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INTRODUCTION

Depending on one's perspective, the multi-faceted decision of the Louisiana Supreme Court in *Gloria's Ranch, L.L.C. v. Tauren Exploration, Inc.*,[1] is either momentous, significant, or mundane. Certainly, the case was composed principally of three distinct phases or issues, with one related to the other, and each conceivably of interest to distinct (but perhaps different) constituencies, including particularly bankers and exploration and production (E&P) companies,[2] yet arguably not in the same manner or for the same reason.

First and foremost, from the perspective of a banker, the opinion was nothing less than momentous, and of great relief to lenders in the E&P space, in that the Supreme Court reversed the decision of the appellate court that had ruled that a lending bank holding a mortgage on mineral leases owned by its borrower, was solidarily liable along with its borrower-mineral lessee (and other E&P companies) for their faults or omissions as determined by the trial court, and affirmed (on different

1. 252 So. 3d 431 (La. 2018). In the interest of full disclosure, this author represented the American Bankers Association and the Texas Bankers Association as *amici curiae* in support of Wells Fargo's writ application to the Louisiana Supreme Court, and on the merits.

2. In the jargon of the industry, "exploration and production" is called "E&P." *See* LA. REV. STAT. § 30:29(I)(5) (2019).

grounds) by the Court of Appeal, Second Circuit.[3] In this much anticipated decision, a unanimous Supreme Court absolved the bank of any responsibility for the $24.5 million judgment rendered by the trial court and affirmed by the appellate court. In so doing, the court restored the institution of mortgage to its important role as a nonpossessory security interest.[4]

Next, at the same time, an E&P company would view the decision as quite significant in that the court clarified a long-standing debate as to the meaning and import of provisions of the Louisiana Mineral Code authorizing the award of "damages double the amount of royalties due," as a remedy for nonpayment of royalties.[5] With respect to this significant issue, the Supreme Court held that this formulation (as it appears in several articles of the Louisiana Mineral Code)[6] authorized a maximum award of double, rather than triple, the amount of unpaid royalties.[7]

Finally, the seemingly mundane phase of the decision that, if even noticed, some might view as routine or uncontroversial, addressed the main contention of the plaintiff that the mineral lease which it had granted had lapsed by reason of the lessees' failure to produce in "paying quantities."[8] As this Article will demonstrate, one particular aspect of this topic is far from mundane or insignificant.

Pretermitting the opportunity to "go big," it might surprise one that this Article solely addresses this seemingly mundane, perhaps "run of the mill," feature of the *Gloria's Ranch* decision—an aspect that was embodied essentially in two words in the Supreme Court's decision,[9] and

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3. *See* Patrick S. Ottinger, All's Well That Ends Well: The *Gloria's Ranch* Decision and its Impact on Credit Documentation (Dec. 6, 2018) (unpublished paper presented at the 2018 Louisiana Bankers Association Bank Counsel Conference), https://www.ottingerhebert.com/wp-content/uploads/Ottinger-Alls-Well-That-Ends-Well-v-9-120618.pdf [https://perma.cc/D5LS-HGYX].

4. "Mortgage is a nonpossessory right created over property to secure the performance of an obligation." LA. CIV. CODE art. 3278 (2020).

5. LA. REV. STAT. §§ 31:139–:140 (2019).

6. *See* LA. REV. STAT. §§ 31:138.1, :139, :140, :212.23(C).

7. *See* PATRICK S. OTTINGER, LOUISIANA MINERAL LEASES: A TREATISE § 13-30(c) (2016) [hereinafter OTTINGER MINERAL LEASE TREATISE].

8. "When a mineral lease is being maintained by production of oil or gas, the production must be in paying quantities. It is considered to be in paying quantities when production allocable to the total original right of the lessee to share in production under the lease is sufficient to induce a reasonably prudent operator to continue production in an effort to secure a return on his investment or to minimize any loss." LA. REV. STAT. § 31:124.

9. So as to not keep the reader in unnecessary suspense, those two words are "accounting manipulations." *See* discussion *infra* Part II.B.

probably overlooked by most readers, embedded as it is in one particularly long footnote.[10]

As ample and appropriate commentary has been (or certainly will be) published on the other features of this important case, this author does not deem it necessary to dissect the court's decision on the momentous or significant issues noted above. However, one critical point of interest that has probably gone unnoticed is worthy of consideration, and that is the manner in which relevant expense information is to be collated and presented in a production in "paying quantities" case.

The Introduction to this Article explains the several issues considered by the courts in the *Gloria's Ranch* case. Part I considers the law of Louisiana on the issue of production in "paying quantities," particularly as to the accounting issues involved in a trial of such a case. These accounting issues are developed further in Part II wherein consideration is given to the meaning of "two sets of books." Finally, the Conclusion of this Article attempts to capsulize the basic premise of this Article, that the maintenance of "two sets of books" is neither nefarious nor sinister but is perfectly aligned with basic accounting principles that focus on the purpose for which financial information is collected or reported.

I. LAW APPLICABLE TO PRODUCTION IN "PAYING QUANTITIES"[11]

A. Basic Principles

1. The Applicable Standard

In connection with the maintenance or perpetuation of a mineral lease by production under the usual "Habendum Clause,"[12] such production must be in "paying quantities." Even if the mineral lease is silent on this

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10. Gloria's Ranch, L.L.C. v. Tauren Expl., Inc., 252 So. 3d 431, 442 n.11 (La. 2018).

11. Certain portions of this Article are an adaptation of prior writings by this author, principally Patrick S. Ottinger, *Production in Paying Quantities – A Fresh Look*, 51 ANN. INST. ON MIN. L. 24 (2004), *reprinted in* 65 LA. L. REV. 635 (2005). *See also* OTTINGER MINERAL LEASE TREATISE, *supra* note 7, at § 3-15.

12. "The 'Habendum Clause' announces the duration of the mineral lease, and is sometimes called the 'Thereafter Clause.' All of the distinct clauses in the mineral lease that address the important issue of lease maintenance come under the ambit of the 'Habendum Clause.' This clause might be said to be the heart of the critical concept of lease maintenance." *See* OTTINGER MINERAL LEASE TREATISE, *supra* note 7, at § 4-06; *see also infra* note 30.

subject, the quantitative requirement still persists.[13] Indeed, it is imposed by law.[14]

The notion that production must be of a certain quantity in order to maintain a mineral lease is as old as the industry itself. Indeed, the earliest mineral lease in Louisiana jurisprudence contains an explicit requirement that production had to be in "workable quantity."[15] As noted by the Louisiana Supreme Court in an early case, the parties to the lease "must have had in mind something else than these dribblings of oil."[16]

Although the requirement that production must be in "paying quantities" had been developed jurisprudentially, it is now codified in articles 124 and 125 of the Louisiana Mineral Code.[17] Relevantly, article 125 made significant changes to the scope of the inquiry as had been developed by the courts, abandoning the pre-Code test that production must be in "paying quantities" as to the interest of the lessor, as well as with respect to the interest of the lessee.[18] The two "prongs" of this former test—first, as to the lessor, and second, as to the lessee—have been called the "objective" standard and the "subjective" standard.[19]

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13. *See* Caldwell v. Alton Oil Co., 108 So. 314 (La. 1926). "In the instant lease the words 'in paying quantities' are omitted. From which it is argued by the defendant that the quantity of oil produced has nothing to do with the continued life of the lease; that just so long as any oil at all is produced from the well the lease cannot be declared forfeited. We are not prepared to give our approval to such a proposition." *Id.* at 315.

