WHAT IS REQUIRED FOR GAS TO BE A MARKETABLE PRODUCT IN OKLAHOMA?

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This article discusses (1) the case law in Oklahoma giving rise to the question of what is required for gas to be a marketable product, (2) the differing view of royalty owners and producers on that question, (3) the uncertainties under the case law, (4) recent changes in the gas industry relevant to the question, and (5) other authorities applicable to the question. The author also proposes a standard to be applied in determining whether gas is a marketable product.

GENESIS OF THE ISSUE

Over twenty years ago, in the 1992 case of *Wood v. TXO Production Corp.,*[1] the Oklahoma Supreme Court held that a lessee's implied duty to market under an oil and gas lease "involves obtaining a marketable product."[2] The issue in *Wood* was whether the lessee could charge its royalty owners for their proportionate share of the costs incurred by the lessee in compressing gas <u>on the leased premises</u> so as to enable the gas to be delivered into the buyer's line, also <u>located on the leased premises</u>.[3] The court held that cost could not be charged to the lessors under the implied duty to market.[4]

Two years after *Wood*, the court decided *TXO Production Corp. v. State ex rel. Comm'rs of the Land Office*.[5] In *CLO*, the court decided that post-production costs for on-lease compression, dehydration and gathering expenses were not chargeable to the CLO under the producer's lease with TXO. The court based its decision on the fact the CLO lease provided the lessee was to deliver to the CLO one-eighth of the gas produced "without cost into pipelines . . . or in lieu thereof, pay to the lessor the market value thereof,"[6] but also said the costs in question were incurred to "prepare the product for market"[7] and "prior to the product being placed into the purchaser's pipeline,"[8] so were "necessary to make the product marketable"[9] and therefore not chargeable to the royalty owner.

Four years later, in *Mittelstaedt v. Santa Fe Minerals, Inc.*,[10] the court addressed, for the first time, whether off-lease post-production costs could be charged to royalty owners. The court made it clear that the fact the costs were for off-lease operations "does not mean the costs are necessarily shared by the lessors,"[11] but also made it clear that such costs "must be examined on an individual basis to determine if they are within the class of costs shared by royalty interests."[12] The court then addressed the specific costs involved in the case, beginning with dehydration. The court said that dehydration costs "necessary to make a product marketable, or dehydration within the custom and usage of the lessee's duty to create a marketable product, without provision for cost to lessors in the lease," are not payable from the royalty interest, but that "excess dehydration to an already marketable product is to be allocated proportionately to the royalty interest when such costs are reasonable, and when actual royalty revenues are increased in proportion to the costs assessed against the royalty interest."[13] The court likewise explained that blending costs "necessary to make a marketable product" are not allocated to royalty owners, but blending costs for "an already marketable product" may be so allocated if the costs are reasonable and royalty revenues increase in proportion to them.[14] A similar rule was given for off-lease compression costs.[15] The court concluded that:

> In sum, a royalty interest may bear post-production costs of transporting, blending, compression, and dehydration, when the costs are reasonable, when actual royalty revenues increase in proportion to the costs assessed against the royalty interest, <u>when the costs are associated with transforming an already marketable product into an enhanced product</u>, and when the lessee meets its burden of showing these facts.[16]

THE DIFFERING VIEWS ON WHEN GAS IS A MARKETABLE PRODUCT

Subsequent to the decisions in *Wood, CLO* and *Mittelstaedt*, a number of cases have been filed by royalty owners—generally seeking to represent a large number of other royalty owners on a class basis—claiming that producers have underpaid royalties by effectively charging the royalty owner for off-lease post-production costs allegedly incurred to make the producer's gas a marketable product. Typically these cases have involved one of the following two scenarios:

1. In the first scenario, the lessee/producer typically sells the gas at the well or a nearby central delivery point to a midstream company such as DCP, Enogex, ONEOK Field Services, or various others. Such sales are often on a "percent of proceeds" ("POP") basis whereby the purchaser pays the producer—typically in exchange for 100% of the MMBtus of gas delivered at the delivery point—a stated percentage of the proceeds ultimately received by the purchaser upon resale, after the purchaser moves the gas to a downstream processing plant (which may be located dozens of miles or more from the lease), processes the gas for the extraction of natural gas liquids ("NGLs"), and sells the residue gas and NGLs at the plant tailgate or further down the distribution chain. The POP contracts also will frequently provide that a portion of the gas being sold to the midstream company may be used for fuel in

transporting, compressing and/or processing the gas, with the percentage of proceeds paid for the NGLs and residue gas also constituting the consideration for the gas used for fuel. In some instances, the POP contract also may provide for a reduction in the proceeds otherwise payable to the producer to offset the purchaser's costs of off-lease transportation, compression or treating of the gas, usually on the basis of "X¢ per unit" of gas purchased.

