SOME ADVICE ON *BICE*, NORTH DAKOTA'S MARKETABLE-PRODUCT DECISION

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ABSTRACT

In 2009, the North Dakota Supreme Court decided *Bice v. Petro-Hunt, L.L.C.,*[1] and in so doing took its position on a question that has bedeviled major oil and gas producing states: Does the lessee, the operating oil company, have a duty to bear the full cost of putting natural gas into a "marketable condition," including the cost of removing water and impurities, of processing gas to separate liquids, and of moving the oil or gas to the mainline pipeline, as part of the implied duty to market? Or, instead, do royalty owners have to bear a share of these costs?[2] The North Dakota Supreme Court took the position favored by lessees, joining jurisdictions that let lessees reduce royalty payments by the cost of making oil and gas marketable.[3]

The theme of this article is that the rejection of a marketable-product rule in *Bice* was based on understandable but nonetheless real and demonstrable mistakes. The deductions at stake affect the welfare of royalty owners throughout the state as well as the balance of rights and benefits between lessors and lessees. The marketable-product issue remains contested in many other states. Indeed, it has split oilfield jurisdictions into two irreconcilable camps, for reasons not addressed in *Bice*. Given the

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1. 2009 ND 124, 768 N.W.2d 496. The background to the discussion of *Bice* and related themes in this article is Mr. McArthur's recent publication. *See* JOHN BURRITT MCARTHUR, OIL AND GAS IMPLIED COVENANTS FOR THE 21ST CENTURY: THE NEXT STEP IN EVOLUTION (Juris Publications 2014). Mr. McArthur's book discusses the two camps of marketable-product jurisdictions in more detail as well as other aspects of the duty to market and the other covenants: the duties to explore, to develop, to protect against drainage, to reasonably accommodate, and to act as a prudent operator.

2. *Bice*, ¶¶ 6-7, 8-10, 768 N.W.2d at 499-500 (describing issue in *Bice*).

3. *Id.* ¶ 21, 768 N.W.2d at 502.

issue's importance, the North Dakota Supreme Court should be receptive, should an opportunity arise, to revisit its earlier decision.

Lessees receive the lion's share of the revenue under standard American oil and gas leases. In return, they have to perform at their own cost the activity involved in securing production. They have to explore, drill, develop, and market oil and gas and pay all or most of the costs associated with these activities. This is why they receive their much larger share of revenues, traditionally a seven-eighths share but in some modern leases five-sixths or even a bit less. In a majority of states, as well as on federal properties, the lessees' responsibilities have been determined to include bearing the full cost of making oil, gas, and other mineral products "marketable." But, since *Bice*, this is not so in North Dakota.

Not only do a majority of oil and gas states apply marketable-product rules, but a majority of oil and gas production in the United States occurs on land governed by a rule that makes the lessee bear marketability costs. These costs include making gas physically marketable and can include moving the gas to the location where it is sold. States so holding are a numeric majority, even before one counts the federal government, which is by far the largest mineral landowner in the country. If one counts by production, most production in the United States falls under a version of the marketable-product rule. And, overall, the marketable-product decisions tend to be the more recent decisions. Nonetheless, the North Dakota Supreme Court adopted the older rule, which, relying on statements in a handful of law review articles,[4] it incorrectly called the majority rule.[5] The court held that lessee Petro-Hunt could deduct the costs of removing hydrogen sulfide and other liquids from the gas stream and separating out the dry gas at a downstream plant.[6]

The great majority of marketable-product cases concern natural gas because the preparation of gas for mainline transportation tends to involve more field services than are required for oil. These services include not only treatment to remove impurities but also processing as part of preparing gas for market. Moreover, oil royalty clauses, unlike gas clauses, tend to have a standard term requiring delivery "free of cost" into the purchaser's pipeline. Courts often use the oil clause one different from the standard natural gas clause to define the lessee's duty to absorb the costs of making oil marketable. The issues in this article are primarily significant to the natural gas side of the industry.

4. *Id.* ¶ 13, 768 N.W.2d at 500-01.
5. *Id.* ¶ 13, 21, 768 N.W.2d at 500-02.
6. *Id.* ¶ 21, 768 N.W.2d at 502.

I. *BICE V. PETRO-HUNT*: THE COURT'S POSITION

Bice was a class action that arose in the Little Knife Field, which produces casinghead gas[7] laden with hydrogen sulfide in addition to oil.[8] The trial court found that the gas had "no discernible market value at the well"[9] because it had not been processed at that point. The class plaintiffs sued to prevent the deduction from their royalty payments of the cost of extracting the sulfur and separating liquids from the dry gas.[10] The opinion described the accounting for gas and gas products sold away from the well and deduction costs incurred to get the gas to market after it emerged from the ground at the wellhead by the common industry names that apply when deductions are allowed: the "work-back" or "netback" method.[11] The plaintiffs' various royalty clauses, though not all identical, were

7. Casinghead gas is gas "produced with oil in oil wells, the gas being taken from the well through the casinghead at the top of the well . . . ." 8 HOWARD WILLIAMS & CHARLES MEYERS, OIL AND GAS LAW 132 (Patrick Martin & Bruce Kramer rev. 2006).

8. *Bice*, ¶ 2, 768 N.W.2d at 498.

9. *Id.* ¶ 6, 768 N.W.2d at 499. Extraction of the hydrogen sulfide turned "sour gas into sweet gas." *Id.* ¶ 8, 768 N.W.2d at 500.

10. *Id.* ¶ 5, 768 N.W.2d at 499. The lessee added all revenue from selling gas and "gas products" and then deducted "certain costs associated with processing the gas." *Id.* ¶ 2, 768 N.W.2d at 498-99.

11. *Id.* ¶ 14, 768 N.W.2d at 501.

substantially similar and provided for payment on "market value of the gas at the well."[12]

The class argued below that the trial court should adopt the "first marketable product rule" in order to require the lessee to bear the costs of producing marketable sweet gas.[13] But the court rejected that request. It decided instead to join the "at the well" jurisdictions in which the lessee has to bear the full cost burden of getting gas to the surface at the well but can share all costs after that point.[14] Petro-Hunt received summary judgment approving its cost deductions and on the appropriateness, in the district court's view, of the work-back method.[15] The North Dakota Supreme Court affirmed in a quite brief decision for what appears to be three reasons.

First, even though it described treatises as conflicted on the appropriate deduction standard, the North Dakota Supreme Court believed that the "at the well" doctrine was the majority position.[16] Rather than citing treatises, it cited three law review articles, all critical of the marketable-product doctrine, as evidence of the majority rule.[17] The decision does not suggest that the court performed an independent review of the caselaw before reaching this conclusion: it contains no substantive discussion of the individual cases making up what it took to be the majority and minority positions, even though the court does provide string cites to certain cases in each camp.[18]

Second, the court cited one of the same law review articles to claim that "the" problem with the marketable-product position is a difficulty in knowing when a product "has become a marketable product."[19]

Third, the court found persuasive a 1995 Eighth Circuit Court of Appeals decision applying North Dakota law, *Hurinenko v. Chevron U.S.A., Inc.*,[20] which, it believed, addressed the same situation as *Bice* and which took an "at the well" stance. Although it did not discuss the federal court's reasoning, the North Dakota Supreme Court apparently took from that decision that the term "at the well" is unambiguous and mandates use of a

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12. *Id.* ¶ 4, 768 N.W.2d at 499.
13. *Id.* ¶ 10, 768 N.W.2d at 500.
14. *Id.* ¶ 21, 768 N.W.2d at 502.
15. *Id.* ¶ 9, 768 N.W.2d at 500.
16. *Id.* ¶ 13, 768 N.W.2d at 500-01.
17. *Id.* (citing Byron C. Keeling & Karolyn King Gillespie, *The First Marketable Product Doctrine: Just What is the Product?,* 37 ST. MARY'S L.J. 1, 51 (2005); Edward B. Poitevent, II, *Post-Production Deductions from Royalty,* 44 S. TEX. L. REV. 709, 716 (2003); Brian S. Wheeler, *Deducting Post-Production Costs When Calculating Royalty: What Does The Lease Provide?*, 8 APPALACHIAN J.L. 1, 7 (2008)).
18. *Id.* ¶ 15, 768 N.W.2d at 501.
19. *Id.* ¶ 17, 768 N.W.2d at 502.
20. 69 F.3d 283 (8th Cir. 1995).

work-back method when comparable sales are not available as an alternative source of value at the wellhead.[21]

This article explores the court's three reasons for the outcome in *Bice*. It finds each lacking and discusses the limits on *Bice* as far as different lease types as well as certain factors that the court may want to consider if—more likely, when—marketable-product issues return to it in the future.

II. MISTAKES IN *BICE*

The brief space that *Bice* devotes to analysis unfortunately prevented the North Dakota Supreme Court from really discussing the issues at stake and from developing a reasoned explanation for its holding. This perhaps led to its error in identifying which position is the majority position on royalty deductions, to the court's finding a "problem" in an unproblematic standard, and to its acceptance of *Hurinenko*'s overly simplistic position.

A. THE COURT THOUGHT IT WAS ADOPTING THE MAJORITY RULE, BUT IT ADOPTED THE MINORITY RULE

In *Bice*, the North Dakota Supreme Court mentioned at the outset of its analysis what it called the majority position: the "at the well" position, which is often associated with Texas and Louisiana law and one that almost always allows proportionate deductions for the costs of all services applied to oil and gas after the wellhead.[22] It cited seven states—the "three major oil and gas producing states, Louisiana, Mississippi and Texas," as well as California, Kentucky, Montana, and New Mexico—as following this position.[23] The court's list was preceded by cites to three law review articles, all authored by critics of the marketable-product rule, that called the "at the well" position the majority position.[24]

In contrast to the seven jurisdictions cited as favoring deductions for all services applied after the wellhead, the court cited only five jurisdictions as

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21. *Bice,* ¶¶ 19-21, 768 N.W.2d at 502. Each side claimed that the term "at the well" was unambiguous but unambiguous in its own favor: the plaintiffs argued that if the court did not find the term unambiguous in not authorizing deductions, then it was ambiguous. *Id.* ¶ 12, 768 N.W.2d at 500.

22. *Id.* ¶ 13, 768 N.W.2d at 500-01.

23. *Id.* ¶ 15, 768 N.W.2d at 501.

24. *Id.* ¶ 13, 768 N.W.2d at 500-01. This one-sided citation to marketable-product critics only is a telling contrast with *West v. Alpar Resources, Inc.*, a more balanced, earlier North Dakota Supreme Court decision in which the court held that a "proceeds" lease does not allow deductions. 298 N.W.2d 484, 487 (N.D. 1980). The *West* court cited three major treatises, two of which supported marketable-product rules and one that rejected such a rule. *Id.* at 489 (citing 3 WILLIAMS & MEYERS, *supra* note 7, at 591-603; 3 EUGENE KUNTZ, LAW OF OIL AND GAS 319-327 (1967); MAURICE MERRILL, COVENANTS IMPLIED IN OIL AND GAS LEASES 212-18 (2nd ed. 1940)).

a "minority" that "have expressly rejected the 'at the well' rule and have adopted the first marketable product doctrine": Arkansas, Colorado, Oklahoma, Kansas, and West Virginia.[25] Because the court cited law review articles as authority for its classification of the majority and minority camps without providing its own analysis,[26] it is fair to conclude that the court did not conduct independent analyses of these cases. The court presumably assumed that the articles were correct in their tally of the majority rule. *Bice* certainly spent no time on the reasons why oil patch courts are divided into two camps or in analyzing the cases that make up those camps.

There are a number of problems with the court's numerology, whatever its source. First, its majority ranking ignores three states, Michigan, Nevada, and Wyoming, which have adopted marketable-product rules by statute.[27] It is only fair to count these states because their statutes embody a rejection of the idea that a term like "at the well" is sufficiently clear to impose costs on the royalty interest and thus reduce royalty payments. The inconsistency of these three statutes with the "at the well" doctrine is best illustrated by the Michigan statute, which was adopted in order to reverse what the Legislature clearly viewed as an erroneous state court endorsement of the lessee-favoring "at the well" position.[28] The Michigan statute bans deduction of "postproduction costs" in leases entered after March 28, 2000, unless a lease explicitly provides for such deductions.[29] In addition, the statute requires that many of the main costs be specifically identified before they can be deducted.[30]

The Nevada statute makes the lessee "liable for all of the costs of production," bars the lessor's interest from being "decreased by the costs of production," and defines such costs as including services frequently

25. *Bice*, ¶ 16, 768 N.W.2d at 501.

26. *Id.* ¶ 13, 768 N.W.2d at 500-01 (citing articles in *supra* note 17).