14. "When a mineral lease is being maintained by production of oil or gas, the production *must be in paying quantities*." LA. REV. STAT. § 31:124 (2019) (emphasis added). "'Must' is mandatory language." Singleton v. State Dep't of Pub. Safety & Corr. *ex rel.* Elayn Hunt Corr. Ctr., 878 So. 2d 555, 556 (La. Ct. App. 1st Cir. 2004).

15. Escoubas v. La. Petroleum & Coal Oil Co., 22 La. Ann. 280, 281 (La. 1870). The mineral lease in *Escoubas* was granted on October 5, 1865, or six months after the conclusion of the Civil War.

16. Anse LaButte (Le Danois) Oil & Mineral Co. v. Babb, 47 So. 754, 757 (La. 1908).

17. Act No. 50, 1974 La. Acts Vol. III (codified as amended at LA. REV. STAT. §§ 31:1–:217 (2019)).

18. "In applying Article 124, the amount of the royalties being paid may be considered only insofar as it may show the reasonableness of the lessee's expectation in continuing production. The amount need not be a serious or adequate equivalent for continuance of the lease as compared with the amount of the bonus, rentals, or other sums paid to the lessor." LA. REV. STAT. § 31:125 (2019).

19. *See* Thomas P. Battle, *Lease Maintenance in the Face of Curtailed/Depressed Markets*, 32 ROCKY MTN. MIN. L. INST. 14-1, at § 14.05 (1986).

As noted in the Comment to article 124 of the Mineral Code,[20] Louisiana's current law on this subject is fashioned in large part on the pronouncements of the Texas Supreme Court in *Clifton v. Koontz*.[21]

Bringing Louisiana's test in line with other jurisdictions, the issue of production in "paying quantities" essentially concerns itself with the operator's motives in continuing production at the level being obtained, and the diligence with which the lessee has operated the leased property, as a guard against speculation on the part of the lessee.[22] Illustratively, the Texas Supreme Court in *Garcia v. King*, observed that the "lessors should not be required to suffer a continuation of the lease after the expiration of the primary period *merely for speculation purposes on the part of the lessees*."[23]

In its simplest application, the doctrine of production in "paying quantities" entails a comparison of two distinct "baskets": a basket of relevant expenses as compared to a basket of monetary value of the defined stream of revenue. The following chart elucidates these points.

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20. "Many leases expressly require that the production be in paying quantities to maintain the lease. However, even though the phrase 'in paying quantities' is not present, the courts will read it into the lease with the result that 'production' sufficient to maintain a lease must be 'in paying quantities.'" LA. REV. STAT. ANN. § 31:124 cmt (2019).

21. 325 S.W.2d 684 (Tex. 1959).

22. *See* Hunter v. Booker, 104 So. 618, 620 (La. 1925) ("That right is predicated upon the theory that oil or gas will be produced in paying quantities. It is only from this source that the landlord can receive compensation for the use of his land. It is therefore a condition precedent to the recognition of that right that it be proven that the wells drilled by defendant did, and that appellant *has used due diligence to cause them to continue to, produce oil or gas in paying quantities*.") (emphasis added).

23. 164 S.W.2d 509, 513 (Tex. 1942) (emphasis added). *See also* Lege v. Lea Expl. Co., 631 So. 2d 716, 718 (La. Ct. App. 3d. Cir.), *writ denied*, 635 So. 2d 1112 (La. 1994) ("The court's appreciation of the development of the law pertaining to production in paying quantities is that the principle was established to prevent a lessee from holding a lease and continuing their operations thereon merely for speculative purposes."). In the interest of full disclosure, this author represented the defendant-lessee in the *Lege* case.

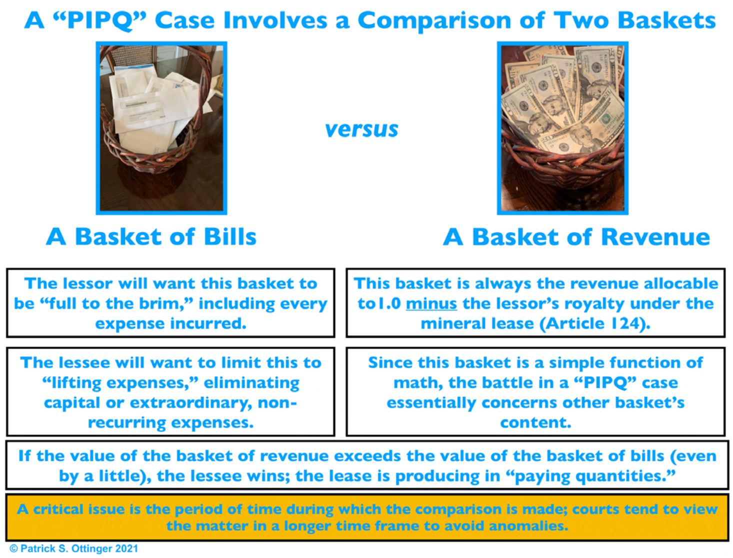

Figure 1: The Doctrine of Production in Paying Quantities Comparison[24]

2. Determination of Revenue to Be Measured Against Expenses

There should be no occasion to have any controversy whatsoever as to the revenue stream allocable to the lessee since it is statutorily defined as being "the total original right of the lessee to share in production under the lease."[25]

In other words, if a mineral lease provides for a one-fourth (1/4) lessor's royalty, the relevant stream of revenue to be employed in the analysis is three-fourths (3/4), even if the lessee is entitled to receive less than that amount of net revenue by reason of the existence of certain overriding royalty interests or other burdens on production.[26]

Thus, a case in which a lessor contends that a mineral lease has ceased to produce in "paying quantities" is essentially focused on the relevant "book" of expenses to be examined against that defined, determinable stream of revenue. The "relevant" expenses are those that constitute "current operating" costs.

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24. A larger, full-color version of this chart may be found at https://perma.cc/4Y22-79WB.

25. LA. REV. STAT. § 31:124 (2019).

26. *See* OTTINGER MINERAL LEASE TREATISE, *supra* note 7, at §§ 3-15(b), 11-02.

3. Discernment of Expenses to Be Measured Against Revenue

a. Characterization or Categorization of Expenses

By its very nature, the resolution of a production in "paying quantities" case turns principally on a proper characterization or categorization of items of expense incurred by the lessee in its production activities. Accordingly, these cases are virtually always expert-intensive.

In evaluating the sufficiency of the production allocable to the full working interest, it is necessary to give consideration to what expenses are considered as being "current operating" costs. The relevant expenses to be considered are usually called "lifting costs," a term having reference to those costs incurred by the operator to "lift" the oil or gas from the ground.[27]

Importantly, costs incurred in seeking to find production are capital in nature, and are not "operating costs," and, hence, are not considered.[28]

This means that costs incurred by the lessee to find the oil or gas (drilling costs), and to establish production (completing and equipping costs) are not considered as they are not "lifting costs." Such costs are capital and non-recurring in nature. The test does not entail consideration of "sunk costs."[29]

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27. "Expenses necessary to lift the oil from the ground." Stewart v. Amerada Hess Corp., 604 P.2d 854, 857 n.8 (Okla. 1979).

28. Pshigoda v. Texaco, Inc., 703 S.W.2d 416, 418 (Tex. App. 1986) (". . . fixed or periodic cash expenditures incurred in the daily operation of a well (sometimes called out-of-pocket lifting expenses) are to be classified as operating expenses, while one time investment expenses, such as drilling and equipping costs are to be treated as capital expenditures"). *See also* Heirs v. Union Tex. Petroleum Corp., No. 90-2418, 1992 WL 91938, at *3 (E.D. La. Apr. 13, 1992) ("In submitting the calculations of the net profits or net losses from the Wylie No. 1 Well, Kelley appropriately excluded from those calculations equipment costs, overhead, depreciation of original equipment, and reworking expenses.").