2. In the second scenario, the lessee/producer itself (or an affiliate of the lessee/producer) typically pays the midstream company to move the gas from the lease to the downstream processing plant, pays the costs of compressing and processing the gas to extract NGLs, including bearing the loss of any gas used as fuel for transporting, compressing and/or processing the gas, and either sells the residue gas and extracted NGLs at the plant tailgate or moves them further down the distribution chain for sale.

In both of these scenarios, the residue gas remaining after extraction of the NGLs typically is delivered into a mainline interstate or intrastate transmission line at the tailgate of the processing plant, where it can be transmitted to an ultimate end user or local distribution company at any downstream pipeline interconnect point, which may be hundreds or thousands of miles away.

In the first scenario, the producer typically pays royalties on the proceeds it receives under the POP contract for the wellhead sale to the midstream purchaser. In the second scenario, the producer typically pays royalties on the "netback" value at the well, after deducting the downstream costs of the off-lease transportation, compression and processing from the downstream proceeds ultimately received for the sale of the residue gas and NGLs. In both scenarios, the lessee/producer may incur costs for treating, dehydrating, separating, compressing or other operations undertaken on the lease, before either selling the gas (in the first scenario) or delivering it to the midstream company (in the second scenario), and those on-lease costs are not allocated to the royalty owners, based on the decisions in *Wood* and *CLO*. The producer's contention typically is that in either scenario the gas is a marketable product at the lease when it is either sold (in the first scenario) or delivered (in the second scenario) into the midstream company's pipeline.[17]

The royalty owners, however, typically argue that gas is not a marketable product until it is acceptable for delivery into the mainline interstate or intrastate transmission line at the tailgate of the processing plant, and further argue that little or no gas is acceptable into such a mainline transmission line until it has been processed for extraction of NGLs, dehydrated to a "dry" condition (generally 7 lbs. water per MMcf or less), and compressed to the high pressure required for entry into a mainline transmission line. Thus, the royalty owners typically argue that all costs incurred prior to delivery into the mainline transmission line are being incurred to produce a marketable product.[18] Therefore, the royalty owners argue, in the first scenario royalties are payable on the value of 100% of the residue gas and NGLs produced at the processing plant (*i.e.*, not just the lessee/producer's share under the POP contract), irrespective of the values actually received under the POP contract, plus 100% of the value of any gas consumed for fuel and 100% of any hydrocarbons that may have condensed and been removed from the pipeline as "drip liquids" en route to the plant. Similarly, in the second scenario, the royalty owners argue royalties are due on the same 100% of the residue gas and NGLs produced at the processing plant, plus 100% of the value of any gas consumed as fuel in transporting, compressing and/or processing the gas, and 100% of any "drip liquids" removed en route to the plant, without deduction of any off-lease costs incurred by the lessee/producer in transporting, compressing or processing the gas in order to achieve those values.

UNCERTAINTIES UNDER THE CASE LAW

Surprisingly, despite the numerous cases filed since *Mittelstaedt* raising this marketable product issue, there is no Oklahoma appellate decision addressing the issue of what is required for gas to be a "marketable product." The reason for this is the royalty cases raising the issue uniformly have been settled, almost always without a trial even being held.[19] As a result, the issue of exactly what is required for gas to be a marketable product in Oklahoma has not been addressed by an Oklahoma appellate court. In *Foster v. Merit Energy Co.*,[20] the United States District Court for the Western District of Oklahoma discussed the uncertainty regarding this and several other related and still undecided issues under *Mittelstaedt*:

- "Having left marketability to be determined as a question of fact, 'the [*Mittelstaedt*] court did not attempt to define either the term 'marketable' or the term 'product.'"[21]

- "The [*Mittelstaedt*] Court . . . had no occasion to discuss how the principles articulated in *Mittlestaedt* might apply to a POP contract."[22]

