

Post Production Expense Deductions



BY M. BRIAN MCMAHON

INTERPRETING AMBIGUOUS ROYALTY PROVISIONS

“A royalty clause should be construed in its entirety and against the party who offered it, and in light of the fact that the royalty clause is the means by which the lessor receives the primary consideration for a productive lease.”

Rogers v. Westerman Farm Co., 29 P. 3d 887 (Colo. 2001)

“In cases of uncertainty not removed by the preceding rules, the language of a contract should be interpreted most strongly against the party who caused the uncertainty to exist.”

California Civil Code §1654

NO EXPRESS CLAUSE: COST OF PRODUCTION

All courts agree that the costs of exploration and production must be borne by lessee alone.

COSTS BORNE BY LESSEE ALONE

Costs incurred in exploring for minerals and bringing them to the surface are not deductible. They include:

1. Costs of geophysical surveys
2. Drilling costs
3. Tangible and intangible costs incurred in testing, completing or reworking a well
4. Secondary recovery costs

Lessee is required to pay royalties at “current price paid by the lessee of like grade and gravity at the wells.”

Lessee is entitled to deduct the cost of dehydration, because oil at the well was wet oil.

Alamitos Land v. Shell Oil Co., 3 Cal. 2d 396 (1935)

The lease authorized the lessee to sell the oil and pay “the proceeds thereof, less cost of handling.”

Court: lessee not entitled to deduct the cost of dehydration because it did not sell oil mixed with water and the lease called for payment based on the proceeds of sale.

Alamitos Land distinguished because there, royalty was based on purchase by the lessee.

Meyers v. Texas Co., 6 Cal. 2d 610 (1936)

Costs of distillate injected into wells to increase oil production, and the overhead associated with injection of distillate, were not deductible expenses.

El Rio Oils v. Chase, 95 Cal. App. 2d 402 (1950)

Pub. Res. Code §6827: “royalties shall be paid...as a percentage of the current market price at the well.”

Processing costs deductible: “It is the rule in California that unless there is clear language to the contrary, the lessor of an oil and gas lease...bears its proportionate share of processing costs...”, citing *Alamitos Land*.

Transportation costs deductible: “‘market price at the well’ is often determined by working back from the price at the point of sale, deducting the cost of processing and transportation to the wellhead.”

Atlantic Richfield Co. v. The State of California,
214 Cal. App. 3 533 (1989)

TWO SCHOOLS RE POST-PRODUCTION COSTS

1. AT THE WELL RULE

All costs incurred after production of oil and gas at the well are deductible.

2. FIRST MARKETABLE PRODUCT RULE

All costs incurred after production to make oil and gas marketable are not deductible.

AT THE WELL RULE

“Market value at the well’ means the value of gas at the well before it is transported, treated, compressed or otherwise prepared for market.”

Heritage Resources, Inc. v. NationsBank, 939 S.W. 2d 118
(Tex. 1997)

STATES THAT ADOPTED THE 'AT THE WELL RULE'

- Texas
- Louisiana
- Kentucky
- North Dakota
- New Mexico
- Pennsylvania
- Michigan
- Mississippi

THE FIRST MARKETABLE PRODUCT RULE

1. Costs incurred in production not deductible: all agree
2. Costs incurred in placing oil and gas in marketable condition not deductible: all agree.
3. Costs incurred after oil and gas are in marketable condition: disagreement.

FIRST MARKETABLE PRODUCT RULE

“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.”

Gilmore v. The Superior Oil Co., 192 Kan. 388 (1964)

FIRST MARKETABLE PRODUCT RULE

Royalties were based on gross proceeds.

Court: Lessee may not deduct the costs of transportation, compression, dehydration and blending in order to make gas marketable.

Court: Lessee may deduct costs to enhance an already marketable product only if (1) the costs are reasonable; and (2) royalties increase in proportion to the costs deducted.

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

FIRST MARKETABLE PRODUCT RULE

“Gas is marketable when it is in the physical condition such that it is acceptable to be bought and sold in a commercial marketplace, and in the location of a commercial marketplace, such that it is commercially saleable in the oil and gas marketplace.”

Rogers v. Westermann Farm Co., 29 P. 3d 887 (Colo. 2001)

NON-DEDUCTIBLE COSTS

<p>ALL COURTS</p>	<p>OKLAHOMA KANSAS COLORADO ARKANSAS VIRGINIA WEST VIRGINIA ILLINOIS</p>	<p>COLORADO & WEST VIRGINIA</p>
<p>EXPLORATION & PRODUCTION COSTS</p>	<p>PLACE PRODUCT IN MARKETABLE CONDITION COSTS</p>	<p>TRANSPORTATION TO MARKET CENTER COSTS</p>

‘Costs of production’ means all costs incurred for exploration, development, primary or enhanced recovery and abandonment operations, including, but not limited to, lease acquisition, drilling, pumping and lifting, recycling, gathering, compressing, pressurizing, heater treating, dehydrating, separating and storing.

Wyoming Statute- WYO. STAT. §30-5-304
ROYALTY PAYMENT ACT

The Wyoming Royalty Payment Act prohibits deductions for gathering costs.

Costs of transporting gas off the lease to downstream points of sale are gathering costs and are not deductible.

Cabot Oil & Gas Corp. v. Followill,
93 P. 3d 238 (Wyo. 2004)

CALIFORNIA COURTS AND THE TWO SCHOOLS RE POST-PRODUCTION

1. Neither the At The Well rule nor the First Marketable Product rule have been expressly addressed by California Courts.
1. Some courts have allowed post production costs: *Alamitos Land v. Shell Oil* (dehydration), *Atlantic Richfield v. California* (transportation and processing)

REQUIREMENTS FOR CLASS CERTIFICATION UNDER FEDERAL RULE 23

1. Numerosity
2. Commonality
3. Typicality
4. Fair & Adequate Representation
5. Predominance
6. Superiority

CLASS ACTIONS CLAIMING IMPROPER ROYALTY DEDUCTIONS

**UPHELD: Kansas, Colorado, West Virginia and
New Mexico**

REJECTED: Oklahoma and Arkansas

A STEP TOWARD TRANSPARENCY - 1

- A. Required information to be included with payments to interest owner:
- A Lease/well identification, month/year of sales, total barrels/MCF, price per barrel/MCF,
 - Total amount of taxes, net value of total sales,
 - Owner's interest expressed as a decimal, owner's share of total value prior to deductions, owner's share of sales value less owner's share of taxes,
 - **A specific listing of amount and purpose or any other deductions from proceeds due to owner upon request of owner.**

- 52 Okl. St. §570.12.

A STEP TOWARD TRANSPARENCY - 2

B. For purposes of the Production Revenue Standards Act:

- All revenue decimals shall be measured to not less than the nearest sixth decimal place; and
- Gas volumes shall be measured as required by Section 474.

C. All information required by subsection A may be provided by electronic means, upon the mutual written consent of the information provider and the owner.

- 52 Okl. St. §570.12.

Kentucky Courts have upheld fraud claims for improper royalty deductions.

M. Brian McMahon
www.brianmcmahonlaw.com
213.628.9800