29. "In economics and business decision-making, a 'sunk cost' is a cost that has already been incurred and cannot be recovered." N. GREGORY MANKIW, PRINCIPLES OF MICROECONOMICS (5th ed. 2009). "Witnesses who discussed the expenditure agreed that it was a capital expenditure. The Pshigodas' expert witness called it a 'sunk cost' and a 'capital investment for the repair of that well.' Texaco witnesses characterized the expense as a 'workover to repair a capital item' and 'an extraordinary item which is not a normal operating expense.' One witness also said the expense was 'absolutely not' an operating cost or a cost directly attributable to the operation of a lease." *Pshigoda*, 703 S.W.2d at 417.

b. Contrary Interests of Lessor and Lessee

In examining the costs that might be of a "current operating" nature, it is helpful at the outset to acknowledge the contrary interests of the lessor and the lessee in disputes over whether a mineral lease is generating production in "paying quantities" for purposes of the lease's "Habendum Clause."

The lessor would urge the court to consider as many items of cost as possible so as to require a greater amount of production before it could be said that "current operating" costs were being met. In other words, the lessor would essentially seek to be unburdened by issues of characterization or categorization, positing instead that virtually *all* expenses should be considered.

However, from the point of view of the lessee, and so as to permit a smaller amount of production in order to satisfy the requirement of being in "paying quantities," it is necessary that fewer items of expense be considered: The lesser the aggregate of expenses considered, the lesser the quantity of production necessary so as to meet or exceed them on a current basis. The lessee would be very interested in properly characterizing or categorizing the costs to be considered by the court, in order to eliminate or exclude ineligible or irrelevant costs.

Accordingly, the adversarial approach to the determination of relevant "lifting costs," of itself, requires the court to determine which costs are to be considered, and which costs are not relevant to the inquiry. This necessary judicial methodology is precisely the constitutional role of a court in a case of this type.

B. An Illustrative Case on the Characterization or Categorization of Costs

Illustrative of the important—indeed, indispensable—role of characterization or categorization of costs in the trial of a "paying quantities" dispute is the case of *Lege v. Lea Exploration Co.*[30] There, the lessors sued the lessee to declare a mineral lease to have terminated by reason of the lessee's failure to produce in "paying quantities."[31]

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30. 631 So. 2d 716, 718 (La. Ct. App. 3d. Cir.), *writ denied*, 635 So. 2d 1112 (La. 1994).

31. Mineral leases used in Louisiana are of the "unless" form, such that the continuation of the lease under its "Habendum Clause" invokes an express resolutory condition. *See* OTTINGER MINERAL LEASE TREATISE, *supra* note 7, at § 4-04(a). When production ceases to be in "paying quantities," and unless the mineral lease is being otherwise maintained, the mineral lease comes to an end,

The lessors contended that, for purposes of ascertaining production in "paying quantities," certain costs and expenses were to be characterized as an "operating expense." The precise issue was stated by the court, as follows:

> The heart of the dispute calls into question the legal classification of certain expenditures by the lessee. Allocation of these expenditures to the category of "operating expenses," which are deductible from a producing properties [sic] gross revenues, could result in our finding that the well did not consistently "produce in paying quantities" and a forfeiture of the lease at some point during the years 1981 through 1984; their classification as "repair and remedial" or "equipment" capital costs, on the other hand, would lead us to affirm the lower court's conclusion that the well never ceased to "produce in paying quantities."[32]

The principal disputed item of expenditure involved the costs incurred by the lessee in converting an existing well to a saltwater disposal system.[33] For a period of time, the lessee disposed of the saltwater by trucking it off of the leased premises, the cost of which would be treated as a "current operating expense," and, accordingly, relevant to the inquiry. The lessors argued that, by analogy, "so should be the expenditures which replace them."[34]

The court articulated that "we are unable to accept the premise of plaintiff's position, that the nature of a lessee's cost is determined strictly by the substitution accomplished."[35] Rather, the court stated that the classification of a given item of expense as being "ordinary and recurring or extraordinary and largely non-recurring in nature" was determinative as to whether that expense item should be considered as an "operating" or "lifting" expense.[36]

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without the necessity of a putting in default, pursuant to article 133 of the Louisiana Mineral Code, which provides that a "mineral lease terminates at the expiration of the agreed term or upon the occurrence of an express resolutory condition." LA. REV. STAT. § 31:133 (2019). *See* OTTINGER MINERAL LEASE TREATISE, *supra* note 7, at § 13-15.

32. *Lege*, 631 So. 2d at 717.

33. *See, e.g.*, Leger v. Petroleum Eng'rs, Inc., 499 So. 2d 953, 955 (La. Ct. App. 3d Cir. 1986) ("salt water production is a necessary part of the production of oil from plaintiffs' property, and . . . there is no way to produce oil from plaintiffs' property without some means of disposing of the salt water").

34. *Lege*, 631 So. 2d at 718.

35. *Id.* at 719.

36. *Id.*

Since the disputed costs were treated as "extraordinary and largely non-recurring in nature," such expenses were not to be characterized as "lifting costs."[37] The mineral lease was maintained, and the claims of the plaintiffs were dismissed.[38]

Consistent with other reported decisions,[39] this case demonstrates that the evidence in a "paying quantities" case should be directed to the appropriate characterization or categorization of an item of expense for purposes of the "Habendum Clause" of a mineral lease.

Costs that are extraordinary, non-recurring,[40] or capital in nature (including, according to *Lege v. Lea Exploration, Inc.*, "repair and remedial" costs)[41] are not to be considered as they constitute "sunk costs," not "lifting costs" associated with the production of the oil and gas found by the efforts of the lessee.

On the other hand, costs that are ordinary or recurring, and are necessary to "lift" the oil and gas to the surface, are the costs that enter the inquiry.

II. ACCOUNTING ISSUES INVOLVED IN A "PAYING QUANTITIES" CASE[42]

A. Relevant Terminology

1. A Bit of a Misnomer: The Notion of "Two Sets of Books"

As in all matters, proper terminology is critical. Illustrative of this observation, an appropriate starting point is to examine the title of this

37. *Id.*
38. *Id.* at 717.
39. *See* Brown v. Sugar Creek Syndicate, 197 So. 583, 592 (La. 1940) ("The question of whether or not the well is producing oil and gas in paying quantities requires a consideration of the operation costs and the revenue, and if a fair and reasonable profit is made, then it is considered a commercial well.").
40. *See* Middleton v. EP Energy E & P Co., 188 So. 3d 263, 267 (La. Ct. App. 2d Cir.), *writ denied* 192 So. 3d 774 (La. 2016) ("Such nonrecurring expenses are not considered as operating expenses for the purpose of determining production in paying quantities."). In the interest of full disclosure, your author represented a defendant in this suit.
41. *Lege*, 631 So. 2d at 717.
42. The author expresses his sincere appreciation to Cecily A. Raiborn, Ph.D., Professor of Accounting, Texas State University (retired), who provided useful guidance and insight into accounting concepts considered in this Part. However, any errors are solely mine.

Article, to the extent that it refers to maintaining "*two* sets of books."[43] Perhaps, if one is mindful of the accepted protocols of financial reporting at the company level, one would recognize that there is no such thing, properly speaking, as "*two* sets of books." This is so because, in a strict sense, few (if any) companies actually maintain "*two* sets of books." Rather, companies maintain one "book," constituting an aggregation of all financial entries of all transactions, including costs and expenses, revenues, reserves, liabilities, assets, etc. From this single "book," one can derive several key measures that are relevant to decision-making, or to meeting reporting requirements.

