Louisiana Law Review

Volume 46 | Number 4
Student Symposium on Oil and Gas
March 1986

Costs Deductible by the Lessee in Accounting to Royalty Owners for Production of Oil or Gas

Frederick R. Parker Jr.

Repository Citation
Frederick R. Parker Jr., *Costs Deductible by the Lessee in Accounting to Royalty Owners for Production of Oil or Gas*, 46 La. L. Rev. (1986)
Available at: https://digitalcommons.law.lsu.edu/lalrev/vol46/iss4/7

This Article is brought to you for free and open access by the Law Reviews and Journals at LSU Law Digital Commons. It has been accepted for inclusion in Louisiana Law Review by an authorized editor of LSU Law Digital Commons. For more information, please contact kreed25@lsu.edu.

Costs Deductible by the Lessee in Accounting to Royalty Owners for Production of Oil or Gas

Introduction

Louisiana Mineral Code article 213 defines "royalty" as "any interest in production, or its value, from or attributable to land subject to a mineral lease, that is deliverable or payable to the lessor or others entitled to share therein."[1] Neither the terms of article 213 nor the accompanying comments shed any light on the question of which costs, if any, are deductible by the lessee in determining the royalty due to his lessor. However, the courts, in addressing the question, have applied the law pertaining to the correlative concept of mineral royalty to determine the proper calculation of royalties due under mineral leases.[2]

Article 80 defines a mineral royalty in these terms:

> A mineral royalty is the right to participate in production of minerals from land owned by another or land subject to a mineral servitude owned by another. Unless expressly qualified by the parties, a royalty is a right to share in gross production free of mining or drilling and production costs.[3]

The terms of this article indicate that in the absence of any express provision to the contrary in the lease agreement, the royalty owner is exempt from any liability for drilling and production costs.[4] The comments accompanying article 80 indicate that while the royalty is a right to share in production free of any production costs, the parties to the

---

Copyright 1986, by Louisiana Law Review.

1. La. R.S. 31:213 (1975) [hereinafter cited as La. Min. Code]. Unless indicated otherwise, all references to articles will be to the Louisiana Mineral Code.

2. Such treatment is in accordance with the terms of articles 17 and 21 of the Louisiana Civil Code. Article 17 states: "Laws *in pari materia*, or upon the same subject matter, must be construed with a reference to each other; what is clear in one statute may be called in aid to explain what is doubtful in another." Article 21 states: "In all civil matters, where there is no express law, the judge is bound to proceed and decide according to equity. To decide equitably, an appeal is to be made to natural law and reason, or received usages, where positive law is silent."

3. La. Min. Code art. 80 (1975).

4. Id. (and see accompanying comments).

lease are free to specify which of those costs, if any, are to be imposed on the royalty owner's share of production.[5] The comments also note that while article 80 does not define production costs, definitional problems may be resolved by "resort to industrial custom and jurisprudence in Louisiana and other jurisdictions."[6]

Article 122 specifies that a mineral lessee "is bound to perform the contract in good faith and to develop and operate the property leased as a reasonably prudent operator for the mutual benefit of himself and his lessor."[7] The mineral lessee's general obligation to act as a reasonably prudent operator includes, among other duties, the obligation to "produce and market minerals discovered and capable of production in paying quantities."[8]

The question of which costs are deductible from royalty often arises as a result of costs incurred by the lessee in the course of fulfilling his implied duty to market the product. This article will focus on the deductibility of costs where the lease agreement does not express any intent contrary to the general provisions of article 80, and it will review and analyze the classification scheme presently employed by Louisiana courts to determine which costs are deductible.

Common Variations of Royalty Clauses

The classification of costs by the courts and the effect of that classification on the amount of royalty to be paid by the lessee is a function of the royalty clause. Although there are currently a great variety of oil and gas lease forms in use, there are three basic types of royalty clauses: (1) the proceeds clause, (2) the market value clause, and (3) the market price clause.[9]

Royalties paid under a "proceeds", "net proceeds", or "gross proceeds" clause are based on the amount actually received by the lessee from the sale of the minerals.[10] While the term "proceeds" does not

---

5. Id.

6. Id.

7. La. Min. Code art. 122 (1975) (and see accompanying comments). La. Civ Code art. 2710. The requirement of article 122 that the lessee perform his obligation as "a reasonably prudent operator" reflects the same objective standard expressed in Civil Code article 2710 which requires that a lessee enjoy the thing leased as "a good administrator."

8. See La. Min. Code art. 122, comment (1975).

9. Fischl, Ascertaining the Value or Price of Gas for Purposes of the Royalty Clause, 21 Okla. L. Rev 22 (1968); Note, Oil and Gas-Obligations-The Meaning of "Market Value" in a Gas Lease Royalty Clause, 57 Tul. L. Rev. 1049 (1983) [hereinafter cited as *Note, Meaning of Market Value*]; Comment, Value of Lessor's Share of Production Where Gas Only is Produced, 25 Tex. L. Rev. 641 (1946-1949) [hereinafter cited as *Comment, Value of Lessor's Share*].