27. MICH. COMP. LAWS § 324.61503b(1) (1999); NEV. REV. STAT. § 522.115 (2000); WYO. STAT. ANN. § 30-5-304(iv) (1999). One of the articles cited by the North Dakota Supreme Court does a good job of discussing the three statutes, correctly sees that these statutes have similar characteristics to the judicially derived law, and also discusses the federal rule. *See* Keeling & Gillespie, *supra* note 17, at 51 n.194. But the authors' recognition of the importance of these statutes does not lead them to change their count; they still claim that "most states" follow an "at the well," not marketable-product, approach. *See id.* at 51.

28. The Michigan Legislature passed its statute after a Michigan court of appeals allowed all deductions under an "at the well" theory in a lease that provided for payment of "gross proceeds at the wellhead." Schroeder v. Terra Energy, Ltd., 565 N.W.2d 887, 890-96 (Mich. Ct. App. 1997). *Schroeder* left open whether Michigan would recognize an implied duty to market under other lease language. *Id.* at 895-96. In response, the Legislature passed the current statute on gas deductions. *See* MICH. COMP. LAWS § 324.61503b(1) (1999).

29. MICH. COMP. LAWS § 324.61503b(1) (1999).

30. *Id.*

provided away from the well such as "gathering, compressing . . . dehydrating, separating, and storing of oil or gas . . . and transporting . . . gas into the pipeline for delivery," though not mainline transportation or gas processing.[31] Thus, it defines costs that states like Texas call "postproduction" costs as "production" costs. The Wyoming statute similarly provides that the "lessee pays all costs of production out of his interest, the lessor's interest being free and clear of all those costs," and contains a definition of the "costs of production" almost identical to Nevada's statute.[32]

Each statute precludes the kind of "at the well" reading lessees ordinarily claim. It surely is necessary to count these states when trying to compute the majority rule between states that adopt the marketable-product rule and those that reject it. If one does nothing more than include these three statutory states, jurisdictions favoring the marketable-product rule move into the majority by changing *Bice's* ranking from seven to five in favor of the "at the well" rule, to eight to seven in favor of marketable-product jurisdictions. The statutory rules do not govern leases entered before the statutes' effective dates, but they do express what each state currently endorses as being the correct rule. Therefore, these states should be in the marketable-product column.

Second, *Bice*'s mathematics leaves out the country's largest and most significant royalty owner of all, the federal government. Federal royalties are based on leases that, in turn, use provisions prepared under the Secretary of the Interior's discretionary power to implement the Mineral Leasing Act, which requires payment on the "amount or value" of production.[33] Federal regulations implementing the Act require lessees to put oil and gas into marketable condition largely at their own expense in a provision that was upheld in the 1960s, although the regulations do allow certain processing deductions.[34] This early interpretation of "value" required the lessee to bear

31. NEV. REV. STAT. § 522.115 (2000).

32. WYO. STAT. ANN. § 30-5-304(a) (1999).

33. 30 U.S.C. § 226(b)(1)(A) (2014) (stating, in general, on lands leased within known structure of producing field, royalty shall be paid "at a rate of not less than 12.5 percent in amount or value of the production removed or sold . . . .").

34. With the Mineral Leasing Act requiring payment under most federal leases on the "amount or value" of production, standard federal leases allow the Secretary of the Interior to determine the "value of the production removed or sold from the lease." For a sample onshore federal lease, see BUREAU OF LAND MGMT., U.S. DEP'T OF THE INTERIOR, OFFER TO LEASE AND LEASE FOR OIL AND GAS, FORM 3100-11 § 2 (2008) ("Lessor reserves . . . the right to establish reasonable minimum values on products after giving lessee notice and an opportunity to be heard"), http://www.blm.gov/style/medialib/blm/noc/business/eforms.Par.71287.File.dat/3100-011.pdf. For an offshore lease, see MINERALS MGMT. SERV., US. DEP'T OF THE INTERIOR, OIL AND GAS LEASE OF SUBMERGED LANDS UNDER THE OUTER CONTINENTAL SHELF LANDS ACT, FORM MMS-2005 § 6(b) (2009) ("The value of production shall never be less than the fair market

marketability costs. It shows that the marketable-product doctrine had a very influential application long before natural gas was deregulated.

When one adds the federal government to the marketable-production jurisdictions, it certainly is true that the largest part of oil and gas production in the United States is governed by a marketable-product rule, to an even greater degree than the count of jurisdictions suggests. The federal leases and regulations reject a reading that the "value of production" means value "at the well."[35] Moreover, when one does give weight to this federal standard, it is very conservative to count a landowner as large as the federal government as equal only to one state, when no state sources more than a fraction of the output from federal land. In 2010, for instance, federal land (onshore and offshore) supplied thirty-four percent of the country's oil and twenty-three percent of its natural gas.[36] Production from federal land dwarfs production from land in any single state and even in any small group of states.

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value of the production. The value of production shall be the estimated reasonable value of the production as determined by the Lessor . . . . Except when the Lessor [decides otherwise in certain conditions], the value of production . . . shall not be deemed to be less than the gross proceeds . . . ."). The federal government's reservation of the power to define "reasonable minimum values" is of long standing. *See* Sarah L. Inderbitzin, *This Little Company Went to Market: IPAA v. Dewitt and the Duty to Market Federal Oil and Gas Production at No Cost to the Lessor*, 54 ADMIN. L. REV. 1167, 1170-71 & n.15 (2002) (citing cases recognizing the power vested in the Secretary of the Interior to establish minimum values); *see also* Ross Malone, *Oil and Gas Leases on United States Government Lands,* 2 INST. ON OIL & GAS L. & TAX'N 309, 340 (1951). The Interior Department's authority to define "production" in "value of production" to mean "gas conditioned for market," and therefore to make the lessee absorb compression and certain other costs, was upheld long ago in *California Co. v. Udall*, 296 F.2d 384, 385-88 (D.C. Cir. 1961). Department regulations require the lessee to bear the costs of treating gas to put it into a marketable condition. 30 C.F.R. § 1205.152(i) (2010). The rules were upheld against industry trade-group attack. *See* Indep. Petrol. Ass'n of Am. v. DeWitt*,* 279 F.3d 1036, 1040-42 (D.C. Cir. 2002) (upholding regulations denying pass-through of downstream marketing costs, aggregation fees, and interhub transfer fees, though reversing Department on unused firm-demand charges by classifying them as transportation charges)*; see also* Amoco Prod. Co. v. Watson, 410 F.3d 722, 727-30 (D.C. Cir. 2005) (upholding regulations that required producers to absorb cost of removing CO2 from coal-seam gas in order to make it marketable to pipelines), *aff'd on other grounds sub nom*. BP Am. Prod. Co. v. Burton, 549 U.S. 84 (2006); Devon Energy Corp. v. Norton, No. 04-CV-0821, 2007 WL 2422005 (D.D.C. Aug. 23, 2007), *aff'd sub nom*. Devon Energy Corp. v. Kempthorne, 551 F.3d 1030, 1032-41 (D.C. Cir. 2008). The federal rule does allow some processing deductions. 30 C.F.R. §§ 1206.158-59 (2010).

35. A number of challengers to the federal rule have argued that their gas is marketable at the well. *See, e.g., Watson,* 410 F.3d at 727-30. This is the same factual argument that producers raise in most contemporary marketable-product cases. However, the courts have upheld the Secretary's discretion to reject that argument. *Id.* at 730-31.

36. The 700,000 onshore mineral acres managed by the Bureau of Land Management are producing 11% of the country's natural gas and 5% of its oil. *See* U.S. DEP'T OF THE INTERIOR, BUREAU OF LAND MGMT., *Oil and Gas*, http://www.blm.gov/wo/st/en/prog/energy/oilandgas html. Offshore federal land in the Gulf of Mexico provides an additional 29% of the country's oil and 12% of its natural gas. *See* U.S. ENERGY INFO. ADMIN., *Gulf of Mexico Fact Sheet*, http://www.eia.gov/special/gulf_of_mexico/.

The position of the federal government ensures that far more than half of the production in the country is subject to a marketable-product rule. The percentage of production that occurs under a marketable-product rule is even more one-sided because most producing states, including such core "at the well" states as Texas and Louisiana, use versions of marketable-product rules in their own leases.[37] And some of these states own land responsible for very substantial production. The land governed by marketable-product leases in these states pushes the share of national production subject to a marketable-product rule even higher.

That even state agencies in "at the well" jurisdictions tend to use marketable-product clauses in their own leases is a compelling reminder that landowners with large enough interests to negotiate with lessees on an at least approximately equal basis are likely to expect some version of a marketable-product rule. These leases suggest what the ordinary lease might look like if the average lessor had bargaining power comparable to the typical lessee's powers.

Even if one minimizes the federal rule's impact by just counting it once and then includes the three statutory states, the tally becomes nine to seven in favor of the marketable-product rule, and this very lessor-favoring count does not recognize the disproportionate importance of federal production. If one were to adjust the count by volume weighting production, output from federal land is so large that the marketable-product share would rise further even though Texas, an "at the well" state, is the largest producing state.

37. For instance, of the two major landowning agencies of the State of Texas, the General Land Office and the University Land Office, both have leases that require, with some variation between the two lease forms, payment of gas royalties on the gross price for the former and the gross production for the latter, with some volume reduction possible for plant processing, but also a specific no-deduction clause that bars most ordinary field deductions. *See, e.g.,* TEX. GEN. LAND OFFICE RELINQUISHMENT ACT OIL & GAS LEASE FORM §§ 4(B)-(C), 7 (rev. Oct. 2001). This is in Texas, the leading "at the well" state. For an example from another seemingly "at the well" state, see the California lease, which requires payment of gas royalties at the current market price, a price that is never to be less than the highest price in the nearest field for like gas. In addition, the California lease has a separate, express, no-deduction paragraph. CAL. STATE LANDS COMM., STATE OIL AND GAS LEASE §§ 4(c), (f) (2004).

It is impossible to compute an exact production share of leases in which deductions can and cannot be taken because even in marketable-product jurisdictions, leases that expressly identify deductions will be enforced. Conversely, even in "at the well" jurisdictions, some gross proceeds and market value leases without any geographic restriction and other leases that bar deductions will not allow deductions—at least, in all states but Texas, in which the supreme court has displayed a reluctance to protect even lessors who have the most clearly written no-deduction clauses. No database cataloguing all of these terms in private leases exists. Overall, though, a state's position on the basic valuation issue discussed here is a good guide to the treatment of most production within its boundaries except on its public (state and federal) property. Thus, it makes sense to roughly estimate the treatment of deductions on all land within a jurisdiction with the jurisdiction's rule, as long as one acknowledges the often significant exception for public land.

Third, the New Mexico rule was not settled at the time *Bice* was decided, but the state certainly could not fairly be classified as an "at the well" state. Class actions allowing marketable-product claims to proceed had been certified in three cases in which lessee appeals of certification had been consolidated, briefed, and argued to the New Mexico Supreme Court. The court decided the appeal barely two months after *Bice*. The resulting *Davis v. Devon* decision[38] properly led commentators to put the state into the marketable-product rule camp.[39] Even had *Bice* only considered New

38. 218 P.3d 75 (N.M. 2009). The New Mexico Supreme Court had not rejected the marketable-product rule before *Davis*, but it had issued a difficult-to-apply but seemingly restrictive decision about implied covenants on a very odd set of facts in a dispute over a potash factory. *See* Cont'l Potash, Inc. v. Freeport-McMoran, Inc., 858 P.2d 66 (N.M. 1993). Many lessees read this decision as making implied duties much less likely. Later, a New Mexico court of appeals interpreted the term "net proceeds . . . at the well" in a way that many found similar to the Texas "at the well" approach. Creson v. Amoco Prod. Co., 10 P.3d 853, 857-60 (N.M. Ct. App. 2000) (citing Texas law favorably). And the Tenth Circuit, although finding that the plaintiff's failure to plead a contract violation prevented it from relying on implied covenants, nonetheless reached out in dictum to endorse *Creson* and stated the view that "at the well" would set the deduction boundary in New Mexico. Elliott Indus. Ltd. P'ship v. BP Am. Prod Co., 407 F.3d 1091, 1108-10 (10th Cir. 2005). In addition, the *Elliott* court favorably cited a Fifth Circuit case which equated the terms "net proceeds" and "market value." *Id.* at 1110. Yet New Mexico state courts had certified a number of deduction classes, leading to the appeal in *Davis*. And when the New Mexico Supreme Court decided *Davis* on September 15, 2009, close on the heels of the July 9, 2009, *Bice* decision, it seemed to have moved New Mexico into the marketable-product camp. The court did not rule on the marketable-product doctrine as such, but it let the cases proceed to trial on marketable-product theories, an outcome that made little sense unless the court envisioned some marketable-product rule applying to private leases in New Mexico.