The reference in this Article to "two sets of books" is itself a bit pejorative, and draws upon the fact that courts—unburdened with any compulsion to speak in precise accounting terminology when, based upon evidence adduced, it desires to castigate or denigrate the perceived conduct or business practices of a litigant—often use this scornful statement.[44] Certainly, these derisive references are intended to be suggestive of a nefarious or sinister motive on the part of the company which maintains "two sets of books."

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43. In reality, it might be stated that a company actually has "three sets of books," rather than merely "two." These "books" relate to information collected, recorded, and maintained for financial accounting, managerial accounting, and tax accounting. There is only one set of true records that are then adapted for the particular purpose needed. Adjustments are then made to the figures to reflect the purpose (either internal decision-making or taxation). Nevertheless, the reference herein to "two sets of books" accords with common jargon in these matters.

44. *See, e.g.*, Smith v. Superior Casing Crews, 299 F. Supp. 725, 730 (E.D. La. 1969) ("I credit the testimony that the plaintiffs accepted the checks because they were told that Superior had to have some way of manipulating its records so that the labor department would think that Superior was paying overtime; that the employees thought Superior had *two sets of books*, one for this purpose, and the other an accurate account.") (emphasis added); Sun Drilling Prods. Corp. v. Rayborn, 798 So. 2d 1141, 1150 (La. Ct. App. 4th Cir. 2001) ("From this conclusion and the evidence in the record, we can only believe that Sun maintained *two sets of books*, one for internal use and one version which it maintained for the public, including its creditors.") (emphasis added); United States v. Chon, 713 F. 3d 812, 817 (5th Cir. 2013) ("Chon was responsible for maintaining the books for the Gateway Hotel throughout the duration of the conspiracy. Chon created *two sets of books*: one that accurately portrayed the gross receipts, and another that substantially understated gross receipts.") (emphasis added).

The premise of this Article resides in the difference between Financial Accounting and Managerial Accounting which may be radically different applications from the same aggregated book of financial information.[45]

"Generally accepted accounting principles," or "GAAP," are the common set of standards, practices, and procedures that have been established by an authoritative accounting rule-making body (such as the Accounting Principles Board or the Financial Accounting Standards Board[46]) or have become accepted over time through universal application within a given industry.[47] One should generally not deviate from GAAP when reporting externally as they are the basis for financial reporting to key stakeholders including investors, lenders, creditors, and some governmental agencies such as the Securities and Exchange Commission.

In short, GAAP accounting uses an accrual basis that focuses on consistency and verifiability, whereas Managerial Accounting focuses on usefulness and flexibility and, thereby, often excludes amounts such as "sunk costs" that have no bearing on future courses of action.[48] One should recognize that, while much Managerial Accounting data comes from Financial Accounting, the purpose is to provide managers with more relevant information for short-term decision-making.

Hence, GAAP accounting is "Full Costing" and "Accrual Based," whereas Managerial Accounting is "Relevant Costing" that often excludes "sunk costs."[49] One should recognize that the Managerial Accounting data come from the same (not different) books, but provide managers with the "correct answers" for short-term decision making.

Indeed, courts in production in "paying quantities" cases have acknowledged that "generally accepted accounting practices may lead to one result, whereas equally accepted accounting practices, using acceptable but alternate methods and practices, can result in an opposite result."[50]

Thus, although a single set of books can have two different calculations that are well established in accounting literature to calculate different measures, this Article uses the rather sneering or disdainful reference to "two sets of books" in order to comport with judicial references and so as to emphasize the issue addressed herein.

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45. CECILY A. RAIBORN, JESSE T. BARFIELD & MICHAEL R. KINNEY, MANAGERIAL ACCOUNTING 45 (3rd ed. 1999).

46. *Id.*

47. DONALD E. KIESO, JERRY J. WEYGANDT & TERRY D. WARFIELD, INTERMEDIATE ACCOUNTING 7 (16th ed. 2016).

48. *Id.* at 3, 393.

49. *Id.* at 74, 392–93.

50. Mason v. Ladd Petroleum Corp., 630 P.2d 1283, 1285 (Okla. 1981).

2. But First, What Are "Books"?

We must digress for a moment. As noted,[51] one often hears a reference to a business maintaining "two sets of books." It is appropriate to precisely explain what is meant by a "book" for these purposes, or in this context.

By these allusions, one is usually not referring to a physical "book" or ledger with leather binding, although that might have been the meaning in the earliest days of that phrase or reference. This "book" is not a physical leather-bound tome to be placed in a library. Rather, it is often as simple as one or more sheets of paper. A traditional accounting "ledger," perhaps maintained in commercially available software, certainly comes to mind.

More likely than not, a "book," as might be the tool or product of an accountant, is an assembly or presentation of data points established or organized by the use of modern accounting software into which an array of cost or revenue information is to be input, and organized and presented in one or another, or still another, form of organization or presentation.

Certainly, as is the essential point of this Article, and as demonstrated elsewhere,[52] the inclusion or exclusion of this bit of data, or that piece of monetary or mathematical information, is fundamentally dictated and determined by the essential context or purpose for which the report—the "book"—is being prepared. Thus, the same data might be logically and appropriately organized, collated, and reported in a particular manner, or with a certain context, depending upon the rules—legal or accounting—pertinent to the report or "book" being created. Accordingly, the expression "two sets of books" does not do justice to this observation, as it is often many more than two reports that might be generated, each for a unique and particular, commercially appropriate purpose.

B. A Case in Point On the Connotation of Maintaining "Two Sets of Books"

Noting that "the determination of operating expenses is often a fact-intensive inquiry," courts have stated that "mere debits and credits listed on a balance sheet are often insufficient alone to determine whether a well is producing in paying quantities."[53] This observation is precisely the underpinning of the notion of "two sets of books."

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51. *See* discussion *supra* Part II.A.1.
52. *See* discussion *infra* Part II.E.
53. Doré Energy Corp. v. Prospective Inv. & Trading Co., No. 2:05 cv 1657, 2010 WL 4068802, at *7 (W.D. La. Oct. 14, 2010). *See also* Lege v. Lea Expl. Co., 631 So. 2d 716, 718–19 (La. Ct. App. 3d. Cir.), *writ denied*, 635 So. 2d 1112 (La. 1994) (finding that an operating expense analysis requires an assessment of

The decision in *Gloria's Ranch v. Tauren Exploration, Inc.*,[54] suggests that the court did not appreciate that "two sets of books" are necessary and supportable (and in no manner *per se* nefarious or sinister) in a production in "paying quantities" case. Indicatively, the Second Circuit noted that, "[a]fter filing suit and further investigating the matter, Gloria's Ranch discovered the operating statements . . . *had been altered to make the wells appear more profitable*."[55] Additionally, the appellate court repeatedly referred to the first set of statements (in contrast to the revised set sent at a later date by Tauren's counsel) as the "authentic, unaltered operating statements,"[56] implicitly disparaging the later materials as being "inauthentic" and "altered."

In similar regard, the decision of the Supreme Court expressed that "Tauren *participated in the accounting manipulations* in an effort to make it appear that the lease was still producing in paying quantities."[57]

If the courts gave any consideration whatsoever to the evolution of a "book," they seemingly thought that the "books" of the lessee had been "cooked," as the saying goes.[58]

These brief passing references invite greater scrutiny as to the evidence in the trial record relative to the lessee's accounting methodology. A review of the trial record in this case demonstrates that the accounting information introduced into evidence reflected nothing other than the typical and appropriate trial of the issues presented by the parties, and certainly nothing more nefarious or sinister than that.[59]

The trial record—particularly the transcript of the testimony of the expert accountant engaged by Gloria's Ranch—indicates that the

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the purpose of the expense; therefore, an expense may not be an operating expense even when it is "necessary to continue and maintain production.").