10. *Note, Meaning of Market Value*, supra note 9, at 1050.

indicate anything as to the deductibility of costs in calculating the amount of royalty due to the lessor, certain expenses have nevertheless traditionally been deducted from the gross proceeds of the sale.[11] This is true whether the royalty clause specified either "proceeds" or "net proceeds," as neither term reflects an intention to expand the lessee's implied duty to market the product.[12] However, where the term "gross proceeds" is used, one may infer an intent to expand this duty.[13] Otherwise, the "proceeds" and "net proceeds" upon which the royalty is based are generally determined by deducting certain costs of marketing the product from the amount actually received by the lessee from the sale of minerals.[14]

Problems of construction may arise where the royalty clause specifies "proceeds," but fails to state whether the proceeds are to be determined "at the well" or "at the place of sale." Absent any express provision to the contrary, it is submitted that the determination should be made "at the well," providing for the deduction of marketing costs from the proceeds to arrive at the amount upon which the royalty would be based.[15] To construe the clause otherwise would be to contradict the general current of authority defining "proceeds" and "net proceeds" as synonymous, since such a construction would have the effect of expanding the lessee's implied duty to market.

Clauses specifying the calculation of royalties based on "market price" and "market value" are generally viewed by the courts as synonymous.[16] They are sometimes distinguished, however, on the basis

---

11. *Comment, Value of Lessor's Share*, supra note 9, at 655. The soundness of the principle is most apparent where the sale occurred other than at the mouth of the well, because the lessee incurs additional expenses incidental to his implied duty to market the product, such as transportation costs. See also Fischl, supra note 9, at 24.

12. "It is difficult to state accurately what expenses are deductible when the term employed is either 'proceeds' alone or 'net proceeds'. It is submitted, however, that there should be no difference in the computation under either term." *Comment, Value of Lessor's Share*, supra note 9, at 655. See Phillips Petroleum Co. v. Johnson, 155 F.2d 185 (5th Cir. 1946), cert. denied, 329 U.S. 730, 67 S. Ct. 87 (1946).

13. "Thus, where the term 'gross proceeds' is employed, it is believed only the direct expenses of *handling* the gas necessary to put it into a salable condition should be deducted." *Comment, Value of Lessor's Share*, supra note 9 at 655.

14. Fischl, supra note 9, at 24.

15. 3 H. Williams, Oil and Gas Law § 645.1 (1985). See also Matzen v. Hugoton Prod. Co., 182 Kan. 456, 321 P.2d 576 (1958) (expenses related to gathering, processing and marketing the gas were deductible from gross proceeds in determining royalty where lessee was required to pay one-eighth of the proceeds from the sale of gas and where the gas was transported and sold off the premises); Martin v. Glass, 571 F. Supp. 1406 (N.D. Tex. 1983) aff'd 736 F.2d 1524 (5th Cir. 1984) (expenses of installing compressor to move the gas to a gathering line for marketing were deductible where lessee was required to pay one-eighth of the net proceeds at the well).

16. See generally *Note, Meaning of Market Value*, supra note 9, at 1050-51; *Comment, Value of Lessor's Share*, supra note 9, at 652-54, and cases cited therein.

that the "market price" is the actual price paid while the "market value" is the hypothetical price that a willing buyer would pay a willing seller for the product.[17] Such a distinction is of no consequence when considered in terms of the deductibility of costs, since marketing-related costs and severance taxes are deductible under both clauses.[18]

Expenses Borne By The Operator Alone

The Louisiana Mineral Code specifies that in the absence of an express contractual provision to the contrary the lessee-operator bears all drilling and production costs.[19] As noted above, what constitutes a production cost is to be determined by reference to the customs of the industry and the jurisprudence.[20]

It is well settled that expenses incurred in oil and gas exploration are costs of production,[21] as are the expenses incurred in bringing the minerals to the surface.[22] Also considered costs of production are those related to any activity customarily conducted by the producer at the wellhead. Such costs are not chargeable against the royalty owner absent some express provision in the lease agreement to the contrary. Among such costs usually absorbed by the lessee-operator are those related to:[23]

(1) Geological surveys,

(2) Drilling,

(3) Testing, completing, or reworking a well,[24]

---

17. See generally *Note, Meaning of Market Value*, supra note 9, at 1050-51; Fischl, supra note 9, at 29-32, and cases cited therein.

18. For market value clauses, see Piney Woods Country Life School v. Shell Oil Co., 726 F.2d 225 (5th Cir. 1984), cert. denied, 105 S. Ct. 1868 (1985); Freeland v. Sun Oil Co., 277 F.2d 154 (5th Cir. 1960), cert. denied, 364 U.S. 826 (1960); Sartor v. United Gas Public Serv. Co., 186 La. 555, 173 So. 103 (1937); Crichton v. Standard Oil Co. of La., 178 La. 57, 150 So. 668 (1933); State ex rel. Boykin v. Hope Producing Co., 167 So. 506 (La. App. 2d Cir. 1936); Altman & Lindberg, Oil and Gas: Non-operating Oil and Gas Interests' Liability for Post-Production Costs and Expenses, 25 Okla. L. Rev. 363 (1972); Rogers, Royalties on Processed Gas, 14 Inst. Min. L. 29 (1967). For market price clauses, see Arkansas Natural Gas Co. v. Sartor, 78 F.2d 924 (5th Cir. 1935), cert. denied, 296 U.S. 656, 56 S. Ct. 381 (1936); Helmer v. Union Producing Co., 40 F. Supp. 824 (W.D. La. 1941); Sartor v. United Carbon Co., 183 La. 287, 163 So. 103 (1935); Wall v. United Gas Public Serv. Co., 178 La. 908, 152 So. 561 (1934); Harrell, Recent Developments in the Nonregulatory Oil and Gas Law, 33 Inst. Oil & Gas L. & Tax'n 17 (1982).

