MILLER STRATVERT

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January 8, 2008

RECEIVED
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HAND-DELIVERED

Mr. David Brooks
New Mexico Oil Conservation Division
1220 South St. Francis
Santa Fe, New Mexico 87504

Re: NMOCD Case No. 13957; In the Matter of the Application of Energen Resources Corporation to Amend the Cost Recovery Provisions of Compulsory Pooling Order No. R-1960, Rio Arriba County, New Mexico

Dear Mr. Brooks:

At the November 29, 2007 hearing in the above matter, we indicated that we would be providing you with copies of the briefing provided to the Rio Arriba District Court in connection with Energen's Motion To Dismiss.

Accordingly, enclosed are copies of (1) Defendant's Motion To Dismiss, Or In The Alternative, To Stay These Proceedings Due To The Primary Jurisdiction Of An Administrative Agency, (2) Memorandum In Support, (3) Memorandum In Support Of Plaintiff's Reply To Defendant's Motion To Dismiss, (4) Supplement To Plaintiff's Memorandum In Support, and (5) Defendant's Reply Pursuant To Its Motion To Dismiss.

Also enclosed is a copy of Professor Martin's 1990 Rocky Mountain Mineral Law Foundation paper that is referenced in our Post-Hearing Memorandum.

Very truly yours,

Miller Stratvert PA

J. Scott Hall

JSH/kfh
Enclosures
cc: James Bruce, Esq. (w/encl)
Candice Lee, Esq. (w/encl)

S:\Clients\6621\38877-SommerEstate^MartinezNo.1\Correspondence\Brooks 1-9-08.doc

6621/38877

FILED IN MY
First Judicial District Court

AUG 31 2007

Santa Fe, Rio Arriba &
Los Alamos Counties
PO Box 2268
Santa Fe, NM 87504-2268

STATE OF NEW MEXICO
COUNTY OF RIO ARRIBA
FIRST JUDICIAL DISTRICT

THE ESTATE OF JOSEPH A. SOMMER, Deceased, THE JOSEPH A. SOMMER REVOCABLE TRUST, and JAS OIL & GAS CO., LLC a New Mexico limited liability company,

Plaintiffs,

v.

No. D-117-CV-07-128

ENERGEN RESOURCES CORPORATION, an Alabama corporation,

Defendant.

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DEFENDANT'S REPLY PURSUANT TO ITS MOTION TO DISMISS, OR IN THE ALTERNATIVE, TO STAY THESE PROCEEDINGS DUE TO THE PRIMARY JURISDICTION OF AN ADMINISTRATIVE AGENCY

Defendant, Energen Resources Corporation, ("Energen"), submits this Reply to the August 13, 2007 "Memorandum In Support of Plaintiff's Reply To Defendant's Motion To Dismiss, Or In the Alternative, To Stay These Proceedings Due To The Primary Jurisdiction Of An Administrative Agency". Energen seeks the dismissal or stay of the District Court proceeding because Plaintiffs challenge well operations and dispute the recovery of costs arising under Order No. R-1960, the administrative compulsory pooling order previously issued by the Oil Conservation Commission. Disputes over such matters are reserved to the Oil Conservation Division by statute, regulation and the terms of the referenced order. These matters are the subject of an administrative proceeding presently pending before the Oil Conservation Division, ("NMOCD" or "Division"), that pre-dates the filing of Plaintiffs' Complaint.

Plaintiffs resist deference to the administrative agency's processes, but fail to adequately explain why principals of primary jurisdiction do not apply here.

Their arguments notwithstanding, it remains the case that Plaintiffs dispute the operating expenses and supervision charges for the well. They assert the occurrence of "unapproved billing of overhead costs" (Plaintiffs' Memorandum, pg. 4) and challenge the operator's authority under the pooling order obtain reimbursement of supervision charges, which they characterize as "management fees". (*Id.*, at pg.5.) These are matters falling squarely within the agency's statutory regulatory authority under the New Mexico Oil and Gas Act:

> *Such pooling order of the division shall make definite provision as to any owner, or owners who elects not to pay his proportionate share in advance for the prorata reimbursement solely out of production to the parties advancing the costs of the development and operation, which shall be limited to the actual expenditures required for such purpose not in excess of what are reasonable, but which shall include a reasonable charge for supervision...* NMSA 1978 Section 70-2-17(C).

Where disputes over such charges arise, that same statute goes on to establish the process for their resolution :

> *In the event of any dispute relative to such costs, the division shall determine the proper costs after due notice to the interested parties and a hearing thereon.* (*Id.*, emphasis added.)

Plaintiffs have also failed to make arrangements for the sale of their gas and have refused to allow Energen to market gas on their behalf. Consequently, Energen has been prevented from recovering reimbursement of Plaintiffs' proportionate share of operating costs and supervision charges which the compulsory pooling order authorizes. The operation of the order is thwarted as a consequence. At the same time, Plaintiffs challenge Energen's authority to sell gas for its own account or for any other interest

owner, threatening that such sales constitute conversion, thereby placing Defendant in an impossible position. (Excerpts of Energen's September 25, 2002 offer to sell Plaintiffs' gas and Plaintiffs' October 15, 2002 response are attached as Exhibits A and B.) The effect of Plaintiffs reasoning, were it put into practice, would place all other interest owners at the mercy of the non-selling party and would prevent any sales from the well. Plaintiffs' position, then, directly implicates the correlative rights[1] of the operator and other interest owners. Correspondingly, under 19.15.6.414 NMAC, the Division has established a procedure in aid of its statutory mandate to protect correlative rights in such a situation:

19.15.6.414 Gas Sales By Less Than One Hundred Percent Of The Owners In A Well *When there are separate owners in a well and where any such owner's gas is not being sold with current production from such well, such owner may, if necessary to protect his correlative rights, petition the Division for a hearing seeking appropriate relief.*

These are among the regulatory remedies invoked by Energen in its administrative Application to the division which requests (1) the amendment of the agency's earlier order, Order No. R-1960, to include new provisions allowing for the pro-rata reimbursement of the operator's costs of operations and supervision charges which may be adjusted annually, (2) further authorizing Applicant to sell a portion or all of the production attributable to the pooled working interest of the non-selling mineral interest owner to enable the reimbursement of those costs. Further, invocation of these administrative remedies is consistent with the agency's express reservation of jurisdiction that is set forth in the administrative order.

[1] NMSA 1978 §70-2-33 H: "[C]orrelative rights means the opportunity afforded, so far as it is practicable to do so, to the owner of each property in a pool to produce without waste his just and equitable share of the oil or gas or both in the pool, being an amount, so far as can be practicably determined and so far as can be practicably obtained without waste, substantially in the proportion that the quantity of recoverable oil or gas or both under the property bears to the

A number of erroneous assertions in Plaintiffs' Memorandum require correction.

At page 7 of their Memorandum, Plaintiffs mischaracterize Energen's Application as seeking an administrative determination of ownership of the gas, claiming this issue is reserved to the Court under their lawsuit. In fact, Plaintiffs' ownership is not disputed,[2] and it is apparent from the face of the Amended Application filed with the Division that no such request is included. (See Exhibit C to *Memorandum In Support Of Defendant's Motion To Dismiss, Or In The Alternative, To Stay These Proceedings Due To The Primary Jurisdiction Of An Administrative Agency.*) Neither can Plaintiffs' Complaint be reasonably understood to include a prayer requesting a determination of ownership.

