-price duty.

In many situations, the appropriate royalty price may indeed be the first-purchaser price. But that is not an acceptable price if the "purchase" is one between affiliates who use prices that cannot be verified in independent sales, particularly if the affiliate resells the product for more, and it is not the right price if a prudent operator would have gotten a better price. It also should not be an acceptable price if the "buyer" is

277. Older leases that discuss raw gas tend to distinguish gas from gas wells, which gets the appellation raw gas, from associated gas from an oil well. There is no persuasive reason to think that the lessors intended to agree that if their wells are gas wells, they are only entitled to payment on the raw gas in its natural condition even if prudent lessees process the gas, move it downstream after applying services to make the gas marketable, and in this way sell it away from the well for better prices. It is hard to imagine a negotiation in which the lessee indicated that it was going to process the gas to secure the best price possible, but insisted that it would only pay a lower value based on pre-processed raw gas even though the lessee itself intended to transform and market the gas as dry gas and liquids. Leases that mention raw gas evolved before the significant markets for liquids, which today are separated from dry gas when the raw gas stream is processed. There is no reason to believe that lessors in these leases were asked to give up their right to whatever sale the lessee decided would secure the best, most prudent price when they signed leases that contain "raw gas" language.

278. 664 P.2d 1335 (Kan. 1983).

279. *Id.* at 1341 (quoting *Exxon v. Middleton*, 613 S.W.2d 240, 246 (Tex. 1981)).

280. 508 P.2d 920, 926 (Kan. 1973).

actually a service company that is merely readying the gas stream for true sale and keeping a share of the proceeds, although this is the prospect that *Fawcett* has unleashed upon Kansas.

To see how unmoored the marketability test can be unless it is rooted in the best price, not just any sale or, even worse, any exchange at all, consider certain dictum in *Coulter*. As already mentioned, all the Kansas Supreme Court had to do in *Coulter* was to determine whether the trial court abused its discretion in approving a class action settlement.<sup>281</sup> The court did not have to decide what the law is, but merely determine if the trial court was right that the class secured fair value for its claims. In almost all approved settlements that are for less than 100 cents on the dollar, the trial judge will recite that both sides still had significant risks of fact, law, or both and that the money agreed upon today is worth more than the risky proposition that the plaintiff might get more if it went through trial. The reviewing court has to decide whether there is a reason to doubt that already deferential judgment. Statements about risks frequently identify risk factors without any effort to determine which, if any, are serious risks.

In discussing the lessee's position that gas was marketable at the well, the *Coulter* court in dictum cited an exhibit that contained a schematic of the stages through which the gas moved and concluded "that some of the gas leaves the well site in a line designated 'free house gas,' suggesting that the gas at the well site is in a marketable condition for household use."<sup>282</sup> Yet "free use" gas is an ordinary feature of American leases, and it normally is authorized under a lease clause that allows the *lessor* to use some of the gas produced on its own premises free of cost. Diverting some of the gas to the lessor for its own use does not create a market transaction. This use does not prove that gas is marketable, much less marketable at the best price possible. The court long ago held in the slightly different context of a gas sales agreement between a pipeline buyer and parties who controlled the rights to gas from various leases that, just as one would expect, the fact that gas can burn and has some use does not prove that it is "merchantable,"<sup>283</sup> and the lessee has a duty to make gas merchantable. That the lessee is delivering free gas to the lessor does not prove that the gas is marketable, nor does the fact that the gas may burn and thus has some possible use. The *Coulter* court's offhand comment may be a misdirection caused by

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281. *Coulter v. Anadarko Petrol. Corp.*, 292 P.3d 289, 308 (Kan. 2013).

282. *Id.*

283. See *infra* notes 286–87 & accompanying text.

the deferential standard for settlement approval and a desire to show that each side had something to argue, but its failure to consider the best price as part of its analysis encouraged its offhand comment on local use gas.

The *Coulter* court gave a second example that is just as misplaced. This second inappropriate comparison suggested that lessee Anadarko might have a point when it argued that the gas it produced was marketable at the well. Referring to the same schematic, the court mentioned a pipeline for “irrig. sales” and said that the line “suggest[ed] that the gas is in marketable condition for use in irrigation systems before it is in a condition to enter the interstate transmission pipeline.”<sup>284</sup> And, indeed, there are a number of small-volume agricultural sales in many natural gas fields. Yet these sales do not necessarily occur in what courts generally would call a market; they certainly are not similar in volume or otherwise comparable to downstream sales of processed gas, and, most fundamentally, they are highly unlikely to draw the best price reasonably possible. One does not see sophisticated lessees lining up to place the bulk of their supplies in irrigation sales, the occasional home heating and cooking sales, or other small-volume uses in the field.