19. See supra notes 1 & 2 and accompanying text.

20. See supra note 19 and accompanying text.

21. 3 H. Williams, supra note 15, at § 645.1.

22. Id.

23. Id. See also § 645.3.

24. Id. This includes both tangible and intangible costs, as well as the cost of installing the Christmas tree.

(4) Secondary recovery, and

(5) Separators at or near the well.

Expenses Borne Proportionately By The Operator And The Royalty Owner

It is generally accepted that the production phase of oil and gas operations terminates upon reduction of the minerals to possession at the well. While the peculiarities of individual lease provisions may provide otherwise, the general rule is that a royalty owner is liable for a proportionate share of the costs incurred subsequent to production.[25] Such "subsequent to production" costs generally include those related to taxes, transportation, and processing.[26]

Taxes

Other than the income tax, persons involved in the oil and gas industry encounter taxation in the form of the severance tax and the windfall profits tax. Lessee-operators are required by law to deduct severance taxes from amounts due to royalty owners before making such payments, whether the payment be in money or in kind.[27]

The burden of the severance tax is placed proportionately on the royalty owner and the lessee.[28] The Louisiana Supreme Court established this basic rule in *Wright v. Imperial Oil & Gas Products Co.*[29] The royalty clause of the lease in *Wright* indicated that the royalty on gas was to be paid at a fixed price in money. The court held that the fact

---

25. Id. at § 645.2. This is particularly true where the royalty is payable "at the well," although the courts have construed royalties to be payable "at the well" where the lease was silent as to the place of measurement. See supra notes 7-16 and accompanying text.

26. See generally LaGrone, Calculating the Landowner's Royalty, 28 Rocky Mtn. Min. L. Inst. 803 (1982); E. Kuntz, A Treatise on the Law of Oil and Gas § 42.2 (1967); 3 H. Williams, supra note 15 at § 645.2.

27. La. R.S. 47:636 (1970).

28. While the terms of La. R.S. 47:636 do not expressly state that the tax is to be borne proportionately by the royalty owner and his lessee, the courts have consistently held that such an allocation of the burden is correct. Furthermore, the terms of La. R.S. 47:636(B) (1970) provide the clear inference for such treatment:

> In the event that any severer of natural resources who has paid the severance taxes upon natural resources severed from the soil or water should receive any rebate or refund thereof or with respect thereto from either the purchaser of the natural resources or the collector, the severer shall distribute to the respective royalty owners and owners of the natural resources at the time of the severance their proportionate share of said rebates or refunds.

29. 177 La. 482, 148 So. 685 (1933). See also Cox v. Cardinal Drilling Co., 188 So. 2d 667 (La. App. 2d Cir. 1966).

that the royalty was payable in money rather than in kind did not impose upon the lessee the burden of the entire tax, but rather that the royalty owner was liable for his proportionate share.

In *Sartor v. Union Carbide Co.*,[30] the court considered the deductibility of severance taxes from a royalty interest of one-eighth of the value of gas calculated at the market price at the well. In holding that the lessee properly deducted the royalty owner's proportionate share of the severance taxes before paying the royalty, the court applied the rationale of *Wall v. United Gas Public Service Co.*, where the Louisiana Supreme Court stated:

> Previous to the moment the gas reached the surface of the ground, the parties owned nothing so far as the gas was concerned, except the right to explore for it and reduce it to possession and ownership. But when the gas reached the surface of the ground, the parties owned it in the proportion of one-eighth to the lessor and seven-eighths to the lessee, and, if it had been contemplated or provided in the lease contract that the gas should be divided in kind, it would hardly be disputed that the division should be made at the well.[31]

The proportional allocation of the liability for the severance tax on the owners of the oil and gas is responsive to the principal nature of the tax. The severance tax is levied, not on those severing the natural resources from the soil or water, but on the resources themselves. Hence, the liability for the tax is assessed against the owners of the severed resources in proportion to their ownership interests therein.[32] The courts have, however, at least implicitly, recognized the right of the parties to contractually place the burden of the tax on the lessee.[33]

---

30. 183 La. 287, 163 So. 103 (1935). See also Arkansas Natural Gas Co. v. Sartor, 78 F.2d 924 (5th Cir. 1935), cert. denied, 296 U.S. 656 (1936).

31. 178 La. at 913, 152 So. at 563.

32. 167 So. at 508.

33. Id. See generally LaGrone, supra note 26, at 805. See also Everett v. Phillips Petroleum Co., 218 La. 835, 51 So. 87 (1950). The lease in *Everett* provided for the royalty payment of a bonus to be calculated as follows:

> [O]ne-eighth (1/8) of the lessee's seven-eighths (7/8) working interest oil first produced and saved . . . if, as and when such oil shall be produced and saved, free and clear of all costs and development or operation, *until* there shall have been produced and saved to the credit of said fractional part of the oil the market value of Fifteen Thousand Dollars ($15,000.00) at the current market price at the time of *production* . . . .