At page 6 of their Memorandum, Plaintiffs represent that the Division "denied" Energen's Application, deferring jurisdiction to the courts. This is incorrect. Presently, Energen's Amended Application is scheduled for hearing on the merits by one of the Division's examiners on September 20, 2007. At a pre-hearing conference held before the Division's legal counsel on August 29, 2007, it was indicated that Plaintiffs would file with the Division their motion to stay the administrative proceeding pending the District Court's disposition of this motion. However, the timing and outcome of the Division's ruling on the anticipated motion cannot be predicted.

Plaintiffs also contend in their Memorandum, at page 6, that Energen's application does not pre-date the filing of their Complaint, suggesting that the administrative proceeding was not previously initiated. It is apparent that Plaintiffs have confused Energen's April 30, 2007 Amended Application with the original Application

---

total recoverable oil or gas or both in the pool and, for such purpose, to use his just and equitable share of the reservoir energy;". The Division is charged with protecting correlative rights pursuant to NMSA §70-2-11 A.

[2] At paragraph 1 of Defendant's Answer to Complaint, it is explained only that the quantum of interest is not correctly expressed in Exhibit A attached to Plaintiffs' Complaint. Plaintiffs' ownership of an 8.3333% interest in the lands dedicated to the well is not disputed.

filed with the Division on March 9, 2007. A conformed copy of the cover page of Energen's original Application is attached as Exhibit C.

Finally, Defendant is obliged to address the contention set forth at page 2 of Plaintiffs' Memorandum that "...Energen has not paid Plaintiffs any royalties...". Although this matter is not relevant to the Motion to Dismiss, attached hereto are sample copies of example checks to Joseph A. Sommer and JAS Oil and Gas Company LLC, along with Owner Detail Sales information evidencing ongoing payment of royalties to Plaintiffs (Exhibit D).

Respectfully submitted,

MILLER STRATVERT P.A.

By: _____

J. Scott Hall
Scott P. Hatcher
Post Office Box 1986
Santa Fe, New Mexico 87504-1986
(505) 989-9614

CERTIFICATE OF SERVICE

I HEREBY CERTIFY that on the 31 day of August, 2007, the foregoing was mailed by U. S. mail, postage prepaid to the following counsel of record:

Kurt A. Sommer, Esq.
Meredith Pelton Clancy, Esq.
Sommer, Udall, Hardwick, Ahern & Hyatt, LLP
Post Office Box 1984
Santa Fe, New Mexico 87504

James Bruce, Esq.
Post Office Box 1056
Santa Fe, New Mexico 87504

J. Scott Hall

ENERGEN
RESOURCES

Paul Rote
General Manager – Land

September 25, 2002

Sommer, Udall, Hardwick, Ahern & Hyatt, LLP
P.O. Box 1984
Santa Fe, NM 87504-1984

Attn: Mr. Joseph A. Sommer

Re: Martinez Well #1

Dear Mr. Sommer:

I am in receipt of your correspondences to Mr. Kirk Flowers dated August 16, 2002 and September 3, 2002. Your concerns expressed in these letters would lead me to believe that your ownership in this well has caused you an inordinate amount of time and aggravation. I hesitate to enter into a dialogue over the merits of each of our positions as I can tell that I would fall short in matching your scholarly arguments and thoughtful analysis. I can, however, empathize with your predicament as I have experienced many of the same issues during my previous ownership of a working interest in a well.

I would like to offer a solution to the problem and ask for your consideration of same. I am willing to recommend to Energen's management the following:

1. Energen will commit to selling your 8.333% gross working interest share of gas (7.291375% net after royalty) under the attached marketing agreement;
2. Energen will allow you to make up your underproduced gas imbalance at a rate of 40% over your gross working interest entitling you to a monthly 11.6662% share of production (10.207925% net) or Energen will agree to purchase the underproduced amount at a rate of $1.25 per MCF;
3. I shall instruct our Accounting Department to reduce your outstanding JIB account by any COPAS overhead charges that were posted to the account during the period you did not sell your gas;
4. You may either pay the resulting JIB account in a lump sum or we can net it from your future gas revenues;
5. Should you desire to remove yourself from ownership in the Martinez #1, Energen would be willing to buy out your interest at a price determined by application of our standard economic valuation analysis for similar wells in the basin.

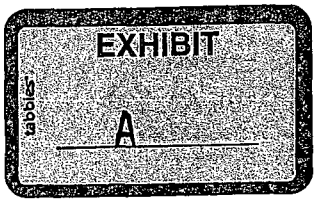
In the event you desire to have Energen sell your gas on your behalf, I am willing to recommend foregoing marketing charges but would require that you pay your share of monthly lease operating and COPAS overhead charges.

Please review this proposal and respond at your convenience.

Yours truly,

Paul Rote

Cc: Mr. Kirk Flowers



Sommer, Udall, H. wick, Ahern & Hyatt, LL
A Partnership of Professional Corporations

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October 15, 2002

Mr. Paul Rote
General Manager - Land
Energen Resources Corporation
605 Richard Arrington, Jr. Boulevard North
Birmingham, Alabama 35203-2707

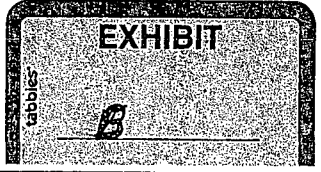
Re: Martinez Well #1

Dear Mr. Rote:

Thank you for replying to my letters dated August 16, 2002 and September 3, 2002. After having received no response of any kind for such a long period of time. I finally placed a telephone call to Mr. Flowers to see whether Energen intended to reply. Possibly my telephone call finally prompted your answer. From the long delay I was convinced that Energen was not taking my correspondence seriously. Having read Energen's proposal of September 25, 2002, I am now persuaded that Energen neither comprehends my concerns nor realizes the precarious legal and financial position in which it reasonably should find itself to be. By way of illustration:

1. Because I did not sign, or become a party to the Joint Operating Agreement (the "JOA"), or amendment thereto, then in converting to its own use through selling all of my MCF's over and above my entitlement of 8.333% of total production, Energen has been and is committing a succession of torts. Rather than address what is due for ongoing torts, Energen's offer blithely assumes that I have consented to and will in the future accept gas imbalances, as shown on Energen's monthly statements through June, 2002. Energen would "graciously" permit me to recover the accumulated "imbalances" at the rate of 40% over my future monthly "entitlements" (if production continues that long). This phase of your offer simply assumes, and is based upon the false premise that, I entered into the JOA and its amendments. Your offer being based upon a false premise, all I can say is "garbage in, garbage out."

2. By the terms of Energen's offer, I would be financially responsible for its past and future asserted cost of producing the gas (according to Energen, $3,764.26 as of June, '02) to which I was entitled and which Energen has sold (less only any COPAS overhead charges). Again, this assumes that I initially had some liability to pay such overhead charges in the first place, arising from my having been a party to the JOA or its amendment. That being a phony major premise, I do not agree with Energen's conclusion that, as of August 31, 2002, I owe Energen $3,764.86, a part of which its offer would "forgive," and would continue to accrue such monthly liabilities. Again, these charges stem from the spurious notion that I agreed in the first place to the JOA and its amendment.



