Turning off the *Fawcett:* The Next Round of *Fawcett v. Oil Producers of Kansas, Inc.*

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Background Law and *Fawcett I*

Calculating Gas Royalties

- *Fawcett* raises the old question of what expenses associated with post-production processing, treatment, transportation, etc. of natural gas may be shared with/deducted from royalty interests.
- Most leases provide that royalty will be calculated on the basis of either the proceeds received from the sale of gas at the wellhead or, if the sale happens downstream, on the basis of what the market value of the gas would have been at the wellhead.
- Kansas follows the **marketable product rule**, which holds that a lessee has an implied duty to incur all the costs needed to place that gas into a marketable form.
- *Sternberg* (1995) held that costs of transporting marketable gas are shareable/deductible from royalty interests.

Fawcett I

The first time this case went to the Kansas Supreme Court it asked the question of how must a lessee calculate royalty payments when it sells raw gas at the wellhead to a midstream company under a contract that pays based on a net-back formula.

- Should the royalty be based on the proceeds of the sale, even though that amount incorporates deductions from the ultimate price received upon resale of the gas in the interstate market?
- Should it instead be calculated on the basis of the interstate market price without regard to the deductions included in the net-back pricing formula?

Fawcett I

- The court held that the proper basis for calculating the royalty is the proceeds actually received under the net-back pricing formula.
- It reasoned that the raw gas sold at the wellhead was in a marketable condition (as required under the marketable product rule), since it was in fact marketed to a midstream buyer under the contract.
- Proviso: to satisfy the marketable product rule, the wellhead gas purchase contract must be made **in good faith**.
- Litigation has ensued over the meaning of “good faith,” especially in related-company transactions.

Fawcett II

- The case is back before the Kansas Supreme Court, where the plaintiffs are attempting to argue that the sale of gas at the wellhead under a net-back pricing formula can never be a good faith sale because it is merely a sham designed to avoid the marketable product rule.
- Court of Appeals held that the plaintiffs could not make this argument because it was already rejected by the holding in *Fawcett I*, which necessarily implied that a good faith sale of raw gas at the wellhead is possible and happened in this case.

The Briefing in *Fawcett II*

EKOGA: Freedom of Contract

- Royalty litigation is a game for royalty owners who aim at a royalty share as far downstream as possible because processing, treatment and transportation have increased the value of the gas as it moves downstream.
- The Court only needs only to read the lease which provides that Royalty is based on the value “at the Well”
- Kansas Courts have already found that the royalty obligation is based on the value at the well
- Marketable Product rule was rejected by the Supreme Court
- If royalty is based on the value at distant markets then Lessees are paying royalty on the expense to enhance the value of the gas
- The Court should uphold the parties Freedom of Contract – “at the well” was chosen by the parties
- This provision is simple and should be interpreted as written
- Transportation, Treatment and Processing are separate businesses that Lessors should not be allowed to participate in cost free
- The Court should fix the royalty jurisprudence

Royalty Owners Arguments

- The point of sale or transfer of title is a question of fact
- Producers should not be able to merely contract to sell “at the well”
- Where the intended market is remains a question of fact
- Only irrigation gas is truly sold at the well
- The valuation point is where the “price” is actually achieved
- At the well is merely a measurement point not a valuation point – the actual sale point is at the transmission line
- The actual sale point is where the gas is in a marketable condition
- A “paper sale” based on transfer of title has never been the test – it must be in a condition acceptable to a purchaser in a good faith transaction
- The waste argument is a red herring – royalty owners will make less money if the deductions are allowed
- Royalty payments are excluded from paying quantities analysis so therefore the royalty burden is irrelevant
- The class contends that the good faith market sale always occurs at the interstate transmission line

National Stripper Well Association

Waste not, Want not

- The majority of wells in Kansas are stripper wells -97.8% of all wells in Kansas producing 86% of Kansas gas
- The class argument ignores reality – midstream marketers buy raw gas and re-sell on the spot market after they have enhanced the value through treatment, processing and transportation
- Gas prices change by the minute – thus the mid-stream purchasers set the price by means of a formula starting with the index price at the spot market and deducting the mid-stream marketer's costs
- Index prices are not actual sales – they are merely measures of actual sales
- Actual sales are made by commodity traders like Eddie Murphy in Trading Places
- Net back contracts shift most of the cost of treatment, processing and transportation to the producer
- Stripper well operators have no leverage and are presented with contracts of adhesion – sign or don't sell gas at all
- Economics dictate that under the class's theory a producer would have to produce 40% more gas to make any profit at all
- 57% of the state's wells produce less that 17mcf/day; only 27.7 produce more than 29mcf/day
- The class's theory will make approximately 4,300 wells non-economic
- Uneconomic wells will not be produced by operators and thus will be plugged causing waste
- The class argues that the Court should ignore the language of the leases – which leaves Courts to determine the point of sale rather than the parties contract

Questions?