218 La. at 856, 51 So. 2d at 95. The court interpreted the language of that bonus clause as specifying the payment in oil having a market value of $15,000.00 without any deduction for the severance tax, as "oil having a market value of $15,000.00 means oil that can be sold on the market for that price, obviously not oil upon which a severance tax is due." 218 La. at 858, 51 So. 2d at 95.

To be distinguished from the severance tax is the Crude Oil Windfall Profits Tax.[34] In *Tenneco West, Inc. v. Marathon Oil Co.*, the United States Court of Appeals for the Ninth Circuit held that a tax shifting clause requiring the lessee to pay any and all taxes "upon or referable to any operations or acts of the lessee" did not shift from the royalty owner to the lessee the entire incidence of the windfall profits tax.[35] In reversing the decision of the district court, which had held that the windfall profits tax was a severance tax, the court of appeals noted that the tax was to be imposed on excess revenue resulting from decontrol of crude oil prices and from increases in world oil prices.[36] Deciding that the tax is imposed on incremental revenue, the court held that although the tax is triggered by removal and sale of the oil, the tax was not "upon or referable to any operations or acts of the lessee," as phrased in the tax shifting clause of the lease.[37] In support of its position, the court further noted that no tax is due under the Act unless the price realized on removal exceeds the statutory base price.[38]

It is submitted that neither the holding in *Tenneco* nor the Crude Oil Windfall Profits Tax Act preclude the shifting of the tax. The holding in *Tenneco* was premised on a strict construction of the language contained in the royalty clause rather than on any general proscription of the right to shift the burden of that particular tax. The court's construction of the nature of the windfall profits tax and the application of that construction to the terms of the *Tenneco* tax shifting clause appears to be correct. The tax being imposed on incremental revenue seems clearly to be at least one step removed from any tax that would be imposed "upon or referable to any operations or acts of the lessee."[39] Furthermore, the Crude Oil Windfall Profits Tax Act contains no express prohibition preventing the shifting of the tax.[40] Therefore, it would seem that a contractual provision explicitly shifting the burden of the windfall profits tax would be effective. It is suggested that the holding in *Tenneco* permits such an inference.

---

34. 26 U.S.C. §§ 4986-4998 (1980 & Supp. 1985).

35. 756 F.2d 769 (9th Cir. 1985). The tax shifting clause required Marathon to pay taxes incidental to "the drilling or operation of any well or wells, the production, extraction, severance, or removal of any oil, . . . the processes, refining, storage or use thereof, [and] the sale . . . or the transportation thereof away from the demised premises." 756 F.2d at 770-71.

36. Id. at 773.

37. Id.

38. Id.

39. Id.

40. See 26 U.S.C. §§ 4986-4998 (1980 & Supp. 1985). See also LaGrone. supra note 26, at 805.

Transportation

In the absence of an express contractual provision to the contrary, royalty owners usually bear a proportionate share of transportation costs.[41] This is particularly true where the royalty clause specifies that the royalty be based on a value determined at the wellhead and where there is no market for the gas at that point.[42]

The Supreme Court of Louisiana considered the question in *Wall v. United Gas Public Service Co.*,[43] where the royalty clause required that the royalty for gas used or sold off the premises be based on one-eighth of the value of such gas calculated at the market price. The lessees transported the gas through private pipe lines a distance of approximately two miles where it was sold to a pipe line company at 5.8 cents per thousand cubic feet. The lessees based the royalty computation on a value of 4 cents per thousand cubic feet, which they contended was the market price at the well. The royalty owner demanded a settlement based on the 5.8 cents sale price. The contract was silent as to the place at which market price was to be determined. The court, in considering the issue, stated:

> We think it reasonable to assume that the parties intended that, if there was a market for gas in the field, the current market price there should be paid. There is where the gas was reduced to possession and there is where ownership of it sprang into existence . . . [W]hen the gas reached the surface of the ground, the parties owned it in the proportion of one-eighth to the lessor and seven-eighths to the lessee, and, if it had been contemplated or provided in the lease contract that the gas should be divided in kind, it would hardly be disputed that the division should be made at the well.[44]

Based on that analysis, the court went on to hold that as the market price was being determined at the well, in the absence of any express provision to the contrary, costs of transporting the product to market were to be borne by both the lessee and the royalty owner. In so holding, the court stated:

> To hold that the lessors in this case should receive in settlement one-eighth . . . of the gross price received by defendants for the gas, would, in effect, be to hold that it was the duty of the lessees to bear all the expense of carrying the gas to a market

41. 3 H. Williams, supra note 15, at § 645.2.
42. See LaGrone, supra note 26, at 819.
43. 178 La. 908, 152 So. 561.
44. Id. at 913, 152 So. at 563.

> beyond the gas field . . . [T]he lessee cannot be taxed with the whole cost of marketing the gas . . . .[45]

Processing and Treatment

Oil and gas usually contain impurities which must be removed to make the product marketable. The raw products also contain other compounds and substances which through various processing and treatment techniques create additional products. Both removal of impurities and further processing or refining increase the value of the product above that which it had in its natural state.[46] At issue is whether the costs incurred in processing the product are deductible.