There is something highly fictitious about using a small local “market” as if it proves that all gas in a huge field is “marketable” when the field never would have been developed for incidental local sales and, indeed, would have to be shut down today were its true target, distant commercial, industrial, and residential markets, suddenly closed to it. The development of the American natural-gas industry is a story of the development of these distant markets: once the technology to support steel pipes became available, natural gas replaced manufactured gas, and it became economic to develop the large fields of the south and west, including the large natural gas fields in Kansas, as distinct gas fields, not just fields with some associated gas produced from oil wells.<sup>285</sup>

The United States has gone through a large structural transformation in an effort to create a true natural gas market in which prices will be efficiently set and buyers and sellers will receive accurate signals. It turns out that those efficient markets usually are found today at downstream locations beyond processing plants. The great bulk of gas in

284. *Coulter*, 292 P.3d at 307.

285. As one example of the growth of the natural (as opposed to manufactured) gas market, a history of the emergence of much of the natural gas industry in Kansas and its difficult efforts to elbow its way into distant urban markets served by distributors of manufactured gas, see CHRISTOPHER CASTANEDA & CLARANCE SMITH, GAS PIPELINES AND THE EMERGENCE OF AMERICA’S REGULATORY STATE: A HISTORY OF PANHANDLE EASTERN CORPORATION 1928–1993, chs. 2–4 (1996).

the United States is sold in those markets. Our vast network of interstate pipelines, and even large intrastate lines, relies on sales into those markets. The best-price duty maintains a link with the reality of this change because its application will direct judges and juries, and the parties themselves, to this market. Absent such a grounding in the fundamental value of a best-price standard, even good courts can become unmoored and begin seeing relevant value in free house gas that is not priced and small sales of untreated irrigation gas that is not physically conditioned to be acceptable to the large pipelines that transport the overwhelming percentage of gas in the United States.

At times, marketability is left to the jury as a fact issue. If buyers and sellers really converge on the wellhead and bargain to buy gas there, a jury may find that sales there establish proceeds and market value at that location as long as the price is the best price reasonably possible, given all available options, the sales are at outlets comparable to those prudent sellers would use, and the price incorporates any available volume premium. But the arrangement still needs to be judged under the lessee's duty to secure the best price possible for comparable bundles of gas. The prices received are not acceptable just because they prompted somebody, anybody, to buy some gas.

The Kansas Supreme Court, in the early gas case in which it interpreted the term "merchantable" in a gas sales contract, rejected the view that gas is merchantable merely because it "will burn, and is capable of producing light and heat, and can be sold and used for that purpose."<sup>286</sup> Instead, the gas had to be of at least the quality "such as is generally sold in the market and suitable for the purpose for which they are intended, although not of the best quality."<sup>287</sup> Defining marketability is one of the places where it is helpful to remember this prudent advice.

Regulatory changes did not divest lessees of their duty to provide marketable products. The implied covenant that spawns this duty is not an abstract concept pulled out of the sky and imposed on an unsuspecting industry. It is a principle laboriously fitted over a matter of several generations into gaps between what is written in the lease, industry practices, and larger lease purposes. Fitting the duty to market to a deregulated gas market is but the latest step in development of these covenants. For instance, industry custom teaches that today the first true markets for natural gas from the field are not at the distant terminus of large pipelines and intakes to local distribution systems and large

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286. *Ely v. Wichita Nat. Gas Co.*, 161 P. 649, 653 (Kan. 1916).

287. *Id.*

industrial customers. They are at the post-plant market centers.

#### V. SHOULD *FAWCETT'S* EQUATION OF A WELLHEAD SERVICE AGREEMENT THAT HAS SOME SALES ASPECTS WITH A TRUE SALES AGREEMENT STAND?

It is rare, though not unheard of, for courts to reverse recent decisions. The Kansas Supreme Court's treatment of a service arrangement with sale aspects as if it is a pure sales agreement will pave the way for lessees who previously had to pay marketability costs for their royalty owners to make their royalty owners absorb those costs. Unlike the two lower courts, the supreme court did not consider the implications of the service nature of the wellhead arrangements or how easily its new rule will allow lessees to avoid costs they previously had to bear merely by dressing the arrangements up with a few trappings of a partial sale. In the absence of any real consideration of what was being exchanged in OPIK's wellhead transactions with mid-stream companies, *Fawcett* is a severely unreasoned decision.