In *Davis*, the court was faced with three natural gas implied covenant classes that had been certified on a "(B)(2)" same-treatment basis, but denied certification under the more frequent "(B)(3)" common question class. *Id.* at 79. The New Mexico Supreme Court affirmed the (B)(2) certification on grounds that Devon had "acted or refused to act or failed to perform" consistent with its legal duty to the class. *Id.* at 81-82. However, the court reversed the refusal to certify the common question class. *Id*. at 83-86. Had the court believed that under New Mexico law, standard lease terms do not have room for a marketable-product rule, or that New Mexico precedent barred such a theory in some way as the lessees argued, it surely would have affirmed the denial of certification in the three common question classes. Instead, it cleared the way for all the cases to proceed to trial on that basis as well as on the (B)(2) claims.

It is true that the New Mexico Supreme Court did not rule on whether New Mexico ultimately will adopt a marketable-product rule. Instead, it expressly reserved this question: "Thus, the question of whether and under what circumstances the marketable product rule applies in New Mexico is not ripe for review at this time." *Id.* at 80. Yet its opinion contains an extensive discussion of the theoretical basis upon which New Mexico courts can find a marketable-product rule as a matter of law or of fact. *Id.* at 83-86 (reversing denial of (B)(3) certification and holding that courts may imply covenant by "effectuating the parties' intentions by interpreting the written terms of an agreement and analyzing the parties' conduct, or they may be stating that a duty imposed by law creates an obligation on one or more of the parties to the agreement."). This discussion would have been irrelevant had the court thought that such a duty does not fit into New Mexico law. Although the court still has not defined its precise marketable-product rule, New Mexico has fallen into the marketable-product camp ever since *Davis*. For a discussion of the New Mexico Supreme Court's subsequent cases, including the special rule carved out for certain state lease forms, see MCARTHUR, *supra* note 1, at 264 n.156.

39. For a thoughtful analysis of New Mexico law on deductions and a prediction that its state courts will adopt a marketable-product rule, see Judge Browning's decision in *Anderson*

Mexico as being in the marketable-product camp and ignored statutes and the federal government, its seven to five count in favor of "at the well" jurisdictions would have fallen to an even six to six. Adding the three statutory states, the count would have been nine to six in favor of the marketable-product rule; adding the federal government, too, as one would have to do if concerned about how most of the production in the United States is treated, the count would rise to ten to six in favor of the marketable-product rule.

Fourth, the *Bice* count omits Alaska, which has been one of the largest oil producers in the United States since the late 1970s. In Alaska, the vast majority of oil production is on state land. The federal government has large onshore and offshore holdings, but most federal land has not been developed, in part for environmental reasons. As a result, state leases presently determine the treatment of deductions on most Alaska production. And the first lease form used by the State has been interpreted to incorporate a marketable-product rule along federal lines, even though the State agreed in settlement with its major lessees to allow certain deductions under that lease form in return for an overall settlement.[40] The second, the current Alaska "new form" lease, expressly bars most field deductions.[41]

Living Trust v. ConocoPhillips Co., 952 F. Supp. 2d 979, 1012-14, 1022-25, 1025 n.7 (D.N.M. 2013); *see also* Anderson Living Trust v. WPX Energy Prod., LLC, No. IV 12-0040, 2015 WL 1321479, at *105-09, *109 n.77 (D.N.M. Mar. 19, 2015) (including the many-page footnote 77 in a decision that explains why Judge Browning found himself compelled to follow a Tenth Circuit reading of New Mexico law that he does not believe is a correct estimate of state law).

40. After oil began flowing through the TransAlaska pipeline in 1976, the State of Alaska and the major producers on state land began to dispute the price on which the producers should pay royalties and what deductions they could take. In the course of multi-year litigation, a judge ruling on summary judgment, after extensive discovery and briefing, rejected the lessee argument that "at the well" required field cost deductions under the standard Alaska lease form, the "DL-1" lease, and instead determined that the point of valuation was the downstream LACT measuring meter. For the rationale, see Memorandum of Decision and Order, No. 1JU-77-84, slip op. at 12-18 (Sup. Ct. Alaska Apr. 9, 1979) (Opinion of Compton, J.). The judge concluded that the state lease had been modeled on the federal lease form. *Id.* at 21. In a decision thirteen years later, another judge found "at the well" ambiguous and construed it against the oil companies. Memorandum Opinion Concerning the Applicability of ¶ 16 to Destination-Market Transactions, No. 1JU-77-847, slip op. at 12-17 (Sup. Ct. Alaska Mar. 25, 1992) (Opinion of Carpeneti, J.). The court found that "literal interpretation" of "at the well" would "not be consonant with reason, or sound public policy." *Id.* at 17. These disputes settled in lessee-specific Royalty Settlement Agreements, which do allow some deductions as part of the larger global settlement with each company, but, as shown above, the judicial interpretation of this first main state lease, the DL-1 lease, was contrary to the "at the well" rule.

41. The newer Alaska lease form, the "new form lease," bars at least most deductions. It requires royalty payments "free and clear of all lease expenses," including free of expenses incurred off the lease including but not limited to costs for such activities as "separating, cleaning, dehydration, gathering, saltwater disposal, and preparing the oil, gas, or associated substances for transportation off the leased area." STATE OF ALASKA, DEP'T OF NATURAL RES., COMPETITIVE OIL AND GAS LEASE, FORM NO. #DOG 200604 § 37 (2009), http://dog.dnr.alaska.gov/leasing/Documents%5CBIF%5CNorthSlopeFoothills%5CAppendixCSampleLease.pdf.

Thus, at present, most production in Alaska is, or would be but for settlement, governed by terms that allow a marketable-product rule. As a result, and because of the state's unusual preponderance of production from public lands, Alaska is best classified in the marketable-product camp, even though the state's courts have not adopted a general rule for private leases one way or the other. The likely increasing role of federal production in Alaska, both onshore and perhaps someday offshore, will only expand the marketable-product rule's sway in Alaska. Adding Alaska would raise the marketable-product tally as of July 2009, the month *Bice* was decided, to ten to six when the three statutory states and the federal government are counted. The count rises to eleven to six when one includes New Mexico, in which various deduction class actions had been moving to trial on marketable-product theories.[42]

This does not exhaust the problems with *Bice*'s majority/minority count. Another factor that should weigh in counting jurisdictions is that only state courts can decide state law with finality; federal courts cannot bind state courts on state law. Making clear the limited federal powers in this area, the United States Supreme Court held, in *Erie Railroad Co. v. Tompkins,*[43] that federal courts must defer to state courts on their own state law.[44] Thus, while one can dispute how much discount should be applied to federal *Erie* guesses, federal court decisions on what state law means for marketable-product issues should receive less weight than state-court decisions on state law.

Of the six state decisions that by July 2009 clearly favored a marketable-product rule (soon seven with the New Mexico Supreme Court's September 2009 *Davis* decision), six—all but Alaska's—are reasoned decisions not only by state courts, but by the highest state courts. Decisions of at least four of these courts—the supreme courts in Colorado, Kansas, Oklahoma, and West Virginia—are major articulations of the marketable-product rule.[45] The federal precedent adopted by the Secretary

42. An Ohio court of appeals addressed that state's deduction rule before *Bice* was decided, but did not decide the issue. *See* Schmidt v. Tex. Meridian Res., Ltd., No. 94CA12, 1994 WL 728059 (Ohio Ct. App. Dec. 30, 1994). The court declined to take a position as a matter of law because the only cases cited on the appropriate standard came from other states and no Ohio court had issued a decision. *Id.* at *3. Ultimately, it decided the case for the royalty owners on grounds of "usage and custom," based on the fact that the transportation fee had not been charged against the lessor's interest in the first "twenty years or more" of production. *Id.* at *6-7.

43. 304 U.S. 64 (1938).

44. Deference to state courts extends to state intermediate courts, not just state supreme courts. West v. Am. Tel. & Tel. Co., 311 U.S. 223, 237 (1940).

45. The Arkansas decision may be weaker than the other state decisions. The Arkansas Supreme Court refused to allow compression cost deductions in a "proceeds received by Lessee at the well" lease, thus taking the marketable-product position on that term and not giving the term "at the well" the kind of weight it would get in, say, Texas, but it did not squarely address the

of the Interior and affirmed by federal courts is also in the direct line of authority for setting federal rules.

In contrast, of the six state jurisdictions (six when New Mexico is removed from this camp) with "at the well" rules by late 2009, two of the rules, those in Mississippi and Kentucky, rested on federal decisions about state law, and so should have been at least somewhat discounted because they were not as authoritative as a state-court decision.[46] Further, at least two of the state decisions counted in *Bice* as "at the well" decisions did not really decide that general issue. *Bice* treats *Montana Power Co. v. Kravik*[47] as putting Montana in the "at the well" camp.[48] Yet *Montana Power* was decided before natural gas was deregulated, before the gas sales market shifted so fundamentally to a downstream market, and before gas

marketable-product doctrine. Hanna Oil & Gas Co. v. Taylor, 759 S.W.2d 563, 564-65 (Ark. 1988). A dissenting judge on the Arkansas Supreme Court rejected the idea that the lessee bears all of what he called "post production" costs. *Id.* at 566 (Hays, J., dissenting) (citing Clear Creek Oil & Gas Co. v. Bushmiaer, 264 S.W. 830 (Ark. 1924)). A federal judge subsequently refused to put Arkansas in the marketable-product camp in *Riedel v. XTO Energy, Inc*., 257 F.R.D. 494, 503-05 (E.D. Ark. 2009). It certainly is true that none of these decisions addressed the point of valuation in the deregulated gas market, but the *Hanna* majority's enforcing the "proceeds" portion of the royalty clause over the "at the well" term reflects a marketable-product orientation, not an "at the well" orientation.

46. The federal decision predicting Mississippi state law is the Fifth Circuit's *Piney Woods Country Life School v. Shell Oil Co.*, 726 F.2d 225, 230-38 (5th Cir. 1984). The Mississippi Supreme Court cited the Fifth Circuit's *Piney Woods* interpretation of Mississippi deduction law in *Pursue Energy Corp. v. Abernathy*, 77 So. 3d 1094, 1099 (Miss. 2011). However, the *Pursue* case did not concern royalty owners challenging the lessee's taking a deduction, but rather the allegedly excessive amount of processing charges that occurred after the plant had been paid off. *Id.* at 1098. Ironically, the plant was the same plant whose costs had been challenged in *Piney Woods*. *See id.* at 1097. The federal decision on Kentucky law is *Poplar Creek Development Co. v. Chesapeake Appalachia, L.L.C*., 636 F.3d 235, 240-44 (6th Cir. 2011). While the first federal decision on state law has some value in predicting what the state rule ultimately will be, particularly if it is a well-reasoned decision, the marginal contribution of additional federal decisions is limited. Federal decisions may influence, but do not have the authority to control, how a state court will decide the issue. Kentucky law also includes three earlier state court of appeals decisions that interpreted "silent" leases to require settlement at the well: two cases were decided before not only gas deregulation but before gas regulation, with one decided in the very early days of implementing the United States Supreme Court's 1954 determination that wellhead gas crossing state lines should be federally regulated. Thus, all three are difficult to appraise in their application to the modern deregulated natural gas market. *See generally* Reed v. Hackworth, 287 S.W.2d 912 (Ky. Ct. App. 1956); Warfield Natural Gas Co. v. Allen, 88 S.W.2d 989, 991-92 (Ky. Ct. App. 1935); Rains v. Ky. Oil Co., 255 S.W. 121 (Ky. Ct. App. 1923). Recently, however, the Kentucky Supreme Court has held that it does follow the "at the well" valuation method. *See* Baker v. Magnum Hunter Prod., Inc., No. 2013-SC-000497-DG, 2015 WL 4967131 at *5-6 (Ky. Aug. 20, 2015). The Kentucky Supreme Court did hold, in a same day decision in *Appalachian Land Co. v. EQT Production Co.*, 468 S.W.3d 841, 843-46 (Ky. 2015) that in the absence of contrary lease language, the producer alone is responsible for severance taxes, which Kentucky statutes define as a tax on the "privilege of engaging in" the business of producing oil by taking it from the earth. (emphasis omitted).

47. 586 P.2d 298 (Mont. 1978).

48. *See* Bice v. Petro Hunt, L.L.C., 2009 ND 124, ¶ 15, 768 N.W.2d 496, 501.

marketable-product disputes began in earnest.[49] Furthermore, *Montana Power* was about a regulatory price issue, not a deduction issue.[50]

The California authority cited in *Bice* is similarly less than a full loaf if cited as support for "at the well" rules because California courts have not directly addressed marketable-product arguments. No California court has yet to decide a case in which a lessor argued for the marketable-product rule. Almost all of the pertinent California decisions predate the rise of the marketable-product controversy, and most involve oil, not gas, and practices about the sale of oil in the early days of California's field development.[51] While California's precedent is suggestive, and the suggestion does tilt the state toward the "at the well" camp, it is not clear where the California Supreme Court will end up on marketable-product issues.

Although these factors suggest discounting the list of "at the well" states, there is one state that could be added to the tentative "at the well" count. *Bice* overlooks Utah, a state in which a 1962 hard-mineral case suggests that it too may well fall into the "at the well" deduction camp. The suggestion is muted, of course, because most of the marketable-product law

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49. *Montana Power*, 586 P.2d at 300.