The general rule in Louisiana was summarized in 1960 by the United States Court of Appeals for the Fifth Circuit in *Freeland v. Sun Oil Co.*[47] In *Freeland*, the lease specified that the royalty on "gas sold or

---

45. Id. at 917, 152 So. at 564. Although the transportation issue was resolved by evidence establishing that a market in the field actually existed and that the royalty paid was the same as the average price paid there, the principle that transportation costs are deductible was clearly established in the case. The reference to the existing market price in the field permits the inference that the general principle is qualified to the degree that transportation costs are deductible only to the extent that they do not reduce the royalty paid below the market price in the field, if one exists. This leads to the further inference that in the absence of a determinable market price in the field, the courts may exercise some discretion in establishing a check on the reasonableness of the deduction.

The United States Court of Appeals for the Fifth Circuit stated a succinct summation of the principle in *Freeland v. Sun Oil Co.*

> [I]n the analytical process of reconstructing a market value where none otherwise exists with sufficient definiteness, all increases in the ultimate sales value attributable to the expenses incurred in transporting and processing the commodity must be deducted. The royalty owner shares only in what is left over, whether stated in terms of cash or an end product. In this sense he bears his proportionate part of that cost, but not because the obligation (or expense) of production rests on him. Rather, it is because that is the way in which Louisiana law arrives at the value of the gas at the moment it seeks to escape from the wellhead.

Freeland, 277 F.2d at 159. See also Sartor v. United Carbon Co., 183 La. 287, 163 So. 103 (1935) (the court in dicta stated "The obvious reason why the market price at the well or field where the gas is obtained cannot be said to cover the market price in the parish where the gas is produced is because of the transportation charges which would necessarily augment the market price in the parish above the market price at the well or field." Id. at 289, 163 So. at 104; Sartor v. United Gas Public Service Co., 186 La. 555, 173 So. 103 (1937); Hemler v. Union Producing Co., 40 F. Supp. 824 (W.D. La. 1941), aff'd in part, and rev'd in part, 134 F.2d 436 (5th Cir. 1943); Piney Woods Country Life School v. Shell Oil Co., 726 F.2d 225 (5th Cir. 1984), cert. denied, 105 S. Ct. 1868 (1985); and Harrell, supra note 18, at 51.

46. See generally Rogers, supra note 18; LaGrone, supra note 26; *Freeland*, 277 F.2d at 154 (discussions of various processing and treatment methods).

47. *Freeland*, 277 F.2d at 159.

used off the premises or in the manufacture of gasoline or other products," would be based on the "market value at the well" of gas so sold or used, while the royalty on "gas sold at the wells" would be based on the amount actually received.[48] While the gas as produced had some *theoretical* value, in fact, due to its wet nature, it had little marketability and, therefore, had no *demonstrated* market value. The lessee entered into a contract with an independent gasoline processing plant to extract the recoverable liquids in order to maximize the value of the gas. The terms of the contract specified that 35.7 percent of the end product would be payable to the processing plant as the cost of extraction. The royalty owners sued the lessee, demanding that their royalty be based on 100 percent of the liquids extracted rather than the 64.3 percent retained by the lessee after processing. In holding that the costs of extraction were deductible, the court stated:

> [T]he value of the raw, wet gas in its relatively unmarketable state at the wellhead was not equivalent to the price which the end product of that industrial process would command. The wet gas was important. Indeed, it was the indispensable raw material. But the availability of the extracting process and its application enhanced the value of the gas. The enhancement is of the value of the gas at the wellhead . . . In determining the market value of such gas at the well where there is no established criteria of a market, the Louisiana approach . . . is to consider the end product of the extraction process as a factor. But it is a factor in reconstructing a market value at a place where there was no, or little, market and consequently an appropriate deduction must be made.[49]

The *Freeland* court went on to summarize the general principle previously established by the Louisiana Supreme Court:[50]

> [The principle] is not . . . limited to the extraction cost necessary to make an absolutely *worthless* thing (gas) into something of value. It stands for the proposition that in determining market value costs which are essential to make a commodity worth *anything* or worth *more* must be borne proportionately by those who benefit.[51]

---

48. Id. at 157.

49. Id.

50. See Tyson v. Surf Oil Co., 195 La. 248, 196 So. 336 (1940); Roy v. Arkansas-Louisiana Gas Co., 200 La. 233, 7 So. 2d 895 (1942).

51. *Freeland*, 277 F.2d at 159. For other relevant federal court decisions, see O'Neal v. Union Producing Co., 153 F.2d 157 (5th Cir. 1946), aff'g 57 F. Supp. 440 (W.D. La. 1944), cert. denied, 329 U.S. 715, 67 S. Ct. 46 (1946); Shamrock Oil & Gas Corp. v.

Although the authority of *Freeland* as an abstract proposition of law is subject to qualification, the case having been decided by a federal court, the rule stated therein nevertheless presents a concise summary of Louisiana law on the issue of the deductibility of processing costs. As observed by one author, the federal courts have consistently restricted the payment of royalties on plant products extracted from gas to cases where the terms of the lease expressly provide for such treatment.[52] The Supreme Court of Louisiana has, on the other hand, consistently recognized the right of royalty owners to receive royalties based on the value of natural gasoline extracted from the wellhead product, although one author has opined that the supreme court has not yet directly addressed the issue in the context of a factual situation where a market price for the gas at the well has been established.[53] Even though some uncertainty may remain as to the revenue side of the issue, it is submitted that the principle so clearly enunciated in *Freeland* represents a fair assessment of Louisiana law on the deductibility of processing costs from royalties due on products thus obtained.