- "What, exactly, are the physical attributes of a product that is 'marketable' in the sense required to qualify as an 'already marketable product' so as to trigger possible cost sharing under the *Mittelstaedt* formulation? What, exactly, is the difference between 'dehydration' (all on the lessee) and 'excess dehydration to an already marketable product' [citation omitted] for purposes of the *Mittelstaedt* formulation? Does this differentiation imply that . . . gas can be dehydrated to the extent necessary to qualify as 'marketable' in the sense discussed in *Mittelstaedt*, but still not be of interstate pipeline quality?"[23]

- "[T]he [Oklahoma] Supreme Court's royalty cases leave a considerable amount of uncertainty as to the relative roles played by lease language, on the one hand, and the implied covenant to market, on the other, in bringing about the results reached in those cases." [24]

All of these issues remain undecided by an Oklahoma appellate court.[25]

THE IMPACT OF RECENT CHANGES IN THE GAS INDUSTRY

In order to properly analyze this "marketable product" issue, some historical context also is necessary. Prior to the latter 1980s and early 1990s, almost all gas produced in the United States was sold at the lease by the lessee/producer to an interstate or intrastate pipeline company. The pipeline company served both a merchant role—buying the raw gas from the lessee/producer and selling the processed residue gas to end users or local distribution companies—and a transportation role—moving the gas from the producer to the end user/local distribution company. As part of its transportation function, the pipeline company typically also either processed the gas at a company-owned plant or had it processed at a third-party plant. The interstate/intrastate pipeline company bore all the costs of transporting, compressing and processing the gas and, at the same time, received all the increased value attributable to the transportation, compressing and processing of the gas, while the lessee/producer did not bear any of the costs or share in any of the increased value. Thus, during this time period, there were almost no "off-lease post-production costs" incurred by a lessee/producer.[26] Because the gas was generally sold at the well to the pipeline company buyer, gas was generally considered to be marketable as long as it was acceptable by the pipeline company buyer when delivered at the lease, before the additional off-lease processes were performed by the buyer.[27]

Beginning in the latter 1980s and continuing through the early 1990s, the Federal Energy Regulatory Commission ("FERC") issued a number of orders having the purpose and effect of making the pipeline companies pure transporters of gas, rather than both merchants and transporters.[28] As a result, the pipeline companies spun off the portions of their pipeline systems and processing plants upstream of their high-pressure mainline transmission lines.

Those spun-off companies, or other newly created companies, became the merchant purchasers and resellers of gas, referred to as "midstream companies," who now either purchase gas at the lease, or transport it for a fee to a processing plant, where the gas is processed and compressed for delivery into the pipeline company's high-pressure mainline transmission line for ultimate sale and delivery to the end user or local distribution company purchaser.[29]

From a lessee/producer's perspective, gas today is no different than it was prior to the FERC's restructuring of the pipeline industry and, since gas today is often being sold or delivered into the same pipelines at the lease, for delivery to and processing at the same processing plants, as it was before the restructuring of the industry, the gas today is just as much a marketable product at the lease as it was before the industry was restructured, when almost all gas was sold to an interstate or intrastate pipeline company at the lease. However, the royalty owner's perspective is just the opposite. They contend that following the restructure of the pipeline industry gas is no longer marketable at the wellhead, and that no gas can be marketable now until it is has been transported to and processed at a downstream processing plant where NGLs are extracted and the residue can be delivered into an interstate or intrastate pipeline company's mainline transmission line.

OTHER AUTHORITIES CONSIDERED

Sooner or later, in the author's opinion, a case presenting the marketable product issue is going to be tried and either a jury will have to be instructed as to what is required for gas to be a marketable product or the court will have to make a finding on that issue. Despite the uncertainties under *Mittelstaedt*, the Oklahoma Supreme Court did make it clear that determining whether gas is a marketable product is a fact intensive question dependent in large part on the custom and usage in the industry.[30] However, as the court discussed in *Foster*, exactly what is required for gas to be marketable under *Mittelstaedt* remains unclear. Notwithstanding that uncertainty, the author believes there are several Oklahoma cases and other authorities that provide guidance for arriving at the appropriate standard to be applied in determining what is required for gas to be a marketable product. These are discussed below.