50. *Montana Power* concerned how a regulated price fits into determining the price appropriate to a "market value" royalty clause. *Id.* The court phrased the issue as "[o]f what relevance are FPC regulations governing the interstate sale of gas to the determination of the 'market price' of gas sold only intrastate?" *Id.* The case had been decided below on the papers, having been submitted on pleadings, interrogatory answers, and stipulations. *Id.* at 299-300. The decision gives no sign that either side raised deduction questions. The court treated the price issue before it as "resolved" by a series of cases that also have nothing to do with deductions. *Id.* at 300-01 (citing decisions on relevance of cases over role of federal regulated price in determining market value and concluding, on issue that was in dispute, that the cited cases proved that federal regulated prices "are of no relevance in setting the amount of royalty to be paid under a market price lease").

The Montana Supreme Court did round out its decision with an aside about a second-best way of measuring market value by deducting costs from a downstream price. *Id.* at 303. But its expression on this uncontested issue not before the court should be viewed in the same way as the undisputed assumption that costs could be deducted at the well in the Kansas decision in *Matzen v. Hugoton Production Co*., where the plaintiffs did not dispute that valuation should be set at the well. 321 P.2d 576, 580 (Kan. 1958). The Kansas Supreme Court later properly distinguished *Matzen* as "not applicable" to questions of where deductions should begin because the *Matzen* parties had stipulated to wellhead deductions, when that court issued its leading deduction decision in *Gilmore v. Superior Oil Co*., 388 P.2d 602, 605 (Kan. 1964).

The offhand dictum in *Montana Power* on an uncontested nonissue was hardly a decision rejecting the marketable-product rule, even though some courts and commentators have cited it as such. *Bice,* of course, read *Montana Power* as putting Montana in the "at the well" camp. Bice, ¶ 15, 768 N.W.2d at 501. Recent federal decisions make the same mistake. *See* S Bar B Ranch v. Omimex Can., Ltd., 601 F. App'x 569, 569 (9th Cir. 2015); Emery Res. Holdings, LLC v. Coastal Plains Energy, Inc., 915 F. Supp. 2d 1231, 1240 (D. Utah 2012). For an example of this reading of *Montana Power* in one of the articles cited by *Bice*, see Keeling & Gillespie, *supra* note 17, at 51 n.193.

51. For an analysis of the California rule, *see* MCARTHUR, *supra* note 1, at 270-74.

has developed after 1962, and the case is not about natural gas. As a result, this early case should not fully dictate the Utah Supreme Court's decision if a marketable-product case ever reaches it.[52]

Under any reasonable combination of these cases, a full and proper count in 2009 would have grouped a majority of oil and gas jurisdictions in the marketable-product camp. Thus, the majority-rule pillar of *Bice* should be pulled out, with the decision then left swaying on two faulty pillars to which this article soon will turn.

The count has remained in favor of marketable-product jurisdictions. Since 2009, three courts, two state and one federal, have taken positions on the issue in states not counted in *Bice*. Of these three, a federal court interpreting Virginia law predicted that Virginia would follow a marketable-product rule.[53] The second decision is the North Dakota Supreme Court in *Bice.*

Third is the Pennsylvania Supreme Court decision in *Kilmer v. Elexco Services Inc.*,[54] a decision that has been cited as rejecting the marketable-product doctrine but one that contains little of the reasoning that usually goes along with that position. The Pennsylvania Supreme Court formally held that a lease that expressly allows deductions (and would be read to do so in marketable-product or "at the well" jurisdictions) is not invalidated by Pennsylvania's unique Guaranteed Minimum Royalty Act ("GMRA").[55]

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52. The Utah Supreme Court's reasoning in a relatively early uranium cost-deduction case suggests that Utah also will take a position allowing deductions if the issue is presented to it in an oil-and-gas setting. *See* Rimledge Uranium and Mining Corp. v. Fed. Res. Corp., 374 P.2d 20, 23 (Utah 1962). The lease required payment on "gross proceeds" including any bonuses or premiums the lessees received, but not any "transportation and development allowances paid or granted to the lessees." *Id.* at 20. The court rejected the plaintiffs' arguments based on the plain meaning of terms like "gross proceeds," provided no discussion in text of the industry meaning of this term, cited only cases that allowed deductions, and held that none of the terms "market value," "proceeds," or "gross proceeds" prevent a lessee from deducting costs. *Id.* at 22-23. Whatever the court would have thought had someone presented a marketable-condition argument, and whatever the lease language about not having to pay royalties on transportation and development "allowances" meant, *Rimledge* is out of step with other decisions in its interpretation that the term "gross proceeds" is consistent with a net proceeds standard, not a gross standard. *Id.* at 22. A federal district court in Utah relied on *Rimledge* in predicting that Utah will join the "at the well" jurisdictions, although unfortunately it, like the North Dakota Supreme Court in *Bice* and the Pennsylvania Supreme Court in *Kilmer v. Elexco Land Services, Inc*., 990 A.2d 1147, 1157 (Pa. 2010), relied on the erroneous assumption that this is the majority deduction rule. Emery Res. Holdings, Ltd. v. Coastal Plains Energy, Inc., 915 F. Supp. 2d 1231, 1241-42 (D. Utah 2012).

53. A federal magistrate predicted that Virginia will adopt the first marketable-condition rule. Legard v. EQT Prod. Co., No. 1:10cv00041, 2011 WL 86598, at *9-13 (W.D. Va. Jan. 11, 2011); *see* MCARTHUR, *supra* note 1, at 265 n.156.

54. 990 A.2d 1147 (Pa. 2010).

55. *Id.* at 1156-58. For the express deduction language and statutory floor language, *see id.* at 1150. *Kilmer* has been cited by a number of Pennsylvania courts and Third Circuit courts, but only one other state court. Most of these subsequent decisions apply *Kilmer* to the Pennsylvania royalty statute and hold that per *Kilmer* a lease providing for net-back or work-back computations does not violate Pennsylvania's Guaranteed Minimum Royalty Act. *See, e.g.,* Carey v. New Penn

The *Kilmer* decision erroneously assumes that the plain meaning of the term "royalty" incorporates an "at the well" valuation point and, like *Bice*, assumes that this is the majority position.[56] Also, the Pennsylvania decision is unfortunately similar to *Bice* in giving no detailed consideration to the reasons for either the "at the well" or marketable-product positions. In addition, its pronouncement on deductions was unnecessary for two reasons. First, the court found that the disputed statute is silent on the deduction issue,[57] a finding that should have made it unnecessary for the court to say anything more about Pennsylvania's ultimate deduction rule. Second, the lease in dispute would be treated as authorizing deductions even in marketable-product states, so the rule the court adopted should not have affected the outcome of the case.[58] In this setting, the court is likely to face requests that it reconsider the state's standard on a fuller record than has been before it thus far.[59]

Explor., LLC, No. 3:09–CV–188, 2010 WL 1754440 (M.D. Pa. Apr. 28, 2010). But *Kilmer* itself did not address the circumstances when particular lease language might or might not allow deductions. Under the logic in *Kilmer*, at least in general, it is surely now correct that deductions authorized by the lease should not be counted in determining the Pennsylvania Act's one-eighth floor, even when the specific deductions and lease language are different from the *Kilmer* lease. *See* Ulmer v. Chesapeake Appalachia, LLC, No. 4:08–cv–2062, 2011 WL 1344596, at *3. (M.D. Pa. Apr. 8, 2011). On the other hand, it should be too broad a reading to conclude, as some courts have, that *Kilmer* endorses the net-back method under all leases no matter what their phrasing, because *Kilmer* only dealt with a lease that authorized deductions. For an example of this broad reading, see Pollock v. Energy Corp. of Am., No. 10–1553, 2011 WL 3667289, at *5 (W.D. Pa. June 27, 2011). The author is addressing the Pennsylvania rule in a forthcoming article, *Pennsylvania, Kilmer, Marketable Products, and Natural Gas Deductions: Revisiting the Unnecessary Issues* (forthcoming 2016).

56. The Pennsylvania Supreme Court described the "majority rule" on deductions by stating "[t]he Gas Companies reject the relevance of *the fact* that a *minority* of jurisdictions have adopted the First Marketable Product Doctrine." *Kilmer*, 990 A.2d at 1155 (emphasis added). The court thus incorporated the companies' incorrect counting of marketable-product jurisdictions. As the prior text in this article shows, a larger number of jurisdictions had followed versions of a marketable-product rule by 2010, some by judicial decision, some by statute, and the largest one of all, the federal government, by administrative interpretation.

57. *Id.* at 1157.

58. Even in the most ardent marketable-product jurisdictions, a lease that stated, as did the Kilmers' lease, that royalties were to be paid on a one-eighth royalty "less this same percentage share of all Post Production Costs," and that then included a specific definition of those costs as including "without limitation, all gathering, dehydration, compression, treatment, processing, marketing and transportation costs incurred in connection with the sale of such production," *id.* at 1150, would be enforceable.

59. The Pennsylvania Supreme Court was only ruling on whether the statutory language, which puts a floor under the royalty share, limits deductions if they push the royalty share below one-eighth of the revenue stream. *See id.* at 1153. On that issue, the court held that the state's Guaranteed Minimum Royalty Act does not intend to limit deductions, and instead that its one-eighth floor on royalties only applies to the share of the revenue stream at the wellhead. *Id*. at 1156-58. In effect, the court interpreted the Act as putting a floor under the base price used in royalty computations but not on deductions that might lower the final payment. *Id.* The court could have walled off this conclusion as a mere statutory interpretation without deciding whether it would adopt a marketable-product rule. Indeed, even the lessee Gas Companies contended that *Kilmer* was not the case for the court to decide whether the state will adopt a marketable-product

Regardless of how one analyzes *Kilmer*, these additional cases do not overturn the net counting in favor of the marketable-product rule in 2009. *Bice* was in error over which rule was the majority rule and which the minority rule in 2009, and it would be in error on the same point if issued today. If a majority/minority count should have played any role in *Bice*, it should have tilted the court toward adopting a marketable-product rule, not away from it.

The point is not that the court should have determined the majority rule and applied it because it is the majority rule. Such a counting exercise, in essence a blind following of the weight of precedent across all producing states to have addressed the issue, is the antithesis of the kind of reasoned decision we rightly expect from our courts. There are significant differences in some of the marketable-product rules, particularly the allowance of certain deductions under the federal and some state rules, such as shown by a recent decision by the Kansas Supreme Court treating what appears to be largely a service arrangement as an at the well "sale" that generates "proceeds."[60] The count may keep changing at the margins for

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rule because that doctrine arose in "common law in interpreting ambiguities in leases, not through statutory interpretation of a preexisting statute." *Id.* at 1155. When the *Kilmer* court phrased the issue to be decided, it was not whether to adopt a marketable-product rule or not, but whether the statute prevents use of the net-back method that the lease so clearly mandated: "whether the GMRA precludes parties from contracting to use the net-back method to determine the royalties payable under an oil or natural gas lease." *Id.* at 1151. The trial court, which granted summary judgment for the Gas Companies, had similarly phrased the question as whether the net-back method—the lease's express provision for deductions on sales away from the well—"violated the GMRA," and "ultimately held that the lease did not violate the GMRA because '[t]he statute in question does not prohibit the inclusion of "post-production" costs to calculate the one-eight royalty. . . .'" *Id.* (internal quotation omitted). The Pennsylvania Supreme Court, which affirmed, could easily have limited its reasoning to that dispositive point. And, indeed, when the court summarized its holding it said nothing about the marketable-product rule as such. Instead, it, too, discussed the issue only in terms of whether the minimum royalty statute prohibited the deductions authorized by the lease, not in terms of any marketable-product issues: "[W]e hold that the GMRA should be read to permit the calculation of royalties at the wellhead, *as provided by the net-back method in the Lease* . . . ." *Id.* at 1158 (emphasis added).

Kilmer is broader than necessary, however, because the court's route in reaching its conclusion was not the direct path from its threshold conclusion that the Legislature intended "both parties'" positions due to the GMRA's silence on the deduction issues, but instead involved a deviation into a twisting, roundabout analysis that includes a digression about the term "royalty," in reality a broad and general category rather than a specific lease term, having an industry-specific "at the well" meaning, *id.* at 1157; for criticism of *Kilmer*, *see generally* McArthur, *supra* note 55.

60. In *Fawcett v. Oil Producers, Inc.,* the Kansas Supreme Court held that in applying Kansas's marketable-product rule, a field contract with a service company that takes gas at the well and provides ordinary marketability services but pays for the gas using a downstream price reduced by the cost of field services, establishes the "proceeds" relevant to royalty payment at the well. 352 P.3d 1032, 1035-36, 42 (Kan. 2015). For an analysis and critique, see John Burritt McArthur, *Mineral Royalties, Deductions, and Fawcett v. OPIK*: *Continuity and Change in the Revised-But-Still-Standing Kansas Marketable-Product Rule,* 64 U. Kan. L. Rev. 63 (2015).

some time to come,[61] but the basic division between jurisdictions is likely to remain.