Although neither the relevant cases in which the issue has been considered nor the general rule established therein present a detailed analysis of the specific costs that may be included, logic dictates that the allowable deduction is of necessity a function of both direct and indirect costs. At issue in determining the reasonableness of the deduction should be the question of whether proper cost accounting techniques have been followed.

Coffee, 140 F.2d 409 (5th Cir. 1944), cert. denied, 323 U.S. 737, 64 S. Ct. 42 (1944); Piney Woods Country Life School v. Shell Oil Co., 726 F.2d 225 (5th Cir. 1984), cert. denied, 105 S. Ct. 1868 (1985). For related decisions by Louisiana courts, see Wemple v. Producers' Oil Co., 145 La. 1031, 83 So. 232 (1919); Coyle v. Louisiana Gas & Fuel Co., 175 La. 990, 144 So. 737 (1932); Crichton v. Standard Oil Co. of La., 178 La. 57, 150 So. 668 (1933); Wall v. United Gas Pub. Serv. Co., 178 La. 908, 152 So. 561 (1934); Gibbs v. Southern Carbon Co., 171 So. 587 (La. App. 2d Cir. 1937); Tyson v. Surf Oil Co., 195 La. 248, 196 So. 336 (1940). See also Rogers, supra note 18 for an analysis of these cases; LaGrone, supra note 26 at 821.

52. See Rogers, supra note 18, at 40.

53. Id. However, one may argue that Rogers' analysis is inconsistent with the decision by that court in *Wall*. The Supreme Court of Louisiana there stated:

> [T]he lessee cannot be taxed with the whole cost of marketing the gas and extracting therefrom the gasoline. That, in sum, was the ruling of the trial judge in the present case . . . His ruling would unquestionably be correct if as a matter of fact the gas had no "market value" in the field. *But we find as a fact that it did.*

178 La. at 917-18, 152 So. at 564 (emphasis added). The royalty in *Wall* being based on the market price, that case cannot be distinguished on the grounds that the decision spoke of market value. These terms are used interchangeably. See supra note 18 and accompanying text.

Expenses Subject To Dispute

Compression

Costs of compression may be considered a specific form of transportation costs, or at least their theoretical equivalent. The need for the compression of gas arises as the pressure in a natural gas reservoir declines due to the depletion of the reservoir. Compression is necessary to force the gas into the main transmission pipe line once the reservoir pressure and the pipe line pressure reach the point of equilibrium. This requires the construction of compressors, at considerable cost, to boost the pressure of the gas so that it will enter the pipe line.[54]

In light of Louisiana decisions which state that, in the absence of contractual provisions to the contrary, the royalty is to be based on a value to be determined at the wellhead, the costs of compression should be deductible.[55] The logic of such treatment is evident when the production function is generally considered to end at the wellhead—the point where the gas is reduced to possession and where ownership is determined.[56] Nevertheless, there exists a divergence of opinion on the subject among the various states.[57]

In *Martin v. Glass*,[58] the United States District Court for the Northern District of Texas held that compression charges were proportionately chargeable against the royalty where the provisions of the lease called for a royalty on gas of "one-eighth of the net proceeds at the well."[59] The lessee in *Martin* installed a compressor to boost the pressure of the gas because there was not enough pressure at the wellhead for the gas to flow into the gathering line, and the lessee deducted a pro-rata share of that cost before paying royalties. In holding that such costs were properly deducted, the court first found that the royalty was to

54. See Altman & Lindberg, supra note 18, at 364; LaGrone, supra note 26, at 809.

55. See discussion regarding the interpretation of royalty clauses, supra notes 9-18 and authorities cited therein.

56. See *Wall*, 178 La. 908, 152 So. 561 (1934); Altman & Lindberg, supra note 18, at 367. See also Siefkin, Rights of Lessor and Lessee with Respect to Sale of Gas and as to Gas Royalty Provisions, 4 Inst. Oil & Gas L. & Tax'n 181, 201 (1953) (cited by Altman & Lindberg, supra note 18, at 369) ("To my mind it is at least equally persuasive to insist that the duty to market is confined to the product *in the state in which it is produced at the well*, and does *not* include any duty, at the lessee's sole expense, to increase its value by processing, any more than it includes a duty to transport it free of charge to distant markets.") (emphasis original). It is submitted that the cost of compressing the gas is a marketing cost and that there is no logical basis for distinguishing that cost or its treatment from any other marketing cost.

57. See Altman & Lindberg, supra note 18, at 366; LaGrone, supra note 26, at 809, and cases cited therein.

58. 571 F. Supp. 1406 (N.D. Tex. 1983), aff'd, 736 F.2d 1524 (5th Cir. 1984).