In *Replogle v. Indian Territory Illuminating Oil Co.*,[31] the plaintiffs/royalty owners had agreed with the lessee/producer that the producer could use gas being produced from a certain oil well for the producer's other operations in Oklahoma City, free of cost to the royalty owners "until such time as there is a market for said gas."[32] Oklahoma Natural Gas Company later attempted to make use of the gas, and made a few purchases from the lessee/producer for a short time, but determined it was unable to use the gas and quit buying it.[33] Plaintiffs argued there was a market for the gas based on the few discontinued sales to ONG, but the court rejected that argument, saying:

> [M]arket . . . alludes to the opportunity for selling the commodity (gas) . . . that is, the existence of a commercial demand for same.[34]

In *Johnson v. Jernigan*,[35] the plaintiff's lease called for royalties to be paid on gas based on the "gross proceeds at the prevailing market rate."[36] The parties agreed there was no market for the gas at the lease, and the lessee moved the gas ten miles off the lease to the point of sale and deducted 2 cents per Mcf from the proceeds for that cost in calculating royalties. The royalty owner sued, alleging the deduction was not allowed under the lease, but the court ruled in favor of the lessee/producer, saying:

> Market rate is the rate at which the gas is commonly sold in the vicinity of the well. It is market rate at the wellhead or in the field that determines the sale price, and not the market rate at the purchaser's location which may be some distance away from the leased premises.[37]

Most recently, in the 2004 case of *Howell v. Texaco Inc.*,[38] the court said this about a lease provision calling for payment of royalties based on market value:

> Market value is the price negotiated by a willing buyer, not obligated to buy, and a willing seller, not obligated to sell, in a free and open market.[39]

The writings of Professors Eugene Kuntz and Owen Anderson also have addressed the issue of when gas is a marketable product. For example, Professor Kuntz's treatise on oil and gas law states:

> It is not always easy to determine, however, when the first marketable product has been obtained. Marketability of the product may be affected because the quality of the raw gas is impaired by the presence of impurities. In this instance, it should be necessary to determine if there is a commercial market for the raw gas. If there is a commercial market, then a marketable product has been produced and further processing to improve the product should be treated as refining to increase the value of the marketable product.[40]

Thus, similar to the *Replogle* court's "commercial demand" analysis, Professor Kuntz would look to whether there is a "commercial market" for the gas. Although the author is not aware of any Oklahoma case specifically defining the term "commercial demand" or "commercial market," in *Allenberg v. Bentley Hedges Travel Service*,[41] the Oklahoma Supreme Court said that "the term 'commercial seller' refers to a seller who is in the business of selling" the goods in question.[42] Similarly, a "commercial demand" or "commercial market" for gas should only require the existence of buyers who are in the business of buying the type of gas at issue or who buy it in the regular course of their business.

Finally, Professor Anderson has advocated a similar approach to determining when gas is marketable, based on what he refers to as the "market realities" as to whether the gas is "marketable in fact":

> While sweet, dry gas is in marketable condition (but not necessarily in a marketable location) at the wellhead, sour or water-saturated gas, depending on

market realities, may not be in a marketable condition (or a marketable location) at the wellhead.

* * *

Of course, in many instances, gas in fact may be in a first-marketable condition at the wellhead. In other instances, gas, such as sour gas, may not be marketable until it is treated. I hesitate to offer a list of specific examples, because the question of when a product first becomes marketable is a question of fact, not law. . . . [I]f wet gas is marketable in fact, the location of a gasoline extraction plant on the leased premises should not trigger royalty on the gross value of the extracted liquids and residue gas because gasoline extraction would be beyond the exploration and production segment of the industry.

[I]n today's gas markets, gas may be first sold at a point and in a condition that is well beyond the point and condition where it becomes a first-marketable product. And the point at which gas becomes a first-marketable product may also vary from area-to-area and perhaps from well-to-well.[43]

While Professor Anderson does not expand on what is sufficient to show the gas is "marketable in fact," it seems clear the "market realities" he relies on would be satisfied by evidence establishing that there is in fact a "commercial market" of willing buyers in the business of buying gas of the type produced or who buy it in the regular course of their business.

THE PROPOSED STANDARD

Based on *Replogle, Johnson, Howell*, *Allenberg*, and the writings of Professors Kuntz and Anderson, the author believes the following formulation constitutes an appropriate standard for determining what is required for gas to be a marketable product:

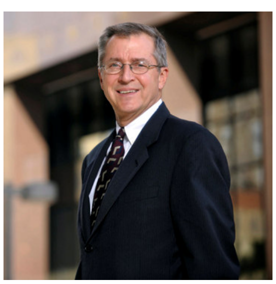
Gas is a marketable product when there is a commercial market for it. This means the gas is of a type capable of being sold to willing buyers in the business of buying such gas, or who buy such gas in the regular course of their business, and who are not otherwise obligated to buy it, in a free and open market. Gas can be marketable at the well if the gas is of a type commonly sold in the vicinity of a well, even though the gas is moved some distance from the well before being sold.[44]

In accordance with *Mittlestaedt*, all of the foregoing should be able to be shown (or challenged) by evidence of the custom and usage in the industry with respect to such gas.