In addition, Energen completely ignores its peril for having converted my gas to its own use, and for its business practice in what it and its predecessors have perpetrated. Not only does its offer not take into account its liability for what it lists as my 3,254 MCFs, but also the 19,357 MCFs to which the remaining working interest owners of Martinez No. 1 Well were entitled as of June of 2002. And even more importantly, think of Energen's potential liability to the fractional working interest owners of the large number of oil and gas wells in which Energen is the owner in New Mexico and elsewhere of less than a 100% working interest, but 100% of the oil and gas of which Energen has been converting to its own use and selling through the years. These numerous other working interest owners belong to a class, the members of which have not found it economically feasible to sue as individuals and were seemingly unaware or indifferent up until now of the potential of joining in a class action without expense to them to recover their damages, compensating and punitive, plus costs and attorney's fees. If Energen is aware of the large punitive damage and attorney's fees being awarded, its offer does not seem to reflect it.

Even for those working interest owners in New Mexico who did sign the JOA and its amendment, I suspect that such a JOA as amended is unenforceable because of being unconscionable, or a contract of adhesion, or both, as a class action would determine.

The elements of an unenforceable adhesion contract are set forth in *Guthmann v. La Vida Llena*, 1985, 103 N.M. 506, 709 P.2d 675, by the Supreme Court as follows, at page 509):

1. The agreement is in the form of a standardized contract prepared or adopted by one party for acceptance of the other.

2. The party proffering the standardized contract must enjoy a superior bargaining position because the weaker party virtually cannot avoid doing business under the particular contract terms.

3. The contract is offered to the weaker party on a take-it-or-leave-it basis, without opportunity for bargaining.

If any of the owners of a small percentage of a working interest in Martinez Well No. 1, or in the numerous other gas and oil wells in New Mexico, did in fact sign the Oil Balancing Agreement (Exhibit "F" to the JOA), it would only have been because such a small operating interest owner had no choice in the matter. Such owner by himself, herself, or itself, could hardly find a marketing company which would bother with a small interest. For example, the JOA of December 12, 1984, shows as owners of very minimal operating interests in Martinez Well No. 1, 3 with 1.2500%, 1 with .31250%, and 9 with .10417%, or .10417%. According to a Statement of Gas Imbalances of June, 2002, two operating interest owners were entitled during that month to 11 MCF's, six to2 MCF's, and nine to 1 MCF's each. For any such owner to find a company that would arrange to market one,

or two, or eleven MCF's, would virtually be impossible. What really happened, however, until at least December 1, 1995, the operator, then Meridian Oil, Inc., did in fact market these one, two, eleven, seventy-two and two hundred forty-one MCF segments to its affiliates, Meridian Oil Trading, Inc., Meridian Oil Production, Inc., Southland Royalty Company and/or El Paso Production Company, credit such minority owners with the sales price received against the asserted cost of production and marketing, and remit the remainder to each operating owner. As a result, the question of marketing was academic, since the operator handled it as noted above. Thus, those who had signed the JOA as amended with its balancing statement contract had no cause to complain about balancing, since there was no balancing. Except for the entitlement of Olivia M. Cordova, which constitutes a 28 33% operating interest that, for all I know, may now be marketed by Energen, the sole change that has physically taken place since each operating interest owner was left to market his or her gas is that of Energen's accounting systems. As before, it continues to produce and market the gas of the minority owners, but is now by its accounting procedure treating gas to which minority owners are entitled as belonging to Energen, billing the minority owners for producing such gas, and substituting MCF credits for money.

The three elements of a cohesive contract are present; (1) the JOA for the Martinez Well No. 1 is on a standardized contract, namely, a copyrighted American Association of Petroleum Landmen Form 610-1982-Model Form Operating Agreement; (2) as the owner of 50% of the operating interest, Energen cannot be removed as operator, and therefore enjoys a superior bargaining position because no owner of a minority operating interest could have avoided entering into the JOA if it wanted to do business with the then operator, Union Texas Petroleum Corporation; and (3) any operating interest owner could take or leave the JOA if it wanted to do business with Union Texas Petroleum, and its successors, of which Energen is one.

Those owners of operating interests on Martinez No. 1 who might have signed the JOA, and other owners of oil and gas wells operated by Energen in New Mexico, have entered into adhesion agreements that are unenforceable, thus enabling them in a class action to prove a conversion of the oil and gas sold by Energen in excess of its real costs of producing and marketing.

Is the JOA, and in particular, the so-called attached Gas Balancing Agreement, unconscionable and therefore not enforceable? In my previous correspondence, I detailed how it was unfair to the holders of working interests who signed it, thus meeting the requirements of unconscionability defined by the New Mexico Court of Appeals in *Bowlin's, Inc. v. Ramsey Oil Co., Inc.*, 99 N.M. 660 (App.), 662 P.2d 661, cert. Denied by Supreme Court at 99 N.M. 644. The Court there defined the basic test as "whether, in the light of the general commercial background and the commercial needs of the particular trade or case, the clauses involved are so one-sided as to be unconscionable under the circumstances existing at the time of the making of the contract." Union Texas Petroleum knew at the time of entering into the JOA for the Martinez No. 1 Well, and the other oil and gas wells in New Mexico, that, if it elected not to market, as it did previously, the oil

and gas to which minority owners were entitled, they would be saddled with out-of-pocket expenses and no income by which to pay for the gas and oil produced but would be required to accept MCF imbalance credits.

If the operator owning 50% of the operating interest had not ceased to market the entitlements of the fragments of the remaining 50% owners of the gas, in the instance of Martinez No.1, the Gas Balancing Agreement would not have come into effect and place each such minority owner in the impossible position of being forced by the Gas Balancing Agreement to be charged with paying in cash Energen's supposed cost of production while receiving in return a non-cash item, namely, a credit for gas to be paid, if ever, from future production of Martinez No. 1 well.

The way in which Energen has managed the production of gas, contrary to the manner that the operators managed it by marketing the entitlement of gas of minority owners, belies the pious and posturing recitation in the Gas Balancing Agreement that recited that:

> Accordingly, this agreement is intended for use as an operating procedure to assist in bringing the gas accounts of the parties into balance as soon as possible and to assist in maintaining such account in balance.

Knowing that the minority owners of operating interests that could never, as a practical matter, market their gas entitlements except through Energen, the latter has, in the case of Martinez No. 1 Well, and, I suspect, of numerous other wells throughout New Mexico, simply piled up credits. This is indeed one-sided, that is, unconscionable.

In the case of Martinez No. 1 Well, the accumulation of credits to minority owners reached the aggregate of 22,611 MCF's at the end of June, 2002, according to figures provided by Energen. If the same imbalances exist throughout Energen's operations in New Mexico, the claims of the minority owners in a class action should be enormous. At this time, only Energen knows the size of such an aggregate class claim. With the quoted price per MCF hovering around $4.00 per MCF, I would venture to say the sum is in the millions of dollars.

Needless to say, the liabilities of Energen thus existing might well have a devastating effect upon, and require filing a restatement of, lower past gross or net income of Energen with the SEC and possibly other governmental agencies.

If Energen's legal counsel is consulted, I believe they also will be inclined to think the pending offer has not taken into account Energen's exposure to far greater perils than are commensurate with such offer.