59. Id. at 1410.

be based on the value of the gas at the wellhead,[60] and then considered the nature of compression costs. Since, under Texas law, gas is produced when it is severed from the land at the wellhead, the court decided that production had been obtained from the wells, as there was sufficient pressure to bring the gas to that point.[61] The court then noted that compression is an element of the marketing function, as it is a "separate and independent step, once or more removed from production."[62] Therefore, the compression costs were held to be a post-production expense, and as such were borne proportionately by the royalty owner and his lessee.[63] In so deciding, the court borrowed heavily from the decision of the fifth circuit in *Freeland*,[64] noting that "while *Freeland* involved the application of Louisiana law, it appears that Texas and Louisiana law are the same: both jurisdictions allow the deduction of post-production cost when royalty is determined 'at the mouth of the well.'"[65] Furthermore, the *Martin* court referred to Louisiana law.[66]

It is suggested that the decision in *Martin* is an accurate reflection of Louisiana law and that the outcome would have been identical had the issue arisen in a Louisiana court. One must bear in mind, however, that while that general rule is relevant under the majority of leases in force, the royalty due is always a function of the terms of each individual lease. However, absent any express contractual provision to the contrary, royalties based on market price, market value, or proceeds should bear a proportionate share of compression costs.

---

60. Id. at 1411-12. The *Martin* court interpreted the royalty clause as follows:

> [R]oyalty is based on the value of all gas produced at the mouth of the well. Costs incurred prior to production are to be borne by the operator, while costs incurred subsequent to production (those necessary to render the gas marketable) are to be borne on a pro rata basis between operating and nonoperating interests.

61. Id. at 1415.

62. Id. at 1416. As authority for that statement, the court referred to 43 Tex. Jur. 2d Oil & Gas § 398, at 47 from which they quoted:

> The lessee's obligation to market is to market *at the wells*, and thus in computing the market value of the gas at the well for royalty purposes *the lessee is entitled to reimbursement for the lessor's proportionate part of the reasonable cost of* transporting the gas to the market, dehydrating, *compressing*, or otherwise making the gas suitable for marketing, including extraction costs resulting from processing.

571 F. Supp. at 1416 n.2 (emphasis added by the court).

63. Id.

64. Id. at 1414; 277 F.2d 154, 159 (5th Cir. 1960).

65. 571 F. Supp. at 1414.

66. The *Martin* court referred to Sartor v. Arkansas Natural Gas Corp., 321 U.S. 620, 64 S. Ct. 724 rehearing denied, 322 U.S. 767 (1944); Wall v. United Gas Public Service Co., 178 La. 908, 152 So. 561 (1934); and Sartor v. United Gas Public Service Co., 186 La. 555, 173 So. 103 (1937). These cases were cited for the proposition that the lessor must bear a proportionate share of post-production costs.

Dehydration

The wellhead product of oil and gas usually contains some water which must be removed to make the product marketable. The quantity of water contained in the product has a direct effect on the difficulty of removal and the attendant costs.[67]

The water will generally separate from the wellhead product of oil through a settling process. However, the oil produced from some reservoirs contains water in an emulsified condition. Such oil must be subjected to chemical or heat treatment in order to remove the water. Following removal, the water must be disposed of in some fashion acceptable from an environmental perspective. This usually entails transporting the water by either truck or pipe line to salt water disposal wells where it is reinjected into underground reservoirs.[68]

The water contained in the wellhead product of natural gas must also be removed, although the quantity of water involved is generally much less than that contained in oil. Most pipe line companies will not purchase gas that contains more than seven pounds of water per million cubic feet of natural gas. Mechanical separators, glycol units, and other devices are used to separate the water from the natural gas.[69]

There appears to be no logical distinction between the costs of dehydration and compression, processing, or transportation that would call for any difference in the treatment of those costs in terms of who should bear them. Such reasoning seems particularly appropriate when viewed in terms of the holding in *Wall* that production terminates at the wellhead. Altman and Lindberg reasoned thus:

> If anything, it appears to be more logical to require the lessee to bear the entire cost of transporting the product to market than to cast the entire cost of compression, dehydration or processing upon the lessee. Transportation of production to a distant market at least contemplates movement of the product in its original state or condition as produced from the well without enhancing its intrinsic value. On the other hand, the product as produced at the wellhead in its natural state is transformed into a more valuable product(s) when it is compressed, dehydrated or processed. . . . The great weight of authority requires the sharing of transportation costs which are, we submit, marketing costs as are compression, dehydration and processing costs. A priori, all are post-production costs, that is, costs incurred after the production function has been consum-

67. LaGrone, supra note 26, at 806.
68. Id.
69. Id.

mated. It follows, therefore, they should all be treated similarly by apportionment of the costs thereof.[70]

The fifth circuit considered the issue of the deductibility of dehydration costs in the Texas case of *Holbein v. Austral Oil Co.*[71] The lease in *Holbein* called for royalties of one-eighth of the amount realized from the sale of the gas. The court held that the dehydration costs were costs incurred subsequent to production and should therefore be allocated proportionately among the lessee and his royalty owners.[72]

Although no Louisiana cases on the issue have been located, it is submitted that in light of the firmly established Louisiana rule that production terminates at the wellhead, a fact pattern identical to that in *Holbein* would be decided the same way by a court in Louisiana. While, as noted above, the terms of each individual lease are determinative of the outcome, absent any express agreement to the contrary, royalties based on market value, market price, or proceeds should be subject to a proportionate share of dehydration costs.