This proposed standard is consistent with the holdings in *Replogle, Johnson, Howell, and Allenberg,* and also is consistent with the writings of Professors Kuntz and Anderson.[45] The proposed standard allows the jury or fact-finder to determine whether the gas at issue is a marketable product based on the realities of the market place for the gas in question and the facts that may be presented as to whether there is a commercial market of buyers for gas in that physical condition. However, the standard is <u>not</u> dependent on whether the gas is marketable to midstream companies versus end users (or others in the distribution chain), on whether the gas can be transported on an interstate or intrastate mainline transmission line, or on whether the gas is further treated or processed after the sale for ultimate resale to end users. This is because the standard depends on whether there is in fact a commercial market for gas of that type, regardless of whether the market consists of end users or other buyers, whether the gas can be transported on a mainline interstate or intrastate transmission line, and whether the gas is further treated or processed after the sale for ultimate resale to end users.[46] Nor is the standard dependent on whether the gas is sold under a POP contract versus some other type of contract, since the type of contract entered into is not a factor in determining whether the gas is or is not a marketable product. As Professor Anderson has said regarding the common practice of selling "wet gas" (meaning gas saturated with NGLs[47]) to gasoline plants on a POP basis, "<u>Such a real and established market presumably makes the wet gas marketable in fact</u> even though the purchase price is unknown until the next sale occurs."[48]

CONCLUSION

For over fifteen years, since the promulgation of the *Mittelstaedt* decision, producers and royalty owners alike have had to deal with the uncertainty of not knowing the standard that will be applied in determining whether gas is a marketable product in Oklahoma. Although the promulgation of a more definitive standard for answering this question will still leave uncertainty as to what a fact finder may determine under any given state of facts, it would be a clear improvement over the present status in which producers and royalty owners do not even know what standard will apply in determining whether gas is a marketable product. The author hopes a case raising this question reaches an appellate court in Oklahoma in the near future so that both producers and royalty owners can have a better understanding of what is required for gas to be a marketable product in Oklahoma, and believes the standard proposed herein should be adopted if and when that occurs.



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[1] 1992 OK 100, 854 P.2d 880.

[2] *Id.* at ¶ 12, 854 P.2d at 883.

[3] *Id.* at ¶ 9, 854 P.2d at 882. The fact that the costs were incurred on the lease is significant. Leases cover a specific location, and a producer's production activities are generally undertaken on a specific area within the lease. Producers typically deliver gas to a third party purchaser or transporter through a meter located on the lease and near the wellhead, and the meter measures the quantity of gas being delivered into the third party's line. Operations undertaken on the lease and prior to delivery of gas into the meter (for example, use of a separator to separate liquids from gas prior to delivery of the gas into the meter) generally have been viewed by the industry as production

activities that are not chargeable to royalty owners. On the other hand, off-lease operations typically are not undertaken by a producer (and cannot be done without acquiring the right to do so on the landowner's property), and generally have been viewed by the industry as post-production costs to an already marketable product that can be charged to royalty owners. (As discussed in note 26, *infra*, the primary circumstance in which "off lease" activities are undertaken by a producer is for the collection and delivery of gas from several nearby wells to a nearby central delivery point.)