The court fortunately did state that the sales must be in good faith and comply with the duty to market to be appropriate to use in royalty computations. This alone may prevent some wellhead prices from being confused with appropriate prices, perhaps even in arrangements like the *Fawcett* arrangements. But it is a surprise and a disappointment that the Kansas Supreme Court gave no sign of considering that whatever OPIK's wellhead arrangements are, they are not traditional sales agreements, and they do delegate to third parties services whose cost OPIK unquestionably would have had to bear in proceeds leases had OPIK decided to perform the services itself. The idea that a lessee can make nondeductible services deductible by its unilateral decisions about how it provides them went out the door with *Gilman* and *Schupbach* and each case's language about siting compressors. The court offered no reason to suddenly legitimate this rejected logic.

Most troubling, the court limited its analysis of OPIK's wellhead agreements to a labeling exercise. As soon as it was satisfied that the arrangement had aspects of sales, it thereafter treated them as if they were true arm's-length sales. Yet what kind of sale is one in which the seller gets all of the buyer's sale revenue back except a charge for performing services the buyer performs before it sells the gas? *Fawcett* offers no persuasive reason for so completely avoiding the substance of these contracts because of their form.

One hopes that the court was not swayed by the full-court press that the producers mounted against the Kansas rule. It certainly was not true

before *Fawcett* that, as one Kansas-based critic and amici argued, Kansas’ “[r]oyalty calculation jurisprudence is a mess.”<sup>288</sup> Kansas’ overall royalty jurisprudence is quite distinguished, although *Fawcett* has dealt it a glancing blow and, ironically, is itself a somewhat “messy” decision, as this Article has tried to show. *Sternberger*, too, has careless dictum that can generate confusion. One hopes as well that the court was not swayed by the lessee and amicus arguments ranging from claims that the court deprived lessees of property without due process of law to claims that making them bear marketability costs would destroy midstream companies and cripple lessees, to say nothing of pushing future investment to states with Texas-type “at the well” rules.<sup>289</sup> It is always in a company’s self-interest to argue that any judicial rule or statute that increases costs will impose crippling burdens, but lessees have been paying marketability costs in more than half of the producing jurisdictions—jurisdictions that account for far more than half of the gas production in the United States—

without crippling consequences. And there is no sign that the midstream business would disappear if lessees have to pay for all of those costs, rather than seven-eighths or a similar percentage of those costs with the royalty owners bearing the rest. If lessees believe that it is most efficient to outsource to midstream companies, they will do so regardless of whether they are paying all of the cost or just most of it.

At the end of the day, the greatest disappointments about *Fawcett* are that the court treated an arrangement that is not primarily about selling gas as if it is, and that it wrote a decision as if it was merely applying existing standards when it was changing them. Contrary to *Gilmore* and *Schupbach*, *Fawcett* gives lessees a way to avoid paying to make the royalty share of gas marketable by unilaterally changing the way they structure their sales contracts. This is a sharp break with the past,

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288. EKOZA Amicus Brief, *supra* note 64, at 1. EKOZA’s brief was not specific about whether it thinks that royalty jurisprudence nationally, or just in Kansas, is a “mess,” but given the purpose of its brief, EKOZA certainly was asserting, at a minimum, that Kansas royalty law overall is messed up.

289. OPIK advanced the “cripple industry” argument in its *Fawcett* Brief of Appellant, *supra* note 31, at 38–41. It combined a financial harm argument and what was in effect a due process argument (though called a “violation of fundamental principles”) in its supplemental brief. *Fawcett* Supplemental Brief of Defendant-Appellant, *supra* note 263, at 16–17. EKOZA also made something like a due process argument as a “policy” argument when it called an implied-at-law obligation to bear the deductions “an affront to freedom of contract principles.” EKOZA Amicus Brief, *supra* note 64, at 13. DCP Midstream warned that the *Fawcett* decision would “increase[] producers’ royalty obligations materially beyond those initially agreed” if the Kansas Supreme Court does not reverse. Brief of Amicus Curiae DCP Midstream, LP, at 15, *Fawcett v. Oil Producers, Inc.* of Kan., 306 P.3d 318 (Kan. Ct. App. 2013) (Nos. 108, 666).

whatever the extent of the rule's actual application. The *Fawcett* exception means that a decision that the lessee adopts for efficiency's sake—the decision to supply services internally or by buying them, an outsourcing that the lessee should undertake only if it cannot provide services more cheaply than independent firms—also determines whether it can deduct costs from the royalty interest. The Kansas Supreme Court would do well to reconsider these aspects of its recent divergence from its own past law if the issue comes before it again.