Problems Of Construction

Aside from the problem of ascertaining whether a royalty provision based on "proceeds" means "gross" or "net" proceeds, as discussed earlier, a problem of construction exists with regard to royalty interests payable at a point other than "at the well." While lease provisions specifying that royalty be based on either "proceeds," "market value," or "market price," without qualification as to where the measurement is to be determined, are generally treated as measurable "at the well,"[73] some leases expressly stipulate that the royalty be payable "in the pipe line" or at "other delivery points."[74]

---

70. Altman & Lindberg, supra note 18, at 378-79.

71. 609 F.2d 206 (5th Cir. 1980).

72. California has likewise held that costs of dehydration are properly deductible where the royalty provisions of the lease specify that the royalty is to be determined "at the well" or based on the "market price." See Alamitos Land Co. v. Shell Oil Co., 3 Cal. 2d 396, 44 P.2d 573 (1935); and Bedder Petroleum Corp. v. Lambert Lands Co., 50 Cal. App. 2d 102, 122 P.2d 600 (4th Dist. 1942). However, there exists a split of authority among other jurisdictions which appears to be based on the terms of the specific royalty provisions in question rather than upon any theoretical basis for treatment of dehydration costs as part of the production function. The lease in Clark v. Slick Oil Co., 88 Okla. 55, 211 P. 496, 497 (1922) specified that the oil was to be delivered "free of cost, in the pipe line," and the lessee there was charged with the entire burden of dehydration costs. So too was the lessee in the Texas case of Reynolds v. McMan Oil & Gas Co., 11 S.W.2d 778, 781 (Tex. Comm'n App. 1928), where the royalty clause called for a royalty of one-eighth of oil "produced and saved," and for the oil to be delivered "free of cost in the tanks or pipe lines."

73. See supra notes 7-16 and accompanying text.

74. See 3 H. Williams, supra note 15, §§ 646, 646.2.

The weight of authority indicates that royalty owners under leases providing for royalties payable "free of cost in the pipe line" are subject to a proportionate share of the expenses of transporting, compressing, dehydrating, and processing the wellhead product to make it deliverable to the pipe line. This treatment is based on the inference that the parties under such a lease assumed that a pipe line connection would be available at the well. The lessee's duty to market the product is not generally seen to encompass the burden of bearing the entire expense of preparing the product for market.[75]

However, a different result has been achieved where the lease calls for "delivery free of cost at the pipe line or other delivery point."[76] Such a lease provision has been construed as imposing upon the lessee the entire burden of transporting the product to market.[77]

Conclusion

The royalty owner's share of production is always a function of the royalty provisions contained in the oil or gas lease. While in theory the royalty due is determined by reference to the intent of the parties as expressed in the lease contract, the terms of that document often do not clearly define which costs are to be borne by the lessee alone and which are to be shared by the lessee and the royalty owner. As a practical matter, the issue has been resolved by the courts through an analysis of the lease provisions and the definition of royalty in the Louisiana Mineral Code. Based on that definition, and absent any express provisions in the lease to the contrary, the courts have construed royalties to be measured and payable "at the well." As a consequence of that determination, all costs of production are borne by the lessee alone, while costs incurred subsequent to production are borne proportionately by the lessee and the royalty owner. However, where the terms of individual leases expressly dictate how specified costs will be allocated, those lease provisions necessarily control.

The costs of severance taxes, transportation, processing, and treatment are considered to be post-production costs and are, therefore, borne proportionately by the lessee and the royalty owner. While some question exists as to the proper treatment of the costs of compression

---

75. Id. at §§ 646.2, 612.1. See Kretni Dev. Co. v. Consolidated Oil Corp., 74 F.2d 497 (10th Cir. 1934), cert. denied, 295 U.S. 750 (1935); Lafitte Co. v. United Fuel Gas Co., 177 F. Supp. 52 (E.D. Ky. 1959), aff'd, 284 F.2d 845 (6th Cir. 1960); Molter v. Lewis, 156 Kan. 544, 134 P.2d 404 (1943); Reed v. Hackworth, 287 S.W.2d 912 (Ky. Ct. App. 1956); Cameron v. Stephenson, 379 F.2d 953 (10th Cir. 1967). But see Hamilton v. Empire Gas & Fuel Co., 117 Kan. 25, 230 P. 91 (1924); Clark v. Slick Oil Co., 88 Okla. 55, 211 P. 496 (1922).

76. 3 H. Williams, supra note 15, §§ 646.2, 612.2.

77. Id.

and dehydration, it is submitted that there can be no logical basis for distinguishing these costs from any other cost incurred subsequent to production. This seems particularly self-evident in light of the Louisiana concept that production ends at the well. The allocation of the burden of those costs remains subject to dispute, however.

While the deductibility of any cost may be determined with reference to its nature, the question remains as to the *reasonableness* of the *particular item* deducted. It is submitted that the deductibility question should focus primarily on the propriety of the deduction in light of acceptable cost accounting standards. Once the theoretical construct has been established that costs in certain categories are deductible, the principle follows that all relevant costs should be included. Among such relevant costs are those of depreciation, overhead, and interest.

In addition to the character or nature of the costs deducted is the question of the reasonableness of the *amount* deducted. The relevance of this question can be seen in terms of the lessee's duty to act as a reasonably prudent operator to the benefit of the royalty owner and himself. When considering the reasonableness of the *amount* deducted, it is submitted that one should first consider the reasonableness of the cost incurred, and then assess the reasonableness of the amount allocated to the lessor in terms of acceptable cost accounting standards.

Frederick R. Parker, Jr.