[4] *Wood* and other cases have made it clear this implied duty to market can be negated by appropriate language in the lease. *Id.* at ¶ 11, 854 P.2d at 883 ("If a lessee wants royalty owners to share in compression costs, that can be spelled out in the lease"). *Accord Rogers v. Heston Oil Co.*, 1984 OK 75, ¶ 19, 735 P.2d 542, 546 (an implied covenant in an oil and gas lease "is a covenant implied in fact to carry out what the parties must have intended" and "becomes a part of the lease only where its inclusion in the lease is not inconsistent with other terms of the lease."). The issue of precisely what language is sufficient to negate the implied covenant is beyond the scope of this article. However, *compare Emery Res. Holdings, LLC v. Coastal Plains Energy, Inc., 2012 WL 1085718,* at *8 (D. Utah Mar. 30, 2012) ("[T]he majority of courts to consider the topic have found 'at the well' royalty clauses to mean the natural gas is valued for royalty purposes at its wellhead location and condition") and *Elliott Indus. v. BP. Am. Prod. Co.*, 407 F.3d 1091, 1109 (10th Cir. 2005) ("[M]arket value at the well" should reflect "'the value of the gas in its unprocessed state as it comes to the surface at the mouth of the well before it is transported and processed.'") (citation omitted) *with Hill v. Kaiser-Francis Oil Co.*, No. CIV-09-07-R (W.D. Okla. Aug. 16, 2012) (lease provisions calling for royalties to be paid on the value or proceeds "at the well" or "at the mouth of the well" are not sufficient to negate the implied covenant, but provisions for royalties to be based on the value or proceeds for "raw gas" are sufficient to do so) and *Fankhauser v. XTO Energy, Inc.*, 2012 WL 601415 (W.D, Okla. Feb. 23, 2012) (lease provisions calling for royalties to be based on value or proceeds of "raw gas" or of gas "at the well" are not sufficient to negate the implied covenant).

[5] 1994 OK 131, 903 P.2d 259.

[6] *Id.* at ¶¶ 7-8, 903 P.2d at 260-61.

[7] *Id.* at ¶ 12, 903 P.2d at 262.

[8] *Id.* at ¶ 15, 903 P.2d at 262.

[9] *Id.* at ¶ 12, 903 P.2d at 263.

[10] 1998 OK 7, 954 P.2d 1203.

[11] *Id.* at ¶ 19, 954 P.2d at 1208.

[12] *Id.*

[13] *Id.* at ¶ 26, 954 P.2d at 1209 (emphasis added).

[14] *Id.* at ¶ 27, 954 P.2d at 1209-10.

[15] *Id.* at ¶ 29, 954 P.2d at 1210.

[16] *Id.* at ¶ 30, 954 P.2d at 1210 (emphasis added).

[17]Producers also contend that natural gas produced at the well is comparable to crude oil produced at the well, which is universally considered to be a marketable product when produced at the well. Both natural gas and crude oil contain mixtures of hydrocarbons and other chemicals, and both typically undergo downstream processes (refining for crude oil and processing for gas) before being sold to end users. A similar process applies to a myriad of other products that are processed or refined before being sold to end users. Examples include corn, cattle, and iron ore.

[18] In support of this argument, royalty owners often refer to midstream company marketing materials saying the midstream company is producing marketable products by processing the gas. However, those materials refer to making the gas and extracted NGLs marketable to end users, and marketability to end users should not be the test of marketability for gas any more than it is for crude oil, corn, cattle, iron ore, or other commodities that are typically sold to refiners, processors, or other midstream companies in a distribution chain and also undergo a myriad of processes and changes before being marketable to end users.

[19]*See, e.g., Brumley v. Conoco Phillips*, Case No. CJ-2001-5, D. Ct. Texas Cty.; *Robertson v. Sanguine*, Case No. CJ-02-140, D. Ct. Caddo Cty.; *Velma-Alma v. Chesapeake Energy Corp.*, Case No. CJ-02-331E, D. Ct. Stephens Cty.; *Velma-Alma v. Texaco*, Case No. CJ-02-304E, D. Ct. Stephens Cty; *Mitchusson v. EXCO Resources, Inc.*, Case No. CJ-2010-32, D. Ct. Caddo County. These cases typically alleged fraud and breach of fiduciary duty also, and sought to recover alleged royalty underpayments going back to the 1980s. Because the Oklahoma Production Revenue Standards Act provides that unpaid royalties bear interest at 12% compounded annually, 52 O.S. § 570.10.D, the potential exposure for principal and interest alone generally ranged from tens of millions of dollars to middle or upper eight figure amounts, and sometimes exceeded one hundred million dollars. Given the uncertainty

in the law and the huge dollars at stake, it is perhaps not surprising that the producers and royalty owners would reach a settlement rather than risk a complete loss to one side or the other.

[20] 282 F.R.D. 541 (W.D. Okla. 2012).

[21] Id. at 548-49, quoting from Byron C. Keeling and Karolyn K. Gillespie, *The First Marketable Product Doctrine: Just What is the "Product,"* 37 St. Mary L.J. 1, at 65 (2005).

[22] *Id*. at 550.

[23] *Id*. at 550, fn. 8.