Accordingly, Energen's offer necessarily, and hereby, is rejected.

Sincerely yours,

Joseph A Sommer

Joseph A. Sommer

JAS:mp

STATE OF NEW MEXICO
DEPARTMENT OF ENERGY, MINERALS AND NATURAL RESOURCES
OIL CONSERVATION DIVISION

2007 MAR 9 PM 5 12

IN THE MATTER OF THE APPLICATION OF ENERGEN RESOURCES CORPORATION TO AMEND THE COST RECOVERY PROVISIONS OF COMPULSORY POOLING ORDER NO. R-1960, RIO ARRIBA COUNTY, NEW MEXICO

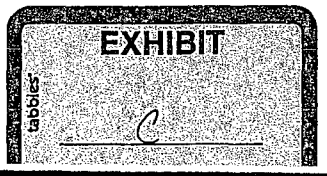
CASE NO. _____

APPLICATION

ENERGEN RESOURCES CORPORATION, by its undersigned attorneys, Miller, Stratvert, P.A., (J. Scott Hall) hereby makes application pursuant to NMSA 1978 Section 70-2-17 (1995) for an order amending the cost recovery provisions of Order No. R-1960 pooling all interests in the Pictured Cliffs formation, (Tapacito-Pictured Cliffs Gas Pool) underlying the SW/4 of Section 2, Township 25 North, Range 3 West, NMPM, Rio Arriba County, New Mexico, forming a standard 160-acre spacing and proration unit. In support thereof, Applicant would show the Division:

1. On May 5, 1961, pursuant to a hearing held on April 19, 1961, the Division issued Order No. R-1960 pooling certain uncommitted interests in the SW/4 of Section 2 preparatory to the drilling by Southern Union Production Company, ("Supron"), of its Martinez No. 1 well at a standard location in the N/2 SW/4 of said Section 2 to a depth sufficient to test the Pictured Cliffs formation.

2. The evidence at the hearing established that the Applicant in that case owned or controlled 100 percent of the available working interest in the N/2 SW/4 of Section 2 and that Applicant sought to pool the remaining interests, including unleased mineral interests, whose owners did not agree to participate in the drilling of the well. The quantum of non-participating interests constituted a relatively small percentage of the



Wachovia Bank Account No. WBCS 2079900524495

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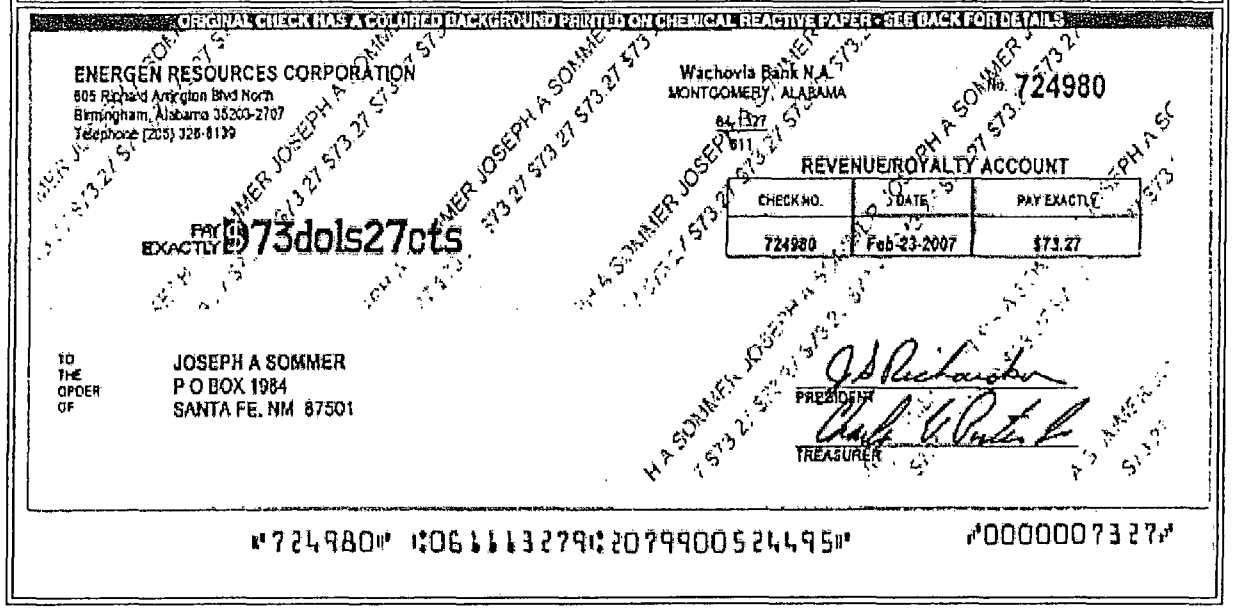

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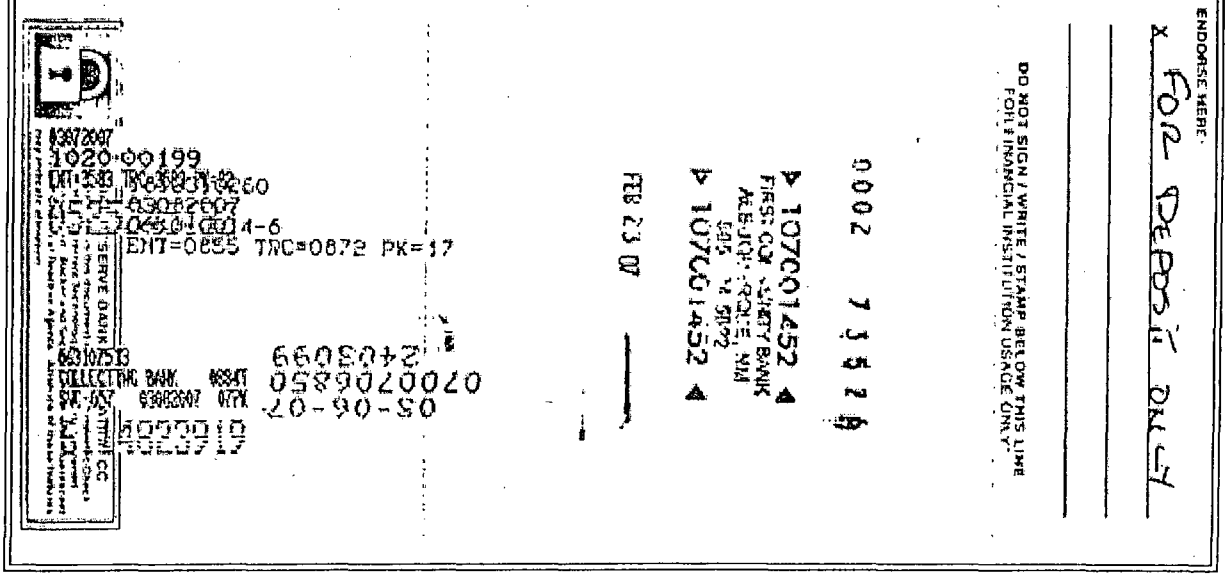


View	Post Date	Amount	Serial No	Sequence No	Deposited Items
1	03/08/2007	$73.27	724980	6114823919	N/A