54. Gloria's Ranch, L.L.C. v. Tauren Expl., Inc., 252 So. 3d 431 (La. 2018).

55. Gloria's Ranch, L.L.C. v. Tauren Expl., Inc., 223 So. 3d 1202, 1211 (La. Ct. App. 2d Cir. 2017), *aff'd in part, rev'd in part*, 252 So. 3d 431 (La. 2018) (emphasis added).

56. *Id.* at 1211–12.

57. *Gloria's Ranch*, 252 So. 3d at 442 n.11 (emphasis added).

58. The well-known expression, "cooking the books," has reference to the fraudulent modification of accounting records, usually for the purpose of deceiving the Internal Revenue Service or some other governmental agency. *See, e.g.*, State Dep't of Soc. Servs. v. Reed, 197 So. 3d 817, 828 (La. Ct. App. 5th Cir. 2016) ("M.R. contends that [the court-appointed expert's] report does not state that he was engaged in 'cooking the books' or 'foul play' and as such he should not have to pay any of the expert fees.").

59. The author has personally examined the trial record as maintained in the office of the Clerk of the Louisiana Court of Appeal for the Second Circuit, including the transcript of relevant trial testimony.

defendants, in responding to a pre-suit demand from the Gloria's Ranch attorney for financial information, sent a so-called "lease operating statement" that aggregated all expenses and revenues, without making a determination that the listed expenses did or did not constitute "lifting expenses."[60] At a later date, counsel for defendants sent a revised report that showed the same revenue, but included a smaller block of expenses, resulting from the elimination of costs that defendant, upon further analysis, deemed irrelevant for purposes of evaluating production in "paying quantities."[61]

Even prior to the receipt of trial testimony, the facts pertaining to the revision of the information contained in the original "lease operating statement" provided in response to plaintiff's pre-suit demand for financial information, was explained by defendants' counsel in his opening statement, as follows:

> We get together with EXCO, everybody else, start looking at what it says, you know, the revenue versus the operations. What we see is that this small company has been accounting like a mom and pop operation running every expense that they can get any sort of tax benefit through the wells.
>
> Louisiana law permits you to take some of those expenses out if they are not directly related to "operating costs." We did some research, find there is this thing called "lifting costs." We made some adjustments to the accounting to reflect the true "lifting costs" instead of every expense that they were running through there. When you make those adjustments, the lease is turning a profit.[62]

Indeed, on the central premise of this Article, the plaintiff's expert witness agreed that there can be "two sets of books," by the following testimony elicited under cross-examination by defense counsel:

> Q. Explain to me how you can have two separate sets of accounting that are both legitimate.
> A. Well, I'm not a CPA, but I do know most operators probably do keep two sets of books. There is tax accounting and financial reporting and operational accounting. There are different types of

60. *Gloria's Ranch*, 223 So. 3d at 1211.
61. *Id.*
62. Transcript of Trial Record at 3535, *Gloria's Ranch*, 223 So. 3d 1202 (No. 51,077-CA).

> costs that are classified different ways for different tax or financial reporting reasons.
> Q. And both are legitimate means of accounting?
> A. Sure.
> Q. Depending on what your goal is, right?
> A. Yes, sir.[63]

Notwithstanding this admission as to the propriety of maintaining, in a proper case, "two sets of books," the same witness continued to persist that the "statements would not have been completely revised coincidentally shortly after the demand letter was issued if the operator was not trying to change the accounting of the well."[64]

Further, testimony of the plaintiff's expert accounting witness characterized the second report submitted by the lessee as "an alteration that removed this charge." The revised report was cast in a less than pristine light by the witness in the following testimony:

> Q. Without belaboring this are you aware of other discrepancies similar to that?
> A. It's the same for all the wells. The - -
> Q. So - - go ahead.
> A. The revised, if you want to call them revised statements that were attached to the response, I believe that in almost all cases the revenue numbers were the same, but the expense numbers magically got lowered.
> Q. So the information that was contained in the lease operating statement that [defendants' counsel initially] sent to Gloria's Ranch had been modified from what was in the possession of Fossil, Tauren and Cubic?
> A. Correct.
> Q. And they were modified by removing expenses, right?
> A. Yes, sir.[65]

It is not the purpose of this Article to suggest that the court "got it wrong," in reaching its ultimate determination as to the status of the mineral lease. The author is actually agnostic to the "mundane" phase of the case on this topic. Certainly, this author has the highest respect for the constitutional role and province of the court to make the critical determination as the judge evaluates the evidence. The point to be made is that there was

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63. *Id.* at 3699–700.
64. *Id.* at 3701.
65. *Id.* at 3639.

recognition at trial—from both parties—that maintaining "two sets of books" is not necessarily nefarious, but rather is supportable.

C. The Very Definition of "Paying Quantities" Production Mandates That the Lessee Maintain "Two Sets of Books"

That two (if not more) "books" are necessary in a production in "paying quantities" case is actually mandated by the very nature of that standard or level of production that is necessary in order to maintain a mineral lease in force and effect under its "Habendum Clause."[66] Every company has a financial record of the entirety of its costs and expenses, and of its receipts or revenues, related to all of its distinct activities and enterprises. This record might be called a comprehensive set of financial statements, including a balance sheet, profit and loss statement, or cash receipts and disbursements statement. Regardless of its moniker, the aggregated set of statements captures the entire universe of all entries affecting both sides of the accounting ledger (assets, liabilities, and equity transactions that include revenues and expenses as well as capital inflows and outflows) for a stated period of time or at a specific point in time.

In order to evaluate the level of production generated by a particular well located on lands covered and affected by a mineral lease, that statement or report needs first to be split into two distinct reports or "books"—one on expenses, the other on revenue—properly allocable to the well under examination. Hence, by this very first essential step, the operator has necessarily (and, thus, appropriately) created "two sets of books," each legitimate and proper in its own right, in pursuit of the isolation of relevant evidence in a "paying quantities" case.

Because there should be no controversy with respect to the revenue side of the test,[67] that "book" of distinct revenue—if properly discerned—might essentially be disregarded (or certainly, needs no further clarification or refinement), focusing instead on the "book" of relevant expenses.

On a unit-of-activity basis (examining a distinct well), a statement might be maintained with respect to a particular well in order that all expense charges are recorded and reported on that single well-basis. So, the first created "book" is now stripped of all wells other than the well in question, another step creating yet another unique, and perfectly legitimate, "book" of expenses.

66. *See supra* notes 12, 30.
67. *See* discussion *supra* Part I.A.

In terms of quantification of production, "paying quantities" is not understood to be that amount of production which would return to the lessee the entire cost of drilling, testing, completing, equipping, developing, and operating a well, plus a profit.[68] Hence, it is not a requirement that the lessee ever recoup its "sunk costs," only that the production be of a sufficient amount so as to meet and cover the "lifting costs" incurred in bringing the production to the surface, and marketing it, "and yield a small profit."[69]

Consequently, by the very foundational definition of the quantitative test involved in a "paying quantities" case, an operator must revise its universal record of costs and expenses in order to remove those costs associated with activities that do not come within the ambit of the relevant or controlling legal standard. This step of removal or elimination clearly results in the exclusion of capital costs, and of those expenses that are extraordinary or non-recurring in nature.

This, again, results in yet another occasion for the creation of yet another "book," as the "paying quantities" case essentially puts at issue the characterization or categorization of costs to be relevantly scrutinized as being ordinary as opposed to extraordinary, capital (including "repair and remedial") in contrast to non-capital, or recurring rather than non-recurring.