[24] *Id*. at 550, fn. 9.

[25]In *Hill v. Marathon Oil Co.*, No. CIV-08-37 (W.D. Okla.), Judge Russell sought to obtain clarification of the marketable product issue by certifying three questions to the Oklahoma Supreme Court, including the question of:

> When is gas "marketable" or how is the term "marketable" defined for purposes of determining when gas becomes a "marketable product" and whether production and post-production costs were incurred to make the gas "marketable" or were incurred to enhance the value of an already marketable product?

Id. at doc. No. 118. However, the Oklahoma Supreme Court declined to answer the certified question, stating that:

> [S]ufficient direction existed in Oklahoma case law to allow the instruction of fact finders . . . . *Mittlestaedt* . . . and the cases cited and analyzed therein provide guidance sufficient to the federal court to address the questions presented.

Hill v. Marathon Oil Co., No. 108098 (Okla. Sup. Ct.), Order dated May 11, 2010. Given the uncertainties on this question, it is unfortunate that the court declined this opportunity to clarify the law. Interestingly, Judge Russell later stated in *Naylor Farms, Inc. Anadarko Oil & Gas Co.*, 2011 WL 7053789 (W.D. Okla., July 14, 2011) that making gas marketable "by inference means of interstate or intrastate pipeline quality" *id.* at n. 2, but subsequently modified that ruling, stating "there is no Oklahoma authority holding that extraction of NGLs is necessary to put gas in a marketable form and that the costs of such extraction must be borne by the lessee"). *Naylor Farms, Inc. Anadarko Oil & Gas Co.*, 2011 WL 7053794 (W.D. Okla., Oct. 14, 2011) (granting in part and denying in part Defendant's motion to reconsider the court's July 14, 2011 Order). Two other judges in the Western District of Oklahoma have rejected the contention that gas must be of mainline pipeline quality to be marketable, stating that such an argument is "inconsistent with Oklahoma law." *Foster v. Apache Corp.,* 285 F.R.D. 632, 642 (W.D. Okla. 2012); *Foster v. Merit Energy Co.*, 2012 W.L. 6161939, at *4 (W.D. Okla. Nov. 21, 2012).

[26] The principal exception to this would be where a lessee/producer gathered gas from several nearby leases and moved it to a nearby central delivery point for sale to the interstate/intrastate pipeline. In such a case, the lessee/producer would incur the cost of moving the gas to the central delivery point and potentially could incur off-lease compression, dehydration and/or treating costs if the gas needed to be compressed, dehydrated and/or otherwise treated in order to be delivered into the purchaser's line at the central delivery point. In the author's opinion, those "near the lease" activities are what the court was referring to in *Mittelstaedt* as off-lease post-production "field processes" that might be necessary to make gas marketable. 1998 OK 7 at ¶ 21, 954 P.2d at 1208. The author believes it is unlikely the *Mittlestaedt* court intended that phrase to refer to the distant off-lease activities of transporting the gas dozens of miles or more through a midstream company pipeline to a processing plant, and then processing/compressing the gas at the plant, as contended by the royalty owners' attorneys in the royalty class action lawsuits. Such distant off-lease activities were undertaken by producers infrequently, if at all, at the time *Mittelstaedt* was decided. Had the court in *Mittlestaedt* intended to rule that such distant off-lease activities were necessary to make gas a marketable product by making it acceptable into a mainline transmission line, it seems likely the court would have explicitly said that acceptability into a mainline transmission line was required for gas to be a marketable product, rather than emphasizing the factual nature of the question, *id*. at ¶ 26, 954 P.2d at 1209, the need to examine any costs "on an individual basis," *id*. at ¶ 19, 954 P.2d at 1208, and the importance of custom and usage in the industry in determining what activities were necessary to make a marketable product, *id*. at ¶¶ 20, 23, 26, 954 P.2d at 1208-09. Further, there would have been no need for the court to discuss the concept of "excess dehydration to an already marketable product," *id*. at ¶ 26, since gas acceptable to a mainline transmission line already is "dry" and not subject to further dehydration.

[27] *See Wood and TXO, supra*, and *Johnson v. Jernigan*, *infra* at n. 35.