As a reflection of the raw political power of the relatively more concentrated lessee interests and the money at stake, the count in favor of marketable-product rules may be diluted legislatively.[62] But given the size of federal production, most production in the United States is likely to continue to fall under versions of marketable-product rules for a very long time even if the state lineup changes. The *Bice* court's erroneous assumption that the "at the well" position is the majority rule is likely to remain erroneous. This mistaken assumption may be the reason that the court did not conduct a real analysis of the merits on the two sides of this disputed industry issue. *Bice*'s brevity and failure to perform that analysis is unfortunate because the parties affected by North Dakota's gas deduction rule deserved a fully reasoned decision on the merits.

The counting error in *Bice* also is unfortunate because *Bice*, in turn, like the handful of law review articles mistaking the majority rule, has been cited as evidence that the majority of oil-and-gas jurisdictions reject the marketable-product rule.[63] Such replications are a reminder of the way that precedent can magnify the impact of statements of error, letting false counting snowball and distort the path of the law, just as precedential networks can beneficially circulate and expand thoughtful, insightful, and correct decisions. Left untended, *Bice* may continue to be a self-fulfilling false prophecy and encourage other courts to adopt "at the well" standards as if they were the majority standard, when they actually reflect the minority viewpoint.

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61. For instance, the Kentucky Supreme Court recently decided a deduction case, *see supra* note 46, which firmed up its ranking as an "at the well" state.

62. Deduction rules are vulnerable to political change in either direction. The Michigan Legislature passed a statute rejecting a judicially created "at the well" rule. *See* discussion *supra* note 28. But in states where producers have more power than Michigan, obviously the political pendulum may swing further in the lessee direction. *Cf, e.g.,* OKLA. STAT. tit. 52, § 902(1) (2012) (Oklahoma's recent statute seeking generally to bar fiduciary claims against those operating wells and performing "any duties owed to any person under a private agreement, statute, governmental order or common law relating to the exploration for, operations for, producing of, or marketing oil or gas, or disbursing proceeds of production of oil or gas . . . .").

63. In *S Bar B Ranch v. Omimex Canada, Ltd.,* a federal court claimed that Montana is in the majority "at the well" camp in part by citing *Bice* for its error on which deduction doctrine is the majority rule and in part by citing *Bice*'s error in reading this position into a prior Montana Supreme Court case. 942 F. Supp. 2d 1058, 1061 (D. Mont. 2013), *aff'd*, 601 F. App'x 569 (9th Cir. 2015). A federal judge in Utah also included *Bice* in its incorrect counting of the respective jurisdictions. *See* Emery Res. Holdings, LLC v. Coastal Plains Energy, Inc., 915 F. Supp. 2d 1231, 1239-40 (D. Utah. 2012).

B. *BICE* PROFESSED TO SEE A "PROBLEM" WITH AN ISSUE THAT IS NO PROBLEM

The *Bice* court culled its second reason for rejecting a marketable-product rule from an offhand comment in one of the three law review articles it cited. It claimed that "[t]he problem with the first marketable product doctrine" is incoherence: "the difficulty in determining when the gas has become a marketable product."[64] The court never demonstrates the difficulty it feared. *Bice* did not contain an analysis or discussion of what "marketable" means, a sifting of any evidence about the gas market, a thoughtful discussion of the various potential marketable-product standards, or a showing of specific difficulties in defining marketability. As its evidence that marketable-product states "have failed to articulate a clear standard for determining when a marketable product has been created," the court just cited to a two-paragraph section in one article that also did not demonstrate why marketability is difficult to prove.[65]

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64. Bice v. Petro Hunt, L.L.C., 2009 ND 124, ¶ 17, 768 N.W.2d 496, 502.

65. *Id.* (quoting Wheeler, *supra* note 17, at 24). Wheeler lists "that it can be difficult to determine when the gas becomes 'marketable'" as "[o]ne of the major criticisms" of the marketable-product rule. Wheeler, *supra* note 17, at 10. But other than explaining that Colorado has treated this issue as a question of fact and citing without explanation one other law review article, he offers no discussion of why this would be such an unusual factual problem for courts or juries. This is very thin soil on which to plant any part of *Bice*.

The Wheeler article repeats this point later in the article as the author claims in discussing Colorado law that "it is impossible to establish an exact formula for determining when gas becomes marketable . . . ." *Id.* at 20. This is either not true—the Colorado formula yields a quite precise standard on which the jury can be instructed— or meaningless, if it intends to mean that any factual standard for marketability is too indeterminate. And, of course, a court always could define a standard based on functional categories were definiteness the only important requirement for a fair rule.

The Wheeler article has other weaknesses. First, it repeats the generic argument that lessees had to use a vague term like "at the well" because it was "difficult to determine exactly which post-production costs may arise" during a lease. *Id.* at 4. Yet it was foreseeable, even by the early 1920s, that such services as compression, dehydration, gathering, and some separation might be needed. There is no reason a lessee had to avoid listing at least the foreseeable services that would be deducted if they applied, perhaps with a catch-all "and any other similar costs." Second, Wheeler denies that making a lessor's interest bear service costs is an imposition of "cost sharing." *Id.* at 5. This semantic sleight-of-hand is wrong because the undeniable economic effect of such a rule is that a lessor does share costs that it otherwise would not bear. Wheeler may just mean in this point that the lessor does not pay these costs literally out of pocket; the charges come from reductions in the royalty stream. Nonetheless, they are just as real as any economic costs. Third, Wheeler claims that the marketable-product rule "does not extend beyond the boundaries of the lease." *Id.* at 9. Not only is this not true, but the jurisdiction that authored the first leading state marketable-product decision, Kansas, made it clear that this would be a misreading of its law back in 1964. *See, e.g.,* Schupbach v. Cont'l Oil Co., 394 P.2d 1, 5 (Kan. 1964). Fourth, Wheeler cites Michigan as an "at the well" jurisdiction even though the Michigan Legislature rejected this judicially adopted standard by adopting a marketable-product rule by statute in 1999. *See* discussion *supra* notes 28-30 and accompanying text. Fifth, in discussing the specifics of individual marketable-product jurisdictions, Wheeler omits the leading Colorado case, *Garman v. Conoco, Inc.*, 886 P.2d 652 (Colo. 1999), two key Oklahoma decisions, *TXO Production Corp. v. State ex rel. Commissioners of Land Office*, 903 P.2d 259 (Okla. 1994) and

There is no special problem in defining marketability. Like all fact issues, the term can be subject to conflicting proof. But marketability remains a typical fact issue.

Initially, it appeared that the major marketable-product jurisdictions would identify specific functions—compression, gathering, dehydration, treatment, processing, transportation—and classify them as per se deductible or not deductible.[66] Such an approach, of course, would not have presented any difficulty in determining marketability, perhaps except for a gray area in which parties might dispute when gathering turns into transportation. But per se categories drew criticism from lessees for a different problem, namely, that a categorical approach was insufficiently flexible. In hopes that they could win at trial what they were not winning by category, lessees sought the very less certain system that *Bice* used to condemn the marketable-product rule.

Marketable-product standards have moved away from purely categorical standards, a change that has increased their flexibility but to some extent reduced the definitiveness of the standard. Ironically, given that *Bice* used a purported problem of indefiniteness as a reason to avoid marketable-product standards, it has been lessees, not lessors, who generally have resisted fixed categories in marketable-product jurisdictions. In these states, lessees prefer fact variable tests because the more factual the standard, the more room they have to argue that gas is marketable "at the well" as long as any sales, even to third parties, occur in the vicinity of the wells in issue. Thus, it is an irony to see a commentator or the North Dakota Supreme Court using a factual flexibility that lessees in marketable-product jurisdictions have championed as a reason to refuse to adopt the rule.

Mittelstaedt v. Santa Fe Minerals, Inc., 954 P.2d 1203, 1209 (Okla. 1998), and the most important Kansas decision, *Gilmore v. Superior Oil Co.,* 388 P.2d 602 (Kan. 1964). Sixth, there are other marketable-product jurisdictions (as this article has shown), and federal properties with their rule. Seventh, Wheeler lists as a criticism of the "at the well" approach that it, like the marketable-product approach, "can often be unpredictable and difficult to administer . . . ." Wheeler, *supra* note 17, at 24. Yet nothing makes this an insoluble fact issue. Such problems should raise doubt about articles like this as support for the court's ruling.

66. For the claim that in the 1990s Kansas and Oklahoma were classifying cost deductibility categorically by function as a matter of law, *see* Owen Anderson, *Royalty Valuation: Should Royalty Obligations Be Determined Intrinsically, Theoretically, or Realistically? Part II*, 37 NAT. RESOURCES. J. 611, 664-65 (1997); *see also* Rogers v. Westerman Farm Co., 29 P.3d 887, 905 n.21 (Colo. 2001) (en banc) (citing Kansas and Oklahoma as jurisdictions that "have seemingly held that certain costs are not deductible as a matter of law."). As the text accompanying notes 71-85 indicates, marketability is a fact issue in at least most marketable-product jurisdictions. In general, deductibility turns upon whether services are going to produce a marketable-product or are applied after one already has been created.

In addition, marketability is not as amorphous as the article cited in *Bice* makes it sound. The legal concept of "a market" connotes active buyers and sellers.[67] It has been applied in many areas, including in hundreds of oil and gas cases about market value and antitrust cases that turn on market definition. The factual standard has led courts to reject as qualifying markets such nonmarket transactions as affiliate sales,[68] isolated transactions,[69] and transactions that are disguised service agreements with the true base price set at downstream locations.[70] As far as definiteness, the standards currently articulated by the four leading marketable-product jurisdictions are described in the following pages.

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67. *See, e.g.*, 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."). In *Parry v. Amoco Production Co.*, Judge Dickinson cited Black's Law Dictionary's definition of a market as a "[p]lace of commercial activity in which goods, commodities, securities, services, etc., are bought and sold." No. 94CV105, 2003 WL 23306663, at *11 (D. Colo. 2003) (citing BLACK'S LAW DICTIONARY 970 (6th ed. 1990)).

68. *See, e.g.*, Tara Petrol. Corp. v. Hughey, 630 P.2d 1269, 1275 (Okla. 1981) ("Whenever a lessee or assignee is paying royalty on one price, but on resale a related entity is obtaining a higher price, the lessors are entitled to their royalty share of the higher price."); Howell v. Texaco, 112 P.3d 1154, 1160 (Okla. 2004) (holding royalty owners are owed the higher market value and that "an intra-company gas sale cannot be the basis for calculating royalty payments").

69. *Parry*, 2003 WL 23306663, at *13-20 (providing a thorough discussion of various small sales, as well as sales that defendant Amoco's counsel had arranged to give the appearance of a local market, in a detailed decision issued after a bench trial). The idea that it is not sensible to treat small, local sales as the benchmark for value of large downstream sales has a long pedigree. *See* Amoco Prod. Co. v. Watson, 410 F.3d 722, 730 (D.C. Cir. 2005), *aff'd on other grounds sub nom.* BP Am. Prod. Co. v. Burton, 549 U.S. 84 (2006); Cal. Co. v. Udall, 296 F.2d 384, 387-88 (D.C. Cir. 1961) (distinguishing "marketing" from "merely selling"). The distinction between just any sale and one that complies with the duty to market presumably was the logic of the jury in *Rogers v. Westerman*, which decided that gas sold at the well was marketable there, but gas not sold there was not. 29 P.3d 887, 894 (Colo. 2001) (en banc). Judge McAnany, a Kansas state court of appeals judge, correctly pointed out that given that "there is some point on every such [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 v. Oil Producers, Inc., 306 P.3d 318, 327 (Kan. Ct. App. 2013) (McAnany, J., concurring). But the Kansas Supreme Court, though mentioning Judge McAnany's point, rejected it as it reversed the lower court. Fawcett v. Oil Producers, Inc., 352 P.3d 1032, 1042 (Kan. 2015).

70. The Kansas Supreme Court distinguished the base gross proceeds from the net sales price after the cost of field services had been deducted under a field-service-and-sales agreement and required royalty payment on the gross price when interpreting a "proceeds" lease. Hockett v. Trees Oil Co., 251 P.3d 65, 72 (Kan. 2011). It did not stay faithful to that principle, though, when this past summer it accepted a net price, not the gross price, as proper for royalty payment when a lessee entered service-and-sales contracts tied to the wellhead with various mid-stream companies. *Fawcett,* 352 P.3d at 1041-42; for discussion, see *generally* McArthur, *supra* note 60. The argument that lessees should be able to pay royalty on a lower price if the buyer provides marketing services and deducts the costs from the sales price also appeared in a case recently before the Oklahoma Supreme Court. Pummill v. Hancock Exploration LLC*,* 341 P.3d 69 (Okla. 2014); for this argument, see Petition for Writ of Certiorari 2, 9-10, *Pummill*, Cause No. 111,096 (Okla. July 16, 2014). But the Oklahoma Supreme Court reversed the three partial summary judgments at stake in *Pummill* for more factual development without addressing the merits of this, or any other, issue. *Pummill*, 341 P.3d at 69.