This precise formulation has been embraced by the courts in virtually all energy-producing states. For example, in *Abraxas Petroleum Corp. v. Hornburg*,[70] the Texas appellate court stated the rule, as follows:

> In the context of an oil and gas lease, the term "production" has been construed to mean a well which pays a profit, however small, over operating and marketing expenses, even though it may never repay its costs and the enterprise as a whole may prove unprofitable. This definition should apply equally to the phrase

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68. *See* Knight v. Blackwell Oil & Gas Co., 1 So. 2d 89, 91 (La. 1941) ("The words 'in paying quantities' can mean the production of oil or gas in such a quantity as will pay a small profit over operation costs of the well, *although the expense of drilling and equipping the well may never be paid*, and thus, the operation as a whole might result in a loss to the lessee.") (emphasis added). The recognition that "sunk costs" "may never be paid," is authority for the removal of those capital costs from the financial "book" or record for purposes of a production in "paying quantities" analysis.

69. The test is recognized in the comments to article 124 by noting that, in order to be deemed in "paying quantities," "the lease must be producing in quantities sufficient to meet current operating expenses and yield a small profit." LA. REV. STAT. ANN. § 31:124 cmt. (2019).

70. 20 S.W.3d 741 (Tex. App. 2000).

> "producing in paying quantit[ies]." Operating and marketing expenses include taxes, overhead charges, labor, repairs, and depreciation on salvable equipment, but not costs or expenses in connection with the original drilling of the well or reworking expenses. Periodic cash expenditures incurred in the daily operation of a well (sometimes called out-of-pocket lifting expenses) are classified as operating expenses, while one-time investment expenses, such as drilling and equipping costs, are to be treated as capital expenditures. Reworking expenses are part of the capital investment.[71]

D. Relevant Commentary on Maintaining "Two Sets of Books"

The proposition that it is neither nefarious nor sinister, but, rather, is both necessary and supportable, to maintain "two sets of books" in a production in "paying quantities" case has been addressed by both commentators and courts.

Noted previously was an article published by this author on the topic of production in "paying quantities."[72] In that article, the following commentary was included on this topic, to-wit:

> Since we are obliged to deal with the accounting facts of life, let's start out by frankly and intelligently recognizing that there is no stigma attached to "keeping two sets of books." The marvel would be if a sizable company, in this day and age, could get by with *only* two sets. It is not at all unusual to find that the books kept by a company for the purpose of internal cost accounting will vary considerably from the books which Uncle Sam requires for income tax purposes. And, . . ., the accounting treatment in preparation of an F.P.C.[[73]] cost case would certainly be different from the treatment on either the annual statement or the tax return. This is perfectly legitimate. In fact the difference in use of the figures *requires* different handling.
>
> Therefore, it should come as no surprise if you find that an oil and gas operator keeps separate figures on the lifting expense of his wells which do not resemble those on his F.P.C., tax, or annual report statements.

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71. *Id.* at 756 (internal citations omitted).
72. Ottinger, *supra* note 11.
73. Now FERC, the Federal Energy Regulatory Commission.

> The most obvious example of this difference is in the handling of intangible drilling costs. Many operators have elected to "expense" these intangibles for the purpose of computing income taxes. Thus in the early life of a producing lease, where there is a lot of drilling, the "expense" of these intangible drilling costs may well exceed the proceeds from production for months or years. Yet by definition such well costs must be ignored in our determination of paying quantities under the habendum clause. You can readily see that such a lease may have current income far in excess of lifting expense and still show an operating loss on the tax books.
>
> The paying quantities rule set up by the courts goes to the substance of the case and is not concerned with mere form. Thus, it is necessary to look past the mere debit and credit book entries in *every* instance and inquire into the essential character of the particular transactions which gave rise to those entries.[74]

Recognizing the significance in such litigation of the role of accounting in terms of the appropriate characterization or categorization of a particular item of expense, one commentator has recommended legislative or accounting guideline revision to address the topic (a suggestion that does not to this author seem necessary or appropriate), as follows:

> The various accounting methods used, however, complicate the court's determination of whether these expenses are indirect and remote or directly attributable to a lease. A solution to these problems would be to require producers to classify allocated administrative overhead expenses in a section of the income statement separate from the operating expenses. Any person with access to the producer's financial statements could then easily identify those overhead costs that should be excluded from the calculation of paying quantities. Only overhead directly attributable to a lease and classified in the operating expense section of the income statement would be applicable to the computation. Such a requirement could be enacted legislatively, but a body more qualified to establish financial accounting requirements is the Financial Accounting Standards Board (FASB). The FASB, by issuing a pronouncement requiring

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74. Ottinger, *supra* note 11, at 35–36 (quoting Edwin M. Cage, *Production in Paying Quantities: Technical Problems Involved*, 10 ANN. INST. ON OIL & GAS L. & TAX'N 61, 68 (1959)).

> separate classification of allocated overhead expenses, could alleviate problems faced by lessors, lessees, and the courts when asked to determine paying quantities.[75]

This author believes that, if properly mindful of the propriety—indeed, necessity—of "two sets of books," courts are more than capable of discerning the relevance of a disputed item of cost for purposes of the "Habendum Clause,"[76] and that the need for legislative or regulatory intervention in the private civil matter of lease maintenance is thus unnecessary. Parties are certainly free to construct a lease clause that requires the lessee to provide specified financial information or reports to the lessor upon request.[77] Additionally, only companies that are regulated by the SEC and non-governmental entities that issue securities to the public are required to comply with FASB guidelines.[78]

Another commentator makes this point in these words, to-wit:

> Identification of the appropriate lifting costs and the determination of production in paying quantities for habendum clause purposes require a thorough analysis of the applicable legal precedents, the financial accounting records, and lease operating details. Because of the economic nature of the habendum clause, the financial income statement cannot be expected to produce the correct habendum clause lifting expense for production in paying quantities. Likewise, the general purpose financial statements prepared under generally accepted accounting principles are not intended to reflect such a narrow scope of defined activity.[79]

This notion—that the absence of uniform, "one size fits all" accounting principles justifies (if not mandates) the different treatment of items of cost or expense for different purposes, in different contexts—has received

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75. Richard D. Koljack, Jr., *Determination of Paying Quantities: An Accounting Perspective*, 18 TULSA L. REV. 475, 485–86 (1983).

76. *See supra* notes 12, 30.

77. The important principle of "freedom of contract" is addressed in Part I of Chapter Two of OTTINGER MINERAL LEASE TREATISE, *supra* note 7.

78. *See* FIN. ACCOUNTING STANDARDS BD., ACCOUNTING STANDARDS UPDATE NO. 2009-01 (2009), https://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176156337846&acceptedDisclaimer=true [https://perma.cc/DD9H-YFJL].

79. John L. Wilson, *Accounting for Production in Paying Quantities Under the Habendum Clause*, PETROLEUM ACCT. & FIN. MGMT. J., Summer 1991, at 130, 134.

judicial approbation. In *Mason v. Ladd Petroleum Corp.*,[80] the Supreme Court of Oklahoma said, as follows:

> Neither can the determination of the issue rest with accounting practices, that is, how such expenses are carried on the books of the leasehold owner-operator. Until such time as accounting practices become standardized, generally accepted accounting practices may lead to one result, whereas equally accepted accounting practices, using acceptable but alternate methods and practices, can result in an opposite result.[81]

That not all "operating statements" prepared by an operator are relevant in a "paying quantities" case was recognized by the court in *O'Neal v. JLH Enterprises, Inc.*,[82] where the court noted, as follows:

> An examination of the operating statements shows that when plaintiffs calculated the operating expenses in order to establish their claim, plaintiffs deducted only some of the expenses that defendants urge were incurred in the four workover operations done by Pace during the 13 months at issue. . . . Filed into evidence by defendants were invoices or work tickets from the companies with whom Pace contracted for the workover services. The workover expenses were listed on Pace's operating statements under the general category of "operating expenses," although no significance should be given to this categorization by Pace as the operating statements were prepared for a client, not in anticipation of litigation over paying quantities.[83]

E. Context and Purpose of the "Book" Matter Significantly

As demonstrated above, it is essential, in a production in "paying quantities" case, to properly characterize or categorize, in a financial statement, record, or "book," a particular item of expense. In other words, context and purpose matter greatly in this regard. Hence, a particular expenditure incurred by the lessee in the operation or development of a mineral lease will be treated and reported (or not) on a "book" prepared for a distinct accounting or financial purpose based upon the reason the report ("book") is prepared.