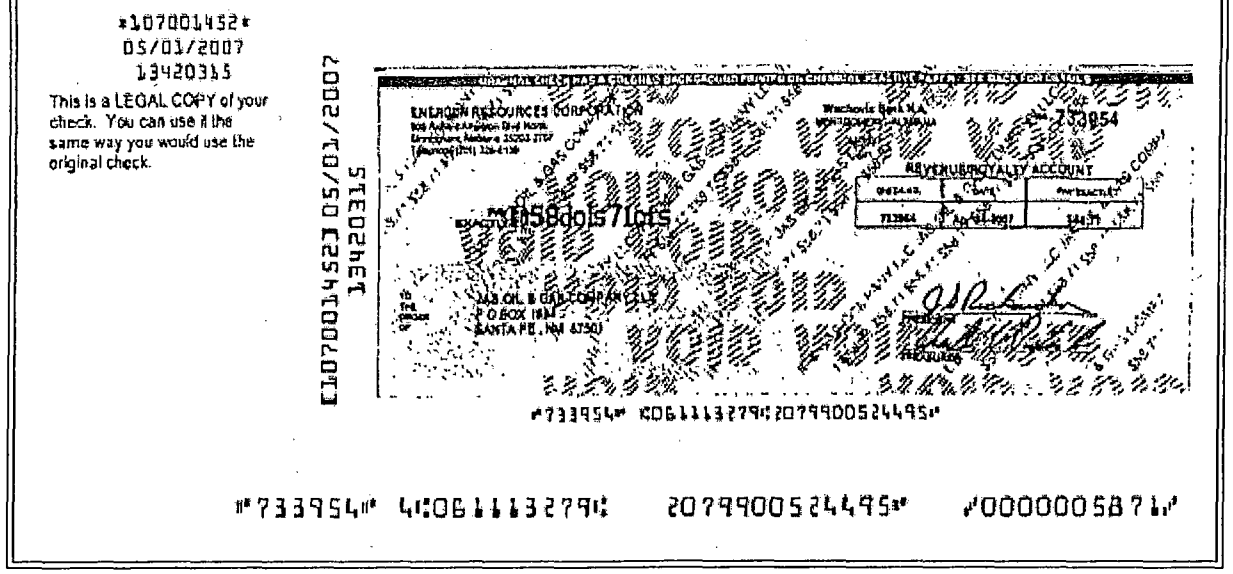
EXHIBIT 2004
D

ENERGEN RESOURCES CORPORATION
Owner Detail Sales
For Owner 1714 JOSEPH A SOMMER

Sale Date	Per End	DOI	Ref	Prd	Type Int.	Pay Cd.	Interest	Quantity	Gross	Compt	Compt Amount	Net	Date Paid	Check No.	Trans No.	Tx Cd
Well: 3132032A MARTINEZ 1 PC																
12/06	01/07	45227		G	URI	M	0.01170103	7.58	51.35	FT	3.05	43.62	02/23/07	724980	118	
										NGPT	0.36					
										SEV	1.81					
										SCH	1.93					
										CT	0.09					
										ADV	0.49					
12/06	01/07	45227		P	URI	M	0.01170103	43.67	33.74	FT	1.16	29.65	02/23/07	724980	119	
										SEV	1.22					
										ADV	0.35					
										CT	0.06					
										SCH	1.30					
					Well Paid Total			51.25	85.09		11.82	73.27				
					Owner Paid Total			51.25	85.09		11.82	73.27				
					Owner Total			51.25	85.09		11.82	73.27				

Wachovia Bank Account No. WBCS 2079900524495

Front Image



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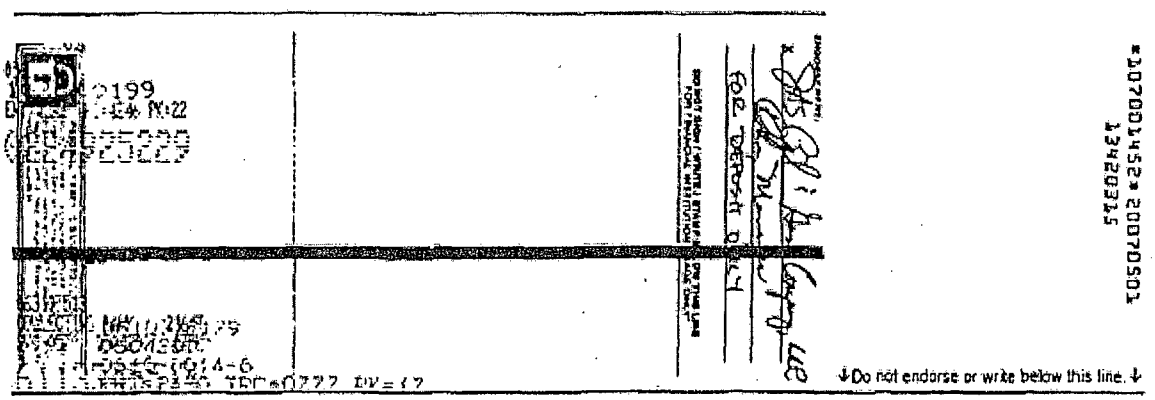

View	Post Date	Amount	Serial No	Sequence No	Deposited Items
1	05/04/2007	$58.71	733954	6113345514	N/A

REV210P
Sale Dates: Incept to Current
Selection: Paid
Paid Dates: from 04/01/2007 to 04/30/2007

ENERGEN RESOURCES CORPORATION
Owner Detail Sales
For Owner 57575 JAS OIL & GAS COMPANY LLC

Sale Date	Per End	DOI	Ref	Prd	Type Int.	Pay Cd.	Interest	Quantity	Gross	Compt	Compt Amount	Net	Date Paid	Check No.	Trans No.	Tx Cd
Well: 3132032A MARTINEZ 1 PC																
02/07	03/07	45227		G	URI	M	0.01170103	6.19	43.47	FT	2.32	37.20	04/24/07	733954	1	
										NGPT	0.26					
										SEV	1.54					
										SCH	1.65					
										CT	0.08					
										ADV	0.42					
02/07	03/07	45227		P	URI	M	0.01170103	32.38	24.49	FT	0.85	21.51	04/24/07	733954	2	
										SEV	0.89					
										ADV	0.25					
										CT	0.04					
										SCH	0.95					
				Well Paid Total				38.57	67.96		9.25	58.71				
				Owner Paid Total				38.57	67.96		9.25	58.71				
				Owner Total				38.57	67.96		9.25	58.71				

Chapter 13 36 Rocky Mtn. Min. L. Inst. (1990)
THE GAS BALANCING AGREEMENT: WHAT, WHEN, WHY, AND HOW

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SYNOPSIS

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§ 13.01 Introduction

[¶1]Under operating agreements, pooling agreements, and pooling statutes, diverse parties will each have a right to a share of production and each will have a right to take in kind or separately dispose of its share of production. This poses an apparent contradiction: if each owns an undivided share, how can one party sell its share while another does not? The current state of the case law is such that it encourages strategic behavior by parties. While the courts struggle with the apparent contradiction that arises from a mixture of common law property principles, contract provisions, and regulation, parties can resolve the problems through the use of a gas balancing agreement. This paper is a review of the law affecting gas production [13-4] and discusses the utilization and management of the gas balancing agreement to resolve problems, including consideration of operator-nonoperator relationships in gas marketing and related matters of obligations to royalty owners.