[28] *See Associated Gas Distributors v. F.E.R.C.*, 824 F.2d 981, 993-96 (D.C. Cir. 1987) (describing FERC's efforts to accomplish a "complete restructuring of the natural gas industry" through Order 436's unbundling of the pipeline companies' transportation and merchant roles); *Transwestern Pipeline Co. v. F.E.R.C.*, 897 F.2d 570, 573 (to same effect); *American Gas Ass'n v. F.E.R.C.*, 912 F.2d 1496, 1503 (D.C. Cir. 1990) (to same effect); *see also Foster v. Merit Energy Co.*, *supra* at 547 (referring to the "radical changes in the business of natural gas production, processing and distribution in the last three decades").

[29] *See, e.g.,* Owen L. Anderson, Royalty Valuation: Should Royalty Obligations Be Determined Intrinsically, Theoretically, or Realistically? Part 2, 37 Natural Resources J. 611 at 634, n. 104 (hereafter, "Anderson"):

> Until recently, gas was customarily sold at the well or in the vicinity of the field to pipelines who acted as merchants of gas. . . . Today, because pipelines are now regulated as common carriers, gas may be sold at the well, in the vicinity of the field, or at some distant market. In other words, there are potentially multiple markets for gas produced from a single field.

[30] 1998 OK 7 at ¶¶ 20, 23 and 26, 954 P.2d at 1208-09.
[31] 1943 OK 417, 143 P.2d 1002.
[32] 1943 OK 417, at ¶ 6, 143 P.2d at __.
[33] Id. at ¶¶ 34-36, 143 P.2d at __.
[34] Id. at ¶¶ 37, 143 P.2d at __ (emphasis added).
[35] 1970 OK 180, 475 P.2d 396.
[36] 1970 OK 180 at ¶ 4, 475 P.2d at __ (emphasis added).
[37] *Id*. at ¶ 5, 475 P.2d at __ (emphasis added).
[38] 2004 OK 92, 112 P.3d 1154.
[39] 2004 OK 92 at ¶ 17, 112 P.3d at __ (emphasis added).
[40] 3 Eugene Kuntz, LAW OF OIL AND GAS, § 40.5(b) (1989) (emphasis added).
[41] 2001 OK 22, 22 P.3d 223.
[42] *Id*. at n. 1 (emphasis added).
[43] Anderson, *supra* at 634, 642-43, 645 (emphasis added).
[44] The last sentence, and the phrase "of a type" in the last two sentences, make it clear that gas from a particular well can be a marketable product even though potential buyers may not be willing to extend a line to the particular well because, for example, of the well's location or other reasons unrelated to the quality of the gas (such as an oversupply of gas). As shown by *Johnson v. Jernigan* and *Mittelstaedt*, gas can be a marketable product even though there is no market available at the well.
[45] Additionally, the proposed standard is consistent with what Justice Opala proposed in his partial dissent in *Mittelstaedt* as the test for determining whether a producer had obtained a "first marketable product," namely that the fact finder dertermine "the point of production at which there are both willing sellers and buyers." *Mittelstaedt*, 1998 OK 7, ¶ 24 (Opala, J., dissenting in part). The proposed standard also is consistent with the decisions of Justices Taylor and Reif in a case in which Justice Taylor was the District Judge and Justice Reif was on the Court of Civil Appeals. *See Watts v. Amoco Prod'n. Co.*, Case No. C-2001-73 (D. Ct. Pittsburgh County, Order dated Dec. 10, 2002, at 5-6) (finding that gas in the counties at issue "was marketable at the wellhead" based on wellhead sales to midstream companies), *aff'd.*, Case No. 98,782 (Okla. Ct. Civ. App., Order dated Sept. 14, 2004, at 3) ("gas produced by the wells in question was marketable at the wellhead").
[46] Of course, if such activities are undertaken by a non-commercial buyer, the gas may or may not be a marketable product, depending on all the facts. For example, in some areas sour gas containing excessive hydrogen sulfide is not acceptable to commercial buyers. In those areas, if a producer were to convince someone who was not in the business of buying gas to purchase his gas, treat it so as to make it acceptable to commercial buyers, and then resell it to a commercial buyer at a price sufficient to recoup the treating cost, the sale to such a non-commercial buyer would not mean the gas was a marketable product. However, in other areas where such gas was routinely purchased by commercial buyers in the business of buying gas of that type, that gas would be a marketable product. As discussed by Professors Kuntz and Anderson, these results are exactly what an analysis based on the market realities of a commercial market call for.
[47] Anderson, *supra* at 634, n. 104.
[48] *Id*. at 637, n. 138 (emphasis added)