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80. 630 P.2d 1283 (Okla. 1981).
81. *Id.* at 1285.
82. 862 So. 2d 1021 (La. Ct. App. 2d Cir. 2003).
83. *Id.* at 1027.

Using as an example the disputed costs at issue in the case of *Lege v. Lea Exploration Co.*,[84] the following chart demonstrates how costs incurred by the lessee to convert an abandoned wellbore for saltwater disposal purposes ("Conversion Costs") should be treated and reported, or disregarded and not reported, depending upon the particular context or purpose for which the record or "book" is being made.

As will be demonstrated, each different and distinct relationship or context in which the issue arises (presenting the issue of whether to include or exclude the consideration of Conversion Costs) treats these Conversion Costs differently, and each is perfectly appropriate, certainly not nefarious or sinister, in the distinct context identified. So, this chart answers the question of whether one would include or exclude the identified Conversion Costs in preparing a "book," or more than likely a popular commercial financial spreadsheet, for the purposes indicated.

The manner in which Conversion Costs are to be treated and reported (or not) with respect to each identified context or purpose is explained below the chart in reference to the note reflected at each point.

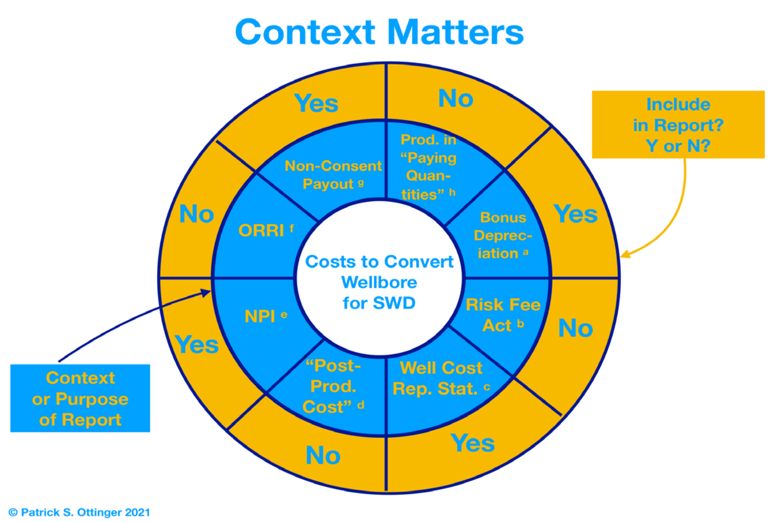

Figure 2: Conversion Costs[85]

84. 631 So. 2d 716, 719 (La. Ct. App. 3d Cir. 1994) ("The court finds, . . ., that the cost of conversion of the saltwater disposal well . . . [is] a capital expenditure and should not be included as an operating expense for the purpose of determining [if] there was production in paying quantities.").

85. A larger, full-color version of this chart may be found at https://perma.cc/4Y22-79WB.

1. Eligibility for Bonus Depreciation

Enacted by the Tax Cuts and Jobs Act of 2017,[86] bonus depreciation (often called "accelerated depreciation") allows the taxpayer to amortize 100% of the cost of "qualified property" acquired by the taxpayer after September 27, 2017, but placed in service between September 28, 2017, and December 31, 2022. The taxpayer's right to claim the depreciation is contingent upon the relevant asset constituting tangible property.[87]

Under our hypothetical situation, equipment and other materials actually incorporated into the saltwater disposal well should constitute tangible personal property, and the relevant Conversion Costs (exclusive of intangible costs) should qualify for accelerated or bonus depreciation.

Illustratively, the entire suite of Conversion Costs as a distinct block of expenses would have to be broken down further for this purpose, and in this particular context. By definition, the costs incurred to convert the borehole would include both tangible and intangible costs. The tangible costs would relate to the cost of corporeal property or equipment used in the borehole conversion—tubing, casing, surface equipment—and the intangible costs (not eligible for bonus depreciation) would be the cost of the services and labor provided by the contractor. Hence, even in this example, the block of Conversion Costs would need to be rendered into two "books," each isolating the qualifying and non-eligible costs.

Thus, a "book" created by a taxpayer to be filed with the Internal Revenue Service in order to claim bonus depreciation of the tangible property will include the associated, qualifying Conversion Costs.

2. Recovery of "Risk Charge" Under the Louisiana Risk Fee Act

The Louisiana Risk Fee Act is embodied in Louisiana Revised Statutes section 30:10A(2).[88] It permits an operator to impose a "risk charge" with respect to certain costs incurred in "drilling, testing, and completing the [unit] well."[89] Costs of *equipping* and *operating* the unit well are notably omitted from the formulation of the "risk charge" to which the operator is entitled.[90]

Because the conversion of an abandoned borehole for saltwater disposal purposes would come within the rather broad ambit of

86. Pub. L. No. 115-97, 131 Stat. 2054.

87. I.R.C. § 168(k) (2018).

88. *See* Patrick S. Ottinger, *It's a Risky Business, but There's an Act for That: The Louisiana Risk Fee Act*, 63 ANN. INST. ON MIN. L. 61 (2016).

89. LA. REV. STAT. § 30:10A(2)(b)(i) (2019).

90. *Id.*

"operating" a unit well, the Conversion Costs would not be included on a report pertaining to the assessment of a "risk charge."

3. Costs to Be Reported Under the Louisiana Well Cost Reporting Statute

The Louisiana Well Cost Reporting Statute, Louisiana Revised Statutes section 30:103.1, *et seq*., requires an operator to provide a "sworn, detailed, itemized" statement of "costs of drilling, completing, and equipping the unit well," upon receipt of a proper written demand by an unleased mineral owner.[91] The purpose of the statute is to provide to an unleased mineral owner a procedure whereby it might be able to be informed as to the status of recoupment of the UMO's share of costs as they are being retained by the operator.[92]

The Conversion Costs would be reflected on such a report as these expenses are assessable to an unleased mineral owner.[93]

4. Costs Deductible As a "Post-production Cost"

"Post-production costs" are costs incurred by the operator in connection with the processing, treatment, handling and marketing of production at or after the wellhead.[94] Louisiana courts have articulated that a lessor under a mineral lease is responsible for its proportionate share of "post-production costs," unless expressly agreed otherwise.[95] Not being directly related to the handling of production, conversion costs are not of

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91. *Id.* § 30:103.1A(1).

92. *See* Patrick S. Ottinger, *After the Lessee Walks Away: The Rights and Obligations of the Unleased Mineral Owner in a Producing Unit*, 55 ANN. INST. ON MIN. L. 59 (2008).

93. "The alternative is to treat the unleased owner as having an 8/8 working or cost-bearing interest. In Louisiana, the unleased owner is not made subject to the risk penalty and is thus given treatment as a free-riding (costs to be taken out of production) 8/8 working interest." Patrick H. Martin, *Unleased and Unjoined Owners—Forced Pooling and Cotenancy Issues*, 56 ROCKY MTN. MIN. L. INST. 18-1, § 18.03[4], at 18-9 (2010).

94. *See* Patrick S. Ottinger, *Calculating the Lessor's Royalty Payment: Much More Than Mere Math*, 6 LSU J. ENERGY L. & RESOURCES 1, 70 (2017).