[¶2]The interest in gas balancing agreements is reflected in the fact that there are many more papers on gas balancing than there are cases. 1 Practitioners are aware of the changing [13-5] conditions in the gas market that have made the gas balancing agreement of greatly increased importance. The market has shifted from long-term contracts to short-term contracts as pipelines have shifted from a merchant role to a transporter role. Gas pricing regulation has gone from area rates to national rates to NGPA categories to FERC Order No. 451 to the Natural Gas Wellhead Decontrol Act of 1989. 2 These changes have serious repercussions for relations among working interest owners, for lessor/lessee relations, and for the functions of [13-6] conservation agencies in fulfilling their responsibilities and duties in preventing waste and protecting correlative rights. The most sensible approach to the problems of gas production that lead to imbalances has been negated by the United States Supreme Court, which has invalidated state ratable

take/common purchaser statutes. 3 The Court has ruled that state regulation is preempted by a federal regulatory program that does not in any manner deal with the problems associated with gas production.

[¶3]A review of several aspects of the law applicable where there is no gas balancing agreement should precede an examination of the gas balancing agreement. It may suggest why some working interest owners will be reluctant to sign a gas balancing agreement. Moreover, if one knows the consequences of a lack of a gas balancing agreement, it may help in recognizing what should be put into a gas balancing agreement to induce others to agree to it and to resolve the problems that may emerge in the absence of agreement.

[¶4]The courts are at a juncture much as they were when they faced the problem of adapting (or developing) the common law principles of waste to the peculiar circumstances of oil and gas production. The courts of most producing states considered common law principles of waste developed in regard to solid minerals and land after the Statute of Westminster II of 1285, and concluded those principles would have to yield in light of the consequences of the rule of capture. 4 One cotenant could not restrain all others from developing the oil or gas, thereby subjecting all to loss from drainage. The courts today face the necessity of molding the common law to the new realities of [13-7] the gas market. While the courts are coming to grips with the intricacies of the multilevel relationships in gas production and marketing, the regime of freedom and self-governance embodied in the law of contracts, coupled with judicious exercise of existing authority by the conservation agencies, offers the best hope of making the appropriate adjustments in relations among working interest owners that must be made to accommodate the new era of gas marketing. 5

§ 13.02 Production Imbalances: Circumstances in Which They Arise

[¶5]The typical joint operating agreement and the pooling orders of most state conservation agencies generally establish a regime of oil and gas ownership susceptible of "production imbalance," as opposed to a regime of "capture" or of "true cotenancy." It is thus necessary to discuss gas imbalances, because there cannot be balancing unless an imbalance has first arisen. The term "production imbalance" will be used in this paper to avoid the confusion that may arise from use of "split-stream sales." 6 The latter term arose at a time when it seemed to indicate multiple pipeline connections at a single well. 7 The marketing of gas today includes multiple sales carried by a single pipeline, and a pipeline may be performing both a merchant function and a transport function in the same well. Production imbalances may arise from a single buyer who is buying at differing levels (unratably) from the same well. The courts apparently have on occasion been confused concerning this aspect of current gas marketing. 8

[13-8]

[¶6]Imbalances can arise in different ways in different contexts. Imbalances occur by design and by happenstance. Our attitudes towards imbalances and our beliefs about the law will be shaped by the equities we perceive in the manner in which the imbalance arose. A pipeline may refuse to take natural gas from one or more of the parties within a unit or from one or more cotenants. 9 A working interest owner in a unit may decide it does not wish to sell at current prices. Such an owner may wish to have an opportunity to sell its share of gas later at a better price or it may hope to demand a share of a selling party's receipts; indeed, such an owner may wish to have it both ways, i.e., to have the opportunity to sell later at a better price than anyone today or if the better price never

materializes to demand money from the selling parties. Imbalance may arise where one producer and one purchaser dominate the field and other smaller producers have no opportunity to sell their share of the gas. A producers may wish to sell gas and may have a contract for the sale of the gas but the pipeline is unable to make a connection to the production facility. 10 Gas purchase contracts frequently have provisions allowing the purchaser to suspend takes or to opt out of the contract, thereby resulting in imbalance.

[¶7]When a stream of gas is produced from a well, an imbalance occurs if someone who has a right to a portion of that stream does not take that portion. If there is a duty to account to another for a sale of something that was owned in common and that duty has not been fulfilled, we speak of that as a failure to account, not as an imbalance. Discussion of balancing presupposes a right to take and a failure to take. One is presupposing some type of ownership right in gas that is produced, and to say that there is an imbalance is also to suppose that the right to take includes the right to make up the failure to take at a particular time.

[¶8]The "production imbalance" approach is to be distinguished from a "true cotenancy" approach and from a "capture" [13-9] approach. These two latter approaches have been urged on the courts. The "true cotenancy" approach postulates an ownership right in every molecule of gas, and any sale of the gas stream inures to the benefit or detriment of every party with an ownership interest. Failure to account for the value realized by a selling party would be keeping money that belongs to others. Such an approach must reject the idea that any party has a right to take a share in kind because everyone shares an ownership right in each and every molecule.

[¶9]The "capture" approach presupposes that each party has a right to take its share of gas, but where a party has the right to take a portion of the stream of gas from a well and that party fails to take its share, the share is forfeited, abandoned, or otherwise lost, much as with the rule of capture where multiple tracts of land are owned by different parties. 11 In some situations, such an approach may be harsh and in others, it may be entirely fair. For example, A and B may each have a 50% interest in the production of a unit well where the well is capable of producing 100 Mcf per day. A agrees to sell his gas to X at $1.00 per Mcf and X promises to take gas based on A's share of the deliverability of the well. B foregoes an opportunity to sell his gas on the same terms and instead takes a short-term sale at $2.00 which soon ends. Thereafter X takes 50 Mcf a day and pays the money to A. B asserts that half of the 50 Mcf is his and he wants his share of the money. In the meantime, another well on an adjacent competitive unit is producing at 100 Mcf and is draining gas from beneath the unit in which A and B have an interest. It would be very harsh to force A to share his market when B forewent an opportunity to make [13-10] a sale. It would be better to apply a rule that says B has simply foregone his right to a share of production. There is no unjust enrichment to A, who has done no more than take the amount of gas that he had a right to take.

[¶10]Neither the "true cotenancy" approach nor the "capture" approach is particularly attractive because each fails to take into consideration some important practical aspects of the gas business. One important thing that a gas balancing agreement does is to reflect contractually this rejection of the other possible regimes—the idea that each party gets a share of all other sales and the idea that a party must take his gas or lose it altogether.