In Kansas, the lessee "has the duty to produce a marketable product, and the lessee alone bears the expense in making the product marketable."[71] Unless the lease expressly provides for deductions, 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."[72] Costs to "enhance" an already marketable product, unlike marketability costs, may be passed on as long as they are reasonable.[73] Exceptions to this implied duty have to be stated expressly.[74]

The impact of the Kansas rule has been somewhat limited because the Kansas Supreme Court has now held that a lessee who hires a service company to transform its gas after the well and sell it downstream, even when that "purchaser" only receives a charge reflecting its services, can treat the net price the company pays after deducting the costs of its services as "proceeds" for royalty purposes.[75] It remains to be seen how service agreements dressed in the garb of sales arrangements will fare under the good faith and implied duty standards, which, as the court reminded readers, the lessee's sales must satisfy before they can set the price for royalty payment computations.[76] But, in any event, the court did not alter the basic requirement that the lessee must produce a marketable product at its own expense.

In Colorado, the lessee must put gas "in the physical condition where it is acceptable to be bought and sold in a commercial marketplace" and move it to "a location, the commercial marketplace, where the gas is commercially saleable."[77] Costs after that point to "enhance" already marketable gas are deductible.[78] In other words, the lessee must pay to put

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71. Sternberger v. Marathon Oil Co., 894 P.2d 788, 799 (Kan. 1995).

72. *Id.* at 800.

73. *Id.* (citing Garman v. Conoco, Inc., 866 P.2d 652, 661 (Colo. 1994) (en banc)).

74. Farrar v. Mobil Oil Corp., 234 P.3d 19, 28-31 (Kan. Ct. App. 2010) (providing a discussion of substantive Kansas law). The opinion includes the conclusion that "[u]nder Kansas law, an implied covenant can only be defeated by express language showing a contrary intent." *Id.* at 29.

75. *See supra* note 70 and accompanying text.

76. Fawcett v. Oil Producers, Inc., 352 P.3d 1032, 1042 (Kan. 2015).

77. Rogers v. Westerman Farm Co., 29 P.3d 887, 905-06 (Colo. 2001) (en banc). *Rogers* was applied in *Savage v. Williams Production RMT Co.*, in which the court of appeals upheld the trial court's finding that gas "was not marketable at the wellhead because it had to be processed and transported to the pipeline . . . ." 140 P.3d 67, 71 (Colo. Ct. App. 2006). In *Clough v. Williams Production RMT Co.,* the court of appeals affirmed judgment based on a jury's rejection of the producer's argument that the gas was marketable at the well. 179 P.3d 32, 34-35 (Colo. Ct. App. 2007). The court of appeals also upheld the trial court's discretionary exclusion of market evidence about the pre-1992 regulated gas market as too remote to claims about the 1996 to 2004 deregulated gas market. *Id.* at 37-38.

78. Garman v. Conoco Inc., 886 P.2d 652, 655 (Colo. 1994) (en banc)) ("Garmans concede that costs incurred after the gas is made marketable, which actually enhance the value of the gas,

the gas in a marketable condition and location. This standard is likely to result in holdings like that of a Colorado state court judge in 2003 after a bench trial: he found the Colorado San Juan Basin gas at issue was "marketable, both as to physical condition and location, only after gathering, compression and treatment and delivery to the inlet for the interstate pipeline."[79]

In Oklahoma, "post-production" costs, by which the Oklahoma Supreme Court appears to mean off-the-lease costs, are not deductible if they are "necessary to make a product marketable, or . . . within the custom and usage of the lessee's duty to create a marketable product . . . ."[80] The court found it "common knowledge" that field processes needed to make gas marketable include, "but are not limited to, separation, dehydration, compression, and treatment to remove impurities."[81] In contrast, costs that merely enhance an already marketable product can be deducted.[82] If an Oklahoma lessee wants to take deductions, it must show that the lease expressly lets it do so.[83]

Finally, 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."[84] For any lease to allow deductions, it 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 . . . ."[85]

None of these standards should pose unusually difficult problems for factfinders. The facts may be complex, but not more complex than the facts in many disputes over economic issues. Even though resting on fact issues, the marketability standards often will lead to the same gas valuation point, the market area between the processing plant and mainline pipeline, and thus provide substantial certainty even if not that of a fixed categorical rule.

should be borne proportionately by all parties benefitted by the operations."). The court further explained that "after a marketable product has been obtained, then further costs in improving or transporting such product should be shared by the lessor and lessee." *Id.* at 661 n.27 (citing 3 KUNTZ, *supra* note 24, § 40.5).

79. Parry v. Amoco Prod. Co., No. 94CV105, 2003 WL 23306663, at *19 (D. Colo. Oct. 6, 2003). *See also* discussion *supra* note 69.

80. Mittelstaedt v. Santa Fe Minerals, Inc., 954 P.2d 1203, 1209 (Okla. 1998).

81. *Id.* at 1208.

82. *Id.* at 1205. As a result, "in some cases a royalty interest may be burdened with post-production costs, and in other cases it may not." *Id.*

83. *See* Wood v. TXO Prod. Corp., 854 P.2d 880, 883 (Okla. 1992) ("If a lessee wants royalty owners to share in compression costs, that can be spelled-out in the oil and gas lease.").

84. Wellman v. Energy Res., Inc., 557 S.E.2d 254, 265 (W. Va. 2001).

85. Estate of Tawney v. Columbia Natural Res., L.L.C., 633 S.E.2d 22, 30 (W. Va. 2006).

These standards will become, and should become, more definite when linked to the duty to market's core value: the lessee's responsibility to get the best price reasonably possible.[86]

Even if the standards continue to be articulated as they are today without a formal link to the best price reasonably possible, they present the kind of factual issue that juries and courts resolve all the time. Today these standards usually will result in a requirement that lessees produce mainline pipeline-ready gas. As the Colorado Supreme Court has stated, "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."[87] This is the same conclusion that the Colorado trial judge cited above reached for San Juan Basin natural gas.[88] In a recent, extraordinarily detailed 284-page decision, federal Judge Browning in Albuquerque determined that the gas at issue before him only came into "marketable condition when it is of sufficient quality to be accepted into the interstate pipeline system,"[89] although he decided not to certify a class for other reasons.

C. THE COURT DEFERRED TOO MUCH TO A FLAWED FEDERAL DECISION

The third and last reason *Bice* stated for rejecting a marketable-product rule is a federal decision making an "Erie guess" about North Dakota law. The decision, *Hurinenko v. Chevron*,[90] involved a "similar royalty dispute" to *Bice*. In *Bice,* the North Dakota Supreme Court found *Hurinenko* "persuasive."[91] Yet *Hurinenko* is not persuasive.

Like *Bice* itself, but even more so, *Hurinenko* provides very little reasoning or explanation for adopting a firm position on an issue as disputed as the marketable-product issue. It is just eight paragraphs long. The first paragraph summarizes the case status and outcome; the last, just six words long, merely states that the court affirms. So there are only six short paragraphs of merits discussion. Overall, the entire discussion consumes less than a page. A fully reasoned explanation sometimes can, it is true, come in a small package. But that is not the case in *Hurinenko.*

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86. *See, e.g.*, MCARTHUR, *supra* note 1, at 252-54, 262-63, 377-78.

87. Rogers v. Westerman Farm Co., 29 P.3d 887, 905 (Colo. 2001) (en banc) (emphasis added).

88. *See supra* note 79 and accompanying text.

89. Anderson Living Trust v. WPX Energy Prod., L.L.C., No. CIV 12–0040 JB/LFG, 2015 WL 1321479, at *6 (D.N.M. March 19, 2015).

90. 69 F.3d 283 (8th Cir. 1995).

91. Bice v. Petro Hunt, L.L.C., 2009 ND 124, ¶ 20, 768 N.W.2d 496, 502.

The dispute again was over casinghead gas, which could not be shipped or sold until contaminants were removed.[92] The applicable lease language required royalties paid on "market value at the well."[93] After the North Dakota Industrial Commission stopped oil production because the oil companies were flaring associated natural gas produced with the oil, the companies built a processing plant to capture and market the gas.[94] They deducted proportionate processing costs from royalty payments. The Hurinenkos, a large family group, accepted deductions for fifteen years. In 1993, however, they sued to challenge the deductions.[95]

At the outset, one can note that this was a vulnerable position. The Hurinenkos' delay exposed them to a sometimes unspoken but vintage oilfield principle that parties who sit on their hands for long periods of time tend to lose, whether on affirmative defenses of waiver and estoppel or because courts are reluctant to reward them and likely to find some other way to rule against them on the merits.[96]

The trial court granted summary judgment for the companies.[97] The Eighth Circuit affirmed by holding that North Dakota already had set a "well-recognized," "established meaning" for the term "market value at the well."[98] In its view, that meaning is that such value is fixed by "the 'work-back' method: deducting processing costs from gross sales revenue."[99] This conclusion would surprise many readers of North Dakota law, and the court cited only two North Dakota Supreme Court decisions, *Amerada Hess Corp. v. Conrad*[100] and *Koch Oil Co. v. Hanson*,[101] as sources of the supposedly "well-recognized," "established" meaning. The reason for surprise is that neither case is on point.

Neither *Conrad* nor *Hanson* concerned deductions. Instead, both cases addressed the discretion extended to the Tax Commissioner to seek out appropriate value under North Dakota's severance tax statute; in *Conrad*, discretion over the Commissioner's adopting a "workback method"[102] (with no one arguing over deductions) and in *Hanson*, discretion over oil volume

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92. *Hurinenko,* 69 F.3d at 284.

93. *Id.* at 285.

94. *Id.* at 284-85.

95. *Id.*

96. For cases on the reluctance to reward perceived delay in the oilfield investment context generally, see John Burritt McArthur, *The Restatement (First) of the Oilfield Operator's Fiduciary Duty*, 45 NAT. RESOURCES J. 587, 691-93 (2005).

97. *Hurinenko*, 69 F.3d at 284.

98. *Id.* at 285.

99. *Id.*

100. 410 N.W.2d 124 (N.D. 1987).

101. 536 N.W.2d 702 (N.D. 1995).

102. *Conrad*, 410 N.W.2d at 127.

measurements.[103] *Bice* correctly noted that the North Dakota Supreme Court had not previously addressed (before *Bice*) what "market value at the well" means for royalty purposes.[104] Thus, the court at least implicitly confirmed that *Hurinenko* was in error to assume that the North Dakota Supreme Court had decided the meaning of "at the well" in these two tax cases or anywhere else.

A deeper look at the two cases shows how far they are from precedent on deductions. In *Conrad*, the North Dakota production-tax statute at issue provided for tax payments on "gross value at the well," which the court defined as "fair market value at the time of production."[105] The issue is a familiar one to oil-and-gas lawyers: when the governing royalty (or tax) standard is "market value," do the operating company's sales prices prove market value so that the proceeds it generates are synonymous with market value, or must "market value" be computed from "outside" prices external to the particular lessee and being paid generally in the vicinity of the disputed property?[106]

Amerada Hess was selling gas through a thirty-four year old agreement in which it received only half of the net income its buyer, Signal Oil and Gas Company, received when reselling the gas.[107] In turn, Signal built and operated a processing plant.[108] Thus, Amerada Hess essentially traded half of the revenue stream in return for Signal's performing the field services that many courts define as marketability services.

The Commissioner, unhappy with this low revenue stream as the basis for tax payments, argued that he had discretion to use prices outside Amerada's actual sales contract and picked downstream prices, from which he deducted downstream expenses in a typical "work-back" computation, to determine the basis for tax computations.[109] The North Dakota Supreme Court affirmed the trial court, which had approved the Commissioner's decision.[110]

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103. *Hanson*, 536 N.W.2d at 708.

104. Bice v. Petro Hunt, L.L.C., 2009 ND 124, ¶ 18, 768 N.W.2d 496, 502.

105. *Conrad*, 410 N.W.2d at 127.

106. The Texas Supreme Court authored the leading decision standing for the separation of proceeds and market value measures of value in *Texas Oil & Gas Corp. v. Vela*, 429 S.W.2d 866, 871 (Tex. 1968). The supreme courts of Oklahoma, in *Tara Petroleum Corp. v. Hughey*, 630 P.2d 1269, 1272-74 (Okla. 1981), and Louisiana, in *Henry v. Ballard & Cordell Corp*, 418 So. 2d 1334, 1337-41 (La. 1982), produced the leading decisions maintaining the unity of the two measures of value.