95. *See, e.g.*, Culpepper v. EOG Res., Inc., 92 So. 3d 1141, 1144 (La. Ct. App. 2d Cir.), *writ denied*, 98 So. 3d 870 (La. 2012) ("Here, there was no provision in the Lease governing the payment of post-production processing expenses, *i.e.*, transportation costs; therefore, the Lessors must bear their proportionate share of those expenses.").

a type that would ever be chargeable to a lessor under a mineral lease as a "post-production cost."

Accordingly, the Conversion Costs would not be set forth on a report pertaining to the deduction of "post-production costs" from the lessor's royalty share of production.

5. Costs Assessable Under a Net Profits Interest

A "net profits interest" (NPI) is an interest in production that is subject to bearing some portion of costs incurred by the operator.[96] It is purely contractual such that its terms determine the propriety of assessing certain costs against the NPI.

The instrument creating a net profits interest typically provides that virtually *all* costs incurred by the operator are assessable against the NPI. Therefore, the Conversion Costs would be itemized and identified on a report generated to reflect expenses to which the NPI is subject.

6. Costs Assessable Under an Overriding Royalty Interest

In contrast to a net profits interest, and although it is purely a matter of contract,[97] an overriding royalty interest would typically be exempt from any costs associated with the well or its operation. This would include Conversion Costs so that a report of monies owed with respect to an overriding royalty interest would not reflect such costs.

7. Costs Includable in Calculation of Payout in a Non-Consent Relationship

Comparable to the calculations associated with a net profits interest, the entitlement of an unleased mineral owner to receive revenue is tethered, first and foremost, to the paramount right of the operator to recover all costs and expenses incurred in securing and producing the oil and gas.[98]

Hence, the Conversion Costs would be included in a "payout" statement as costs to be recovered by the lessee prior to the UMO being entitled to receive its share of unit production.

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96. LA. REV. STAT. § 31:171 (2019).

97. *See, e.g.*, J. Fleet Oil & Gas Corp. v. Chesapeake La., L.P., No. 15-2461, 2018 WL 1463529 (W.D. La. 2018). In the interest of full disclosure, this author represented the defendant-lessee in this case.

98. *See* Ottinger, *supra* note 92.

8. Costs Includable in Determination of Production in "Paying Quantities"

As demonstrated by the ruling in *Lege v. Lea Exploration Co.*,[99] Conversion Costs are not to be considered in evaluating the level of production under the "Habendum Clause" as such costs are capital, non-recurring, and extraordinary in nature.[100]

CONCLUSION

By its very nature, a lessee of a mineral lease who is responding to a challenge by its lessor that the lease is no longer producing in "paying quantities," must collate, organize, and present its record of expenses to only put forth those eligible or pertinent costs that constitute "lifting costs." To be excluded are expenses that are characterized as capital in nature, non-recurring, or extraordinary.

Although the moniker "lifting costs" is a convenient label that facilitates the clear understanding that the only relevant costs are those incurred in bringing to the surface the oil or gas, once those products are discovered, and hence, does not include the capital or "sunk" costs incurred in finding such minerals, one should not assume or conclude that costs incurred *after* the wellhead are without any relevance. Rather, the courts have indicated that "marketing costs" might also be pertinent to the inquiry,[101] and of course, these costs are principally incurred *after* the wellhead, or after the product has been "lifted" to the surface.[102] Seemingly, those non-capital or ordinary costs that are commonly characterized as "post-production costs" are relevant to the inquiry under

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99. 631 So. 2d 716, 719 (La. Ct. App. 3d Cir. 1994).

100. *See* Middleton v. EP Energy E & P Co., 188 So. 3d 263, 267 (La. Ct. App. 2d Cir.), *writ denied*, 192 So. 3d 774 (La. 2016).

101. *See, e.g.*, Skelly Oil Co. v. Archer, 356 S.W.2d 774, 780 (Tex. 1961) ("The words, 'paying quantities', as used in this charge and as applied to a gas lease, mean that the gas discovered must be sufficient to pay the lessee a profit, though small, over operating and marketing expenses, although it may never repay the cost of drilling the well."); *see also* Reese Enters., Inc. v. Lawson, 553 P.2d 885, 898 (Kan. 1976) ("Expenses which are taken into account in determining 'paying quantities' include current costs of operation in producing and marketing the oil or gas.").

102. However, no reported decision under Louisiana law has squarely held that these costs are pertinent to the inquiry.

the "Habendum Clause," even though, in a proper case, the lessor might be responsible for its proportionate share of such costs.[103]

Consequently, the major battle in a suit of this topic will involve arguments by the lessor that other costs should be considered, and a suite of experts would be involved to argue one side or the other.

As stated by one court, "[a]ll income associated with a well is not production income; all expenses associated with a well are not operating expenses . . . . Operating expenses are ordinary, recurring expenses; they do not include capital expenditures."[104] This accurate statement of the law is itself justification for revising an operator's books and records to ensure that the correct—and only the correct—expenses are relevantly considered in a production in "paying quantities" controversy.

The data to be considered by the court would essentially originate with the operator, from its financial "books," as the information filed by operators with the Louisiana Office of Conservation and published on its website (Strategic Online Natural Resource Information System, or SONRIS), does not include expense information.[105]

As in any civil trial, the introduction of evidence, including reports or statements of costs and expenses that are pertinent to a determination of production in "paying quantities," is subject to the offer of evidence by one party, and objections thereto, if any, by the adverse party. In *Menoah Petroleum, Inc. v. McKinney*,[106] it was stated that the "trial court utilized the reports filed by the defendant, not objected to by the plaintiff, to determine the profitability of the unit in 1986." Seemingly, the fact that the plaintiff did not object to the report allowed it to come into evidence, and thus constituted evidence that led to the court's determination that the mineral lease had ceased to produce in "paying quantities."

Rare is the operator who maintains on a regular basis a "book" or record of expense information that particularly or uniquely comports with the test for production in "paying quantities." Thus, by definition, the relevant "book" or record must be created out of the more universal information, necessitating determinations as to the proper characterization

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103. *See* Patrick S. Ottinger, *A Funny Thing Happened at the Wellhead: "Post-Production Costs" and Responsibility Therefor*, 8 LSU J. ENERGY L. & RESOURCES 1, 73 (2019).

104. Doré Energy Corp. v. Prospective Inv. & Trading Co., No. 2:05 cv 1657, 2010 WL 4068802, at *7 (W.D. La. Oct. 14, 2010).

105. *Strategic Online Natural Resources Information System*, LA. DEP'T OF NAT. RESOURCES, https://www.sonris.com [https://perma.cc/S4BS-XP6Q] (last visited Apr. 25, 2021).

106. 545 So. 2d 1216, 1220 (La. Ct. App. 2d Cir. 1989).

or categorization of the expense information, employing appropriate accounting principles and protocols.

Although, as stated above, the mere reference to "two sets of books" in financial quarters is considered pejorative, "there is no stigma attached to 'keeping two sets of books.'"[107]

This very process is one that generates and results in "two sets of books." An indispensable process, it is far from nefarious or sinister, and is both necessary and supportable. Certainly, any recasting of historical financial records necessitated in order to remove irrelevant capital costs, and to include only "lifting" costs, should not be characterized as an "accounting manipulation" or an "alter[ation] to make the wells appear more profitable," at least in the absence of evidence of actual fraud on the part of the operator.

If there is a "moral of the story," it is that the court should be cognizant of the fact that maintaining "two sets of books" is not nefarious or sinister, but is necessary and supportable, and no inference should be drawn as to an untoward motive.

107. *See supra* text accompanying note 69.