[1] True Cotenancy in Real Property

[¶11]A cotenancy or tenancy in common in property is a tenancy by several distinct titles but by unity of possession or any joint ownership or common interest with its grantor. 12 As Powell states, "The chief attribute of a tenancy in common is unity of possession by two or more owners. All co-owners, or cotenants, of a tenancy in common share a single right to possession of the entire interest." 13 In oil and gas, we are all familiar with the manner in which such cotenancy or concurrent ownership arises. If A and B both own Blackacre by inheritance, there is true cotenancy. If A and B both own the mineral estate on Blackacre, there is true cotenancy. Either A or B will have the right to go on Blackacre and produce all the oil or gas from the property. In most states, it has long been the rule that one cotenant cannot stop the other cotenant from developing the property and selling the production therefrom. A and B will have the right to partition Blackacre so that they do not have to put up with each other in answering questions about what can be done with Blackacre. In a true cotenancy, it is not correct to say that there is an imbalance in production because there is no separate ownership to get out of balance; if the parties in a true cotenancy enter into a joint operating agreement, it may permit imbalances to arise if the agreement has provisions [13-11] that effectively partition the ownership of the production itself. 14 Under the common law as accepted in most states, each cotenant has the right to go on the land and produce the fugacious minerals that may be present. The producing cotenant owns the production thus obtained — all of it. The producing cotenant has title to the minerals. Thus, the removal of minerals cannot be conversion or waste. 15 But the producing cotenant is under a duty to account to the nonproducing cotenant(s). This has generally been for the market value of the production, which has also generally been the price received by the producing party. Accompanying the right of each cotenant to produce has been the right of each cotenant to seek a partition of the property held in cotenancy. This has been fair for both the producing party and the nonproducing party: if either one has not liked the arrangement, he could get out of it by a partition.

[¶12]The cotenancy regime has application to other arrangements or circumstances involving the production of gas only by analogy. 16 Where pooling has occurred, either through contract or compulsory order of the state, partition is generally not available nor desirable. Furthermore, the pooled unit is governed either by the terms of the contract or of the statute and order under which the pooling took place, not by the common law rules of cotenancy. While one might look to cotenancy for some guidance in resolving questions of gas balancing, the unavailability of partition makes the pooled circumstance or joint operating circumstance quite different from true cotenancy.

[13-12]

[2] Joint Operating Agreements

[¶13]Joint operating agreements are entered into by working interest owners in a variety of circumstances. In a typical situation, A has a lease on one tract and B has a lease on a second tract. A and B sign a joint operating agreement so that they can develop their respective properties together. Does this create a cotenancy in the leases? The parties to the joint operating agreement certainly have not relied on the assignment clause of the lease, and they have not created liabilities to one another's royalty owners. I do not think anyone intends to create a cross-conveyance of a property right in another when they enter such an agreement. Does the joint operating agreement create a cotenancy in the oil

or gas produced? One must analyze the joint operating agreement to see if it truly intends to create a cotenancy. The typical joint operating agreement will be examined below.

[¶14]The parties who enter into joint operating agreements generally go out of their way to negate the attributes of cotenancy. The courts should respect that rather clear intention not to create a cotenancy as known to the common law. The 1977, 1982, and 1989 versions of the AAPL-610 all contain an express provision that the sharing of production clause shall not "be deemed an assignment or cross-assignment of interests covered hereby." 17 Nor do parties intend to create a partnership. 18 It is generally accepted that the joint operating agreement does not in itself "pool" the royalty owner's interest, which it arguably would if there were a cross-assignment of the lease itself. From the provisions of the typical joint operating agreement, it is clear also that while the rights of each lessee are limited in some aspects of dealing with each lease, the title to each lease remains with the lessee. There is no cotenancy created in the leases. There could only be some sort of cotenancy in the gas produced, though one should note that gas once produced is personalty or movable. 19 But the hallmark attribute of [13-13] cotenancy is itself denied by the joint operating agreement. That is, "Cotenants have an equal and coextensive right to occupy the premises. The only limitation is that they must not exercise such right so as to exclude the other cotenants from their equal right to access." 20 The joint operating agreement always provides that each working interest owner has the right to take his own share of production in kind. This right to take in kind is the power to exclude others from that share. The joint operating agreement clearly does accomplish something akin to cotenancy, but it is a mistake to ascribe to it the full attributes of a common law property cotenancy. Rather, the joint operating agreement is a contract that relates to property rights. The essential purpose and function of the joint operating agreement is the act of production of oil or natural gas, not the marketing of the substances produced. The same is true for pooling agreements and orders. The reasons for different owners coming together for joint efforts in production of oil and gas do not exist for the marketing of production. This is not to say that parties and state conservation agencies need not concern themselves with each party having an opportunity to market production or ultimately to realize an ownership right in production, but that is different from recognizing the marketing of production as a joint endeavor.

[3] Pooling Agreements

[¶15]Pooling agreements come closer to creating what looks like a cotenancy. The courts are divided on whether a pooling of rights in oil and gas should be regarded as a cross-conveyance or a mere contract. Generally, the question comes up in the context of a procedural issue such as venue for litigation or the power of the holder of the executive right to pool the interest over which the executive holds rights. 21 Whichever the position [13-14] adopted, the pooling agreement generally does no more than the pooling agreement, and any related contract such as a joint operating agreement, purports to do. That is to say, if I own Blackacre and I pool my oil and gas rights with those of the owner of Greenacre, the pooling does not give Greenacre's owner the right to come and grow cotton on Blackacre. If we agree that we will both own all production from Blackacre or Greenacre, then we both own such production. If we agree that we will each own the right to take a certain share from the production, then that is what we own.

[4] Pooling Orders from State Agencies

[¶16]If there is doubt that parties who agree to pool their rights have cross-conveyed an interest in property, there ought to be even greater doubt that a compulsory pooling order of a state conservation agency forces a conveyance of property rights. The state conservation agencies have a special role in oil and gas production. They are established to prevent waste and protect correlative rights. When they go beyond their delegated responsibilities, they are acting ultra vires. 22 It is generally accepted that a state agency cannot adjudicate title. By the same token, they cannot convey title to land or minerals (as opposed to establishing a right to share in production). When an agency enters an order force-pooling the right to produce oil and gas, the agency is affecting valuable property rights. One must look to the statute of each state to see what the effect of an order is, but generally it can be said that force-pooling creates a special kind of coownership or cotenancy in the production of a unit well. It is analogous to the cotenancy in land or mineral estates but it is not the same thing. For one thing, the statute must give every owner a fair opportunity to receive his just and equitable share of the production from the unit. For common law cotenancy in most states, that is provided by the fact that each owner can go on the land and produce, but the compulsory pooling order (and related spacing order) restricts the operations to the designated operator. Second, in common law cotenancy, each cotenant can demand [13-15] partition from the others and go about his business on his own, each drilling his own well on his own partitioned tract. This is not likely to be possible for the force-pooling order. The pooling is generally done because only one well is to be drilled on the unit, at least initially. To have parties each drill wells would be to negate the pooling order. In order for each owner in the unit to have the opportunity to receive his just and equitable share of production, it may be necessary for the agency to let each owner take his own share and dispose of it separately. It would seem to be confiscation of the right to property for a state conservation agency to tell A, the owner of an interest in 80 acres, who is pooled with B, the owner of 160 acres, that B will be the operator and the operator can take the gas attributable to A and commit it to B's long-term contract at $.38 per Mcf. If A can make other arrangements, then the state should let him take his own gas. If B's contract terminates, A ought to be able to continue to sell his own gas without B being able to suddenly demand two-thirds of any revenue enjoyed by A for his small sale. The agency, in other words, must have the power to undertake some kind of partition and provide some kind of balancing in order to fulfill its duty to allow each owner the opportunity to receive his just and equitable share. 23