107. *Conrad*, 410 N.W.2d at 127.

108. *Id.*

109. *Id.*

110. For the trial court's rulings, see *id.* at 127.

A striking feature of *Conrad* is that the court treated it as entirely a question of deference and statutory construction, not a contractual issue of lease interpretation (tax statutes do not involve lease issues) or a matter to which implied duties might apply. The statutory scheme showed that taxes were to be levied on "fair market value," the tax applied whether sales occurred or not, and the statute specifically authorized the Commissioner to use the "prevailing price then being paid," not just "proceeds of sale" or the equivalent for gas of "like kind, quality, and character."[111] The court also cited what it called the majority oil-and-gas rule that "market value" is distinct from the lessee's sales price.[112] The decision did not turn on either deductions or the phrase "at the well."

Koch Oil v. Hanson was no more relevant to *Hurinenko* and *Bice* than *Conrad*. *Hanson* resolved a dispute over whether the Commissioner could reject Koch's hand-measured oil volume readings at the well and instead determine the volume upon which taxes had to be paid using Koch's mechanical downstream volume measurements, which tended to show a higher volume of oil.[113] Ordinarily, one would expect downstream measurements to be somewhat lower than wellhead measurements because there would be small amounts of leakage. Thus, the higher downstream volume measurements suggested that the wellhead volumes were too low. The court, finding that the "oil extraction tax is of a complex and technical nature," deferred to the agency and found that the Commissioner "could reasonably conclude that meter gauging [performed downstream] is more accurate than hand gauging [performed at the well]."[114] Using the meter gauge readings was a reasonable way of determining "fair value."[115]

The court also rejected Koch's optimistic but somewhat blind (after *Conrad*) argument that because it sold its gas in arm's-length sales, the Commissioner was bound to accept the value generated in those sales as the basis for tax computations.[116] This argument fell before a dismissive cite to *Conrad* and its broadly deferential view of the Commissioner's power to determine "fair market value,"[117] which rejected just this kind of position.

If it had any relevance, *Koch* would stand for a principle that the Commissioner is not bound by "at the well" volumes and, more generally,

111. *Id.* at 129 (citing N.D. CENT. CODE § 57-51-05 (1987)).
112. *Id.* at 129-30.
113. Koch Oil Co. v. Hanson, 536 N.W.2d 702, 705 (N.D. 1995) (downstream monthly measurements audited showed "volume gains" over wellhead measurements in forty-six of forty-eight months audited, with a total gain over period of 137,822 barrels).
114. *Id.* at 706-07.
115. *Id.* at 707-08.
116. *Id.* at 707.
117. *Id.*

that fundamental values should not be distorted by that geographic reference. Koch argued that "it is impossible to determine values at the well when using downstream measurements . . . ."[118] The court rejected this version of an "at the well" argument. But *Koch*, like *Conrad*, was not about deductions, leases, or implied duties, and unlike *Conrad*, it was not even a case about economic valuation as such. It was about volume measurement, not what price or costs apply once one has determined volumes.[119] It would be hard to think of two oil or gas cases less relevant to *Hurinenko* and *Bice* than *Conrad* and *Hanson*. Unfortunately, the sum total of *Hurinenko*'s reasoning about the "well-recognized," "established" meaning of "at the well" comes from these two cases that do not define or apply "at the well." These cases provide no support for the North Dakota Supreme Court in *Bice*.

III. RELATED ISSUES TO CONSIDER WHEN DEDUCTIONS COME AROUND AGAIN

One of the strong beliefs of common law courts is that facts matter. As a result, it is better to advance the law in short, concrete steps rather than by a leap of rational projection. If the North Dakota Supreme Court does again face the marketable-product issue, it will be in a better position to articulate a proper rule—one way or the other—when it has a record before it. The record should contain evidence about what "at the well" means, how the field was developed, where gas is sold today compared to in the earlier regulated market, whether the field was developed primarily to serve distant demand or local demand, and whether prices that purportedly reflect local "markets" are true economic prices at all. Beyond this, a few words can be said about the marketable-product issues generally.

The court certainly will face arguments that the plain meanings of "at the well" and perhaps "production" mean value set at the well,[120] versus

118. *Id.*

119. *Id.* at 707-08 ("The Commissioner's use of downstream metered measurements of the volume of oil . . . has nothing to do with valuation of the barrels of oil to be taxed.").

120. *See* Bruce Kramer, *Interpreting the Royalty Obligation by Looking at the Express Language: What a Novel Idea?*, 35 TEX. TECH. L. REV. 223, 253 (2004) ("'At the well' therefore describes not only location but quality as well. Market value at the well means market value before processing and transportation, and gas is sold at the well if the price paid is consideration for the gas as produced but not for processing and transportation.") (internal quotation marks in original); Scott Lansdown, *The Marketable Condition Rule*, 44 S. TEX. L. REV. 667, 671 (2003) ("Historically, there was a clear recognition that, under most oil and gas leases, the point of valuation for royalty purposes was at the well.") (internal quotation marks omitted); David Pierce, *The Renaissance of Law in the Law of Oil and Gas: The Contract Dimension*, 42 WASHBURN L.J. 909, 935-36 (2004) ("If the lease provides for a gas royalty based upon 'market value at the well,' the issue will be what was the market value of the gas, at the well."); *cf. generally* John Lowe,

arguments that these terms are silent or at least ambiguous on deductions[121] and, in contrast, purpose arguments that the court should be guided by the overriding purpose of the lessee's duty to provide a marketable product. This is the fundamental divide between the two groups of cases. The legal meaning of "at the well" is dependent upon which camp a state joins. In marketable-product jurisdictions, "at the well" is not specific enough to authorize deductions; in "at the well" jurisdictions, the term is, as the label suggests, treated as sufficient. Thus, there is circularity in finding "at the well" sufficient to justify an approach before the court addresses which approach makes sense to it. The North Dakota Supreme Court, though siding with an "at the well" approach, provided no discussion of why it did so in terms of the fundamental underlying division. Nor did *Hurinenko*.

Marketable-product jurisdictions reject the argument that saying "at the well" is enough to signal an intent to take deductions for services rendered from the wellhead on. It is notable that, for language allegedly intended to authorize deductions, the wording "at the well" says nothing at all to show that it is intended to regulate cost deductions, much less anything about which costs. For that reason, the Colorado Supreme Court has found the term silent on deductions[122] and certainly not providing clear or adequate notification of any cost treatment, whatever the reason the term was used. And, even if one finds the non-cost language ambiguous, as did the West Virginia Supreme Court,[123] ambiguous leases are interpreted against the lessee, the party in charge and traditionally the drafter, pursuant to the vintage rule of the American oil patch and one that the North Dakota Supreme Court enforced in *West v. Alpar Resources, Inc.*[124] It is the failure

Defining the Royalty Obligation, 49 SMU L. REV. 223, 244-66 (1996) (discussing "plain terms" jurisdiction*s* and "cooperative venture" jurisdictions).

121. All of the major marketable-product jurisdictions have rejected the idea that "at the well" is specific enough to authorize deductions by its own terms. For the Colorado ruling, see *infra* text accompanying note 122; for the West Virginia ruling, see *infra* text accompanying note 123. The author has discussed the Kansas rule in McArthur, *supra* note 60. For the Oklahoma rule, *see* Mittelstaedt v. Santa Fe Minerals, Inc., 954 P.2d 1203, 1210 (Okla. 1998) (the Oklahoma Supreme Court articulating that state's rule in a manner inconsistent with "at the well" doctrines).

122. Rogers v. Westerman Farm Co., 29 P.3d 887, 897-901 (Colo. 2001) (en banc).

123. Estate of Tawney v. Columbia Natural Res., LLC, 633 S.E.2d 22, 28-29 (W. Va. 2006).

124. For *West*'s rule of construction, see *infra* text and accompanying notes 145-48. In *West v. Alpar Resources, Inc.*, Alpar Resources showed the kind of language a party would use—although it used the wrong agreement to do so, with most courts rejecting efforts to modify leases through division orders—if it wanted to authorize deductions when it cited a division order sent by the lessee to the Wests with language specifically allowing deductions. 298 N.W.2d 484, 486 (N.D. 1980). The Wests refused to sign the form. *Id.* The proposed but unsigned division order provided for royalty on "net proceeds" and defined that term to mean actual proceeds minus "dehydration, gathering, compressing, treating and any other actual costs and expenses required to make the gas marketable and transport same to the point or points of delivery to the purchaser." *Id.*

of such terms to say what lessees later allege they mean that led to the Colorado Supreme Court's famous (or infamous) observation that lessees used "at the well" deliberately in order to "avoid directly stating their objectives in sharing costs"[125] and the West Virginia Supreme Court to accuse lessee producers of using the concept of "post-production" costs as a code to escape their responsibility to bear production costs.[126]

The court will face the question of how a changed marketplace affects lease language that was adopted when a marketable product so commonly was sold at the well. Natural gas deregulation upended the market in the late 1980s and early 1990s, as intended, and the major buyer/seller transactions moved downstream of processing plants. The function of providing a product, which is marketable in the primary market sought by most producers, was once fulfilled at the well, but today is fulfilled by downstream sales after processing plants.

It may be a factor in gauging the significance of this transformation that most after-well field services, like processing, could be applied at the well, but not economically. Many of the functions performed to put gas into marketable, pipeline-ready form theoretically could be handled at the well.[127] But to do so often would be grossly inefficient. Lessees, of course,

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Courts generally find division orders insufficient to modify the lease because the purpose of division orders is not amending the lease but establishing ownership shares for royalty payment purposes. *See generally* John Burritt McArthur, *The Mutual Benefit Implied Covenant for Oil and Gas Royalty Owners*, 41 NAT. RESOURCES J. 795, 803-10 (2001). In North Dakota, the Legislature has prohibited lessees from using division orders to water down substantive royalty payment terms. N.D. CENT. CODE § 47-16-39.3 (2014) ("A division order may not alter or amend the terms of the oil and gas lease. A division order that varies the terms of the oil and gas lease is invalid to the extent of the variance and the terms of the oil and gas lease take precedence."). In contrast to the language in the division order proposed to the Wests, which was invalid because it was the wrong agreement to try to amend a lease (not because the language was vague or ambiguous), "at the well" does not tell an average reader that it is intended to address a cost issue at all.

125. Rogers v. Westerman Farm Co., 29 P.3d 887, 899 (Colo. 2001) (en banc).

126. Wellman v. Energy Res., Inc., 557 S.E.2d 254, 264 (W. Va. 2001) ("To escape the rule that the lessee must pay the costs of discovery and production, these expenses have been referred to as 'post-production expenses.'"). Even Owen Anderson, though he ultimately came out in favor of allowing deductions for services provided after the well, nonetheless concluded similarly after a careful analysis of the background to marketable-product issues. He found that courts that rely on such terms as "market value at the well" and "proceeds" as controlling are taking select terms in what generally are form contracts out of the context and ignoring other lease terms, including the term "production" and the fact that a finished product is a requirement for "market value" or "proceeds" sales. Anderson, *supra* note 66, at 637-38 ("'[P]roceeds' and 'amount realized' . . . suggest an actual sale . . . . [F]or there to be a real market price or market value, there must be a market, a marketable product, a ready and willing seller, and a ready and willing buyer.").

127. Some processing can be provided at or near the well, in which case it is called "field processing." *See Processing Natural Gas*, NATURAL GAS SUPPLY ASSOCIATION, http://naturalgas.org/naturalgas/processing-ng/ (last visited, July 9, 2015). The Kansas Supreme Court discussed the lessee's discretionary power to select the location for providing gas

should minimize costs, and thus maximize profits, wherever they legally can. But taking steps to gain economies of scale for their own savings should not make formerly nondeductible costs suddenly deductible.

In making any decision, the court should be cognizant that the argument in *Bice* that field costs can be deducted because there is no market at the well,[128] thus allowing deduction on the theory that the costs are incurred to increase value, produces the opposite conclusion on the same facts in marketable-product states. That there is no market at the well suggests, as does logic, that the gas is not yet marketable. The issue is, after all, whether the lessee is obligated to produce a marketable product, a product once often found at the well but today most often downstream. Marketable-product jurisdictions hold that if it is the lessee's duty to produce a marketable product, it has to produce one that can be sold, and this condition cannot be met at the well if there is no market at the well.[129] A related question for the court will be whether marketability is satisfied by the "first" marketable product, or the product instead has to be marketable at a price acceptable under the duty to market, that is, the best price reasonably possible, as this author has urged.[130]

The court almost certainly will face briefing that touts local sales near at least some wells as proof that natural gas generally is marketable "at the well" all over North Dakota. Yet local sales often have problems of thin markets, comparability, and best-price issues, and they certainly do not reflect the market for which most of the country's major gas fields were developed and in which prudent lessees try to sell their gas. The gas infrastructure of major gas fields, including large field gathering systems and long mainline pipelines, was not built to supply occasional free use, field use, or local heating and cooking. It was built to maximize profits, to secure the best prices, and to serve "distant" demand from large gas and electricity utilities and commercial customers who sought processed dry gas

marketability services in two cases about compression costs in 1964. Gilmore v. Superior Oil Co., 388 P.2d 602, 604-06 (Kan. 1964) (describing facility installation and discussing lack of consultation with lessor over compressing station); Schupbach v. Cont'l Oil Co., 394 P.2d 1, 5 (Kan. 1964). In each case, the court found that geographic terms of possible restriction in the lease, "at the mouth of the well" in *Gilmore* and an identical term in *Schupbach*, did not authorize deductions when the services that generated the costs were intended to make gas marketable.

128. Bice v. Petro Hunt, L.L.C., 2009 ND 124, ¶ 20, 768 N.W.2d 496, 502 (claiming that because the gas, like the gas in *Hurinenko*, "has no market value at the well, the only way to determine the market value of the gas at the well is to work back from where a market value exists, meaning using the work-back method . . . ."). The marketable-product conclusion, of course, is quite different: because there is no market at the well, "production" is not complete, the lessee has not finished its implied duty to produce a marketable product, and royalty should be paid on the value of the gas where it is marketable.

129. *Id.* ¶ 16, 768 N.W.2d at 501.

130. On the best-price responsibility, see MCARTHUR, *supra* note 1, Part VI.B.

in the condition that lets it enter and be shipped in large, often interstate, pipelines. Thus, it is no surprise to find some courts concluding that gas becomes marketable only when it is in a condition and location to enter such large transmission pipelines, not small gathering lines.[131]

The "at the well" argument also raises questions about preserving the value of liquids as opposed to the dry methane gas. Over time the liquids entrained in natural gas have become increasingly valuable, so much so that today companies often seek liquids-rich gas in preference to dry gas. The general liquids stream, the "Y-grade" stream, is separated from the dry methane gas by processing and liquids from each other by fractionation.[132] The use of "at the well" to limit recoveries to raw gas would deprive the lessors of their share of the liquid content of their gas.[133] Yet it long has been the rule that even when leases are silent about minerals not known to be marketable at the time of signing, lessees have to pay royalties on additional minerals if the market evolves so that these minerals come to have separate economic value, unless the lease specifically excludes these minerals.[134] Taken literally, the "at the well" approach advocated by many lessees would block this mutual sharing of common value.

131. *See supra* text accompanying notes 77-79.

132. The Natural Gas Supply Association provides a generic description of these processes. For its description of processing and of fractionation, the procedure for separating individual liquids, see *Processing Natural Gas*, *supra* note 127, http://naturalgas.org/naturalgas/processing-ng/ (last visited, July 9, 2015).

133. For instance, a producing lessee is trying to justify a policy of only paying royalties on a price appropriate to raw unprocessed gas (with no separate payment for liquids), even though it sells its gas after processing downstream. *See generally* Brief for WPX Energy Prod., LLC, Abraham v. WPX Energy Prod., LLC, 20 F. Supp. 3d 1244 (D.N.M. 2014) (No. CIV 12–0917 JB/ACT). The author is an expert for the class in that case.

134. This issue arose in *Haynes v. Eagle-Picher Co.*, 295 F.2d 761 (10th Cir. 1961). The plaintiffs owned a royalty interest entitling them to five percent of the market value "at the place mined or produced of all oil, gas, asphaltum, lead, zinc and all other minerals or substances whatever, which may be mined or removed . . . ." *Id*. at 762. There was "no market" for the ore until it was reduced to concentrates, which traditionally had been sold as lead concentrate and zinc concentrate. *Id.* Lessee Eagle-Picher adopted "advanced processing techniques" that let it also save sulphur, cadmium, and germanium out of concentrate residue and urged that "custom and practice which existed for many years . . . of paying royalties only on the market value of the concentrates" precluded its having to pay on these three minerals that it had learned to extract from the concentrate residue. *Id.* at 765. The court held that even though the ore may have had no value where mined, it did where "produced" [thus including off-site processing in "production"] and holding it "common knowledge that minerals are not separated from the earth in pure form and that, except in rare instances, some processing is necessary to render them marketable." *Id.* at 764. Eagle-Picher had to pay royalties on the three added minerals that its further processing turned into marketable products. On the question of which minerals are covered from the gas stream, see also the highly influential helium decision in *Northern Natural Gas Co. v. Grounds*, 441 F.2d 704 (10th Cir. 1971).

Lessees likely will argue that paying the royalty share imposes too many costs on them.[135] In considering this argument, one fact to balance is that the lessee already receives the lion's share, usually a seven-eighths share of revenues, but under more modern leases, sometimes five-sixths. Such higher shares compensate for the lessee's added costs, including all drilling costs and other costs incurred to satisfy its cluster of duties, including the duty to market. The unfairness argument uses rhetoric that sounds as if all marketability costs are being shifted to the lessee. Yet no one disputes that the lessee must bear the majority of these costs; the dispute is only over whether it can shift a small proportion of the costs to the royalty interest. The lessee's greater revenue interest does not itself prove that it should bear all costs, but it is a reminder that lessors have given very valuable consideration in order to have the lessee produce a marketable product and, even before considering deductions, only get a small part of the resulting revenue in return.

The difference between "at the well" jurisdictions and marketable-product jurisdictions seems unlikely to be bridged. Instead, the industry is likely to remain split into today's two camps, with some variation within the marketable-product standards. At the end of the day, the difference may come down to the fundamental interpretative difference that John Lowe suggested as an explanation for different positions on whether lessees have to share take-or-pay settlements and prepayments: whether one takes a narrow plain meaning approach to the lease, looking to the words for meaning—even if they are vague—but not to the lease purpose as such, or instead putting more emphasis on the purpose of the lease and reading the words in that context.[136] If marketable-product issues return again to the North Dakota Supreme Court, these considerations should help guide its decision.

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135. The Kansas Supreme Court faced cost arguments in a recent case in which it reversed the court of appeals. *Fawcett v. Oil Producers, Inc.*, 352 P.3d 1032 (Kan. 2015), *rev'g* 306 P.3d 318 (Kan. Ct. App. 2014). Lessee Oil Producers, Inc. advanced a "cripple industry" argument. Appellant's Opening Brief at 38-41, *Fawcett*, 306 P.3d 318 (No. 11-CV-90). It combined a financial harm argument and what was in effect a due process argument (called a "violat[ion of] fundamental principles") in its supplemental brief. Supplemental Brief of Defendant-Appellant, at 16-17, *Fawcett*, 306 P.3d 318 (No. 11-CV-90). The Eastern Kansas Oil and Gas Association, an amicus, 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." Brief of Amicus Curiae E. Kan. Oil & Gas Ass'n at 13, *Fawcett*, 306 P.3d 318 (No. 11-CV-90). DCP Midstream, appropriately enough a mid-stream company, warns that the decision below 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*, 306 P.3d 318 (No. 11-CV-90).

136. *See generally* Lowe, *supra* note 120, at 244-66 (dividing cases into "plain terms" and "cooperative venture" jurisdictions).

IV. A MAJOR LIMIT ON *BICE*

It is a mistake to read *Bice* to mean that North Dakota lessees can always deduct the marketability costs of natural gas. Those who live by the word historically sometimes have to die by the word. Those who insist on plain-meaning analysis sometimes will find they do not like the meaning the words generate. If "at the well" is a binding, geographic authorization to deduct all costs incurred after the well, leases without such limitations or other express language authorizing deductions, be they proceeds or market value leases, should not allow any deductions.

This issue arose in a proceeds lease in *West v. Alpar Resources, Inc.*,[137] a North Dakota Supreme Court decision long predating *Bice*. The lease required payment on "one-eighth of the proceeds" of sale on gas wells where the gas was sold.[138] The lessors refused to sign a division order calling for lower "net proceeds" payments and expressly authorizing a series of deductions.[139] In that frustrating Olympian impersonality that appellate decisions can suffer, the opinion did not describe the full set of costs at issue, but the costs included the expense of extracting hydrogen sulfide from the sour gas as well as "other costs incurred by Alpar prior to the sale of the gas."[140]

Alpar Resources cited cases that it argued support an "at the well" approach; the Wests, cases supporting the marketable-product position.[141] The court discussed three treatises, the *Williams & Meyers*, *Kuntz*, and *Merrill* treatises, the "major treatises on oil and gas law," which it correctly found "demonstrate the unsettled nature of the law in this area."[142] The court's accurate summary of the state of the law in *Alpar* contrasts notably with its approach in *Bice*. In *Bice*, the court cited articles coming from only one side, the "at the well" side, of this issue.[143] Furthermore, the *Bice* court incorrectly treated the deduction issue as at least settling in favor of the "at the well" position,[144] when it has not.

Ultimately, the *Alpar* court found the "proceeds" lease without an "at the well" limitation ambiguous.[145] "Rational arguments," it believed, could

137. 298 N.W.2d 484 (N.D. 1980).
138. *Id.* at 486.
139. *Id.*
140. *Id.* at 487.
141. *Id.* at 487-88.
142. *Id.* at 489-90 (citing 3 WILLIAMS & MEYERS, *supra* note 7, at 591-603; 3 KUNTZ, *supra* note 24, at 319-27; MERRILL, *supra* note 24, at 212-18).
143. Bice v. Petro Hunt, L.L.C., 2009 ND 124, ¶ 13, 768 N.W.2d 496, 500-01.
144. *Id.* ¶¶ 13-21, 768 N.W.2d at 500-03 (treating at the well as the majority rule).
145. *West*, 298 N.W.2d at 490.

be made to support the position that this meant a gross proceeds standard and to support the contrary view that royalty should be set at the wellhead, with deductions after that.[146] It cited the rule that ambiguities are construed against the lessee, who usually is "well informed" and therefore has "many advantages" in drafting leases and "could have easily included express language to that effect in the lease."[147] Royalties, therefore, were due on total proceeds, not proceeds minus deductions.[148] Nothing in *Bice* conflicts with this language. Gross proceeds leases, naked proceeds leases, presumably naked market value leases, and other leases with no geographic referent should not allow deductions in North Dakota even if the court continues to maintain that "at the well" leases do.[149]

V. THE COURT SHOULD RECONSIDER ITS DEDUCTION RULE ON THE MERITS.

Bice rests on shaky, eroded ground. The court's decision on the marketable-product standard is of great importance to this state: to its natural gas producers and royalty owners, to its investors as well as farmers and small businessmen, to those employed in the industry as well as those receiving income from it. As a result, the court should revisit its holding on North Dakota's gas-deduction rule when an opportunity arises. In making its analysis, it should jettison the incorrect assumption that marketable-product courts are in the minority, and it should not assume that answering a factual question about markets poses an unusual complexity to be avoided. The court should remove any *Hurinenko* blinders before

146. *Id.* Yet "proceeds," like "gross proceeds," has an industry meaning. *See* Hockett v. Trees Oil Co., 251 P.3d 65, 71-72 (Kan. 2011) (listing the operative royalty language and interpreting "proceeds" as requiring royalty payment on "gross sales price"). The term "proceeds," used without more, is not ambiguous.

147. *West*, 298 N.W.2d at 491.

148. *Id.*

149. Lessees who endorse the "at the well" approach will argue that deductions should be allowed beyond the well even in gross proceeds leases, unless the lease specifically prohibits deductions. In other words, rather than require the lease to authorize deductions, they assume that deductions are always allowed unless prohibited. And, indeed, in the most extreme case, the Texas Supreme Court has allowed deductions in a "market value at the well" lease even when more specific language expressly prohibited deductions: the language included a specific prohibition 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." Heritage Res., Inc. v. NationsBank, 939 S.W.2d 118, 120-23 (Tex. 1996) (emphasis added). The majority treated "market value at the well" as providing that all expenses incurred after the well are deductible, *id.* at 122-23, but did not provide any plausible explanation for the very, very specific no-deduction language. The opinion spawned a forceful dissent. *Id.* at 131 (Gonzalez, J., joined by Abbott, J., dissenting). A four justice minority voted to rehear the case. Heritage Res. Inc. v. NationsBank, 960 S.W.2d 619, 619 (Gonzalez, J., joined by Cornyn, Spector, and Abbott, JJ., dissenting from denial of rehearing), to no avail.

analyzing the underlying merits, and it should weigh de novo the reasoning of marketable-product and "at the well" jurisdictions. The court should consider the duty to market with its requirement that lessees secure the best price possible; the fact that lessees choose to provide many services downstream rather than at the well for their own economic benefit; the fact that most gas fields would not be in production if not for downstream markets, whose supply is purchased as pipeline-ready gas; and the post-deregulation shift of primary natural gas markets from at or near the wellhead to downstream market centers after the processing plant. It is this last change that has led marketable-product jurisdictions to bar deductions in order to preserve what they see as the same general obligation the lessee always has borne: that of producing a marketable product.