[¶17]To summarize: the pooling order of a state agency only creates a kind of cotenancy. While it is useful to look to common law property analogies, it would be a mistake for the courts to try to bring the full body of property law relating to concurrent property ownership into the regime of pooling orders. Rather, conservation law is sui generis. The courts should look to the statutes governing the agencies and the parties and should try to effectuate the purposes and goals of those statutes in the context of a changing market in which production is sold. The Statute of Westminster II of 1285 regarding waste, and the Statute of Anne of 1705 regarding accounting among cotenants have little bearing on the law of [13-16] the 1990s relating to gas marketing under a joint operating agreement. 24

§ 13.03 Consequences of Imbalances in the Absence of Balancing Agreement

[1] The Marketing Cotenant

[a] The Nature of Cotenancy

[¶18]True cotenancy does arise often in oil and gas law. Under the generally accepted law of cotenancy, any cotenant may use and enjoy the entire property as if he were the sole owner, limited only by the same right in the other cotenants. 25 While there may be a duty to account to other cotenants, there can be no conversion. However, an Oklahoma case has apparently misapplied this generally accepted principle to hold that a pipeline purchaser who buys gas from a cotenant/operator with notice that the operator lacks authority to dispose of all the gas becomes a converter.

[b] Teel v. Public Service Company of Oklahoma

[¶19]The case of Teel v. Public Service Company of Oklahoma, 26 was brought by the owner of a half-interest in a working interest in five wells in a common source of supply. Defendants Public Service Company of Oklahoma and Transok Pipeline bought gas from the operators of the wells who were cotenants with Teel, and the parties had entered into an operating agreement. Under the operating agreement, as interpreted by the court, Teel had the right but not the duty to take his gas in kind. The action was for an accounting and for determination of leasehold rights against the operators and the purchasers; the complaint was amended to allege conversion if the gas remaining in the wells was insufficient to compensate or balance for the gas already taken. The case against the operators [13-17] was settled. The trial court made an accounting based on the contract price, which the judge found to be identical to the fair market value of the gas. After an award to Teel, he appealed the trial court's finding that fair market value was the price received by the operator and the refusal of the trial court to find that the purchasers converted his gas, claiming that they were unjustly enriched. On appeal, the Oklahoma Supreme Court ruled that a pipeline purchaser who buys gas from a cotenant/operator with notice that the operator lacks authority to dispose of all the gas becomes a converter. After Teel revoked the authority of the operators to dispose of his share of gas and the purchaser became aware of this, the purchaser became a converter. The court remanded for consideration by the trial court of the fair market value of the gas.

[¶20]The Teel decision has been limited by Anderson v. Dyco Petroleum Corporation, 27 but this case appears to import the law of cotenancy to joint operating agreements and units. In this case, the Oklahoma Supreme Court held that Oklahoma law did not recognize a claim for conversion on the facts in litigation. The plaintiffs, along with Dyco and others, owned various percentages of the working interest in a natural gas well. Panhandle had been purchasing gas from the well from Dyco and other working interest owners and paying these working interest owners for the gas purchased. The plaintiffs had not received any of the proceeds from the sales, and they were not parties to the agreement Dyco had with Panhandle for the sale of natural gas. Dyco refused to allow them to ratify its agreement with Panhandle. The court held Panhandle was entitled to judgment in its favor as a matter of law. It said Oklahoma law provided no tortious action for conversion in favor of working interest owners like the plaintiffs against a purchaser of natural gas who buys gas from one or more other working interest owners in the same well. Under Oklahoma law, the working interest owners in the well were tenants in common. Each cotenant was entitled to market production from the well, and the sale of gas to a purchaser by one or more cotenants without consent of the other cotenants is lawful. [13-18] Under ordinary circumstances, it does not involve conversion on the part of either the purchaser or the working interest seller, because each cotenant has the right to develop the property and market production under the common law. The Teel decision

was limited to the facts of that case: for there to be conversion, the cotenants must have named another cotenant to exploit the cotenancy for their mutual profit by entering into an operating agreement among themselves to have the operator market or sell gas produced from the well. It also requires that there be no division order. 28 Moreover, the court said that a purchaser must have notice that a working interest owner not a party to the division order has revoked the operator's right to sell his/her share of gas under the operating agreement and the purchaser must continue to treat the situation as if it is purchasing the nonconsenting cotenant's share of gas, while failing to account to each working interest owner for his/her pro rata share of the proceeds. The Teel situation, the court said, only comes into play when a purchaser purports to buy gas of an owner from an operator which is not authorized to deliver it. The appellants in Dyco took the position that any time one cotenant sells gas to a purchaser, the purchaser becomes liable to each and every other working interest owner for conversion simply by the force of the working interest owner's desire to sell his gas and be paid in proportion to his percentage of working interest in the well, even though not a party to any purchase contract. The court found nothing in the facts of the case that would indicate gas purchased by Panhandle under agreement with Dyco, on behalf of itself or itself and some of the other working interest owners, would constitute either a wrongful sale or purchase of the plaintiffs' interest, as was the case in Teel.

[¶21]The Oklahoma Supreme Court has apparently in Dyco decided to treat all unit/joint operating agreement situations as common law cotenancies. 29 It would be preferable for the court [13-19] to treat the situation as akin to a cotenancy for some, though not all, purposes. The rules and concerns of cotenancy developed in circumstances where an agreement was not present and should not be imported blindly to a property arrangement governed by contract, statute, and order with concerns quite different from those of the common law.

[2] The Rights and Duties of Parties to an Operating Agreement or Pooling Order

[a] The Right to Take, the Right to Sell, and the Duty to Sell

[¶22]The typical joint operating agreement seems to contain a contradiction. First, it provides that all the parties share the ownership of production. The 1982 AAPL agreement provides that:

[¶23]all costs and liabilities incurred in operations under this agreement shall be borne and paid, and all equipment and materials acquired in operations on the Contract Area shall be owned, by the parties as their interests are set forth in Exhibit "A." In the same manner, the parties shall also own all production of oil and gas from the Contract Area...." 30 This provision, by itself, would suggest that the gas is owned by everyone as it comes out of the ground. But joint operating agreements generally go on to provide that each owner is to take its own share of production.

[¶24]Under the typical operating agreement, each working interest owner will have the right and the duty to take its proportionate share of production in kind and dispose of it. Where the owner fails to take or dispose of its share, the operator may be expressly given the right to sell or purchase the non-taking owner's share. But the operator is virtually never given the right or power to sell or purchase the non-operator's share of [13-20] production, should the non-operator choose to sell its share itself. 31

[¶25]There are several reasons for the provisions. First and most obvious, the parties generally want this right to take and market their own production. It will be to the

working interest owners' advantage to market separately in many instances. Moreover, each lessee has a duty to its own lessors to market gas as a prudent operator. The lessee who attempts to turn the marketing duty over to another working interest owner may find itself liable to its lessor for breach of its marketing duties. Beyond these two aspects are two other considerations: the potential for antitrust claims against the parties to a joint operating agreement, and the tax consequences if the parties are deemed to be a corporation. The possibility of antitrust litigation over joint operating agreements or unit operations seems a quaint notion to us from this vantage, but it was at one time a real possibility. 32 The tax concerns go back to a 1935 Supreme Court decision 33 and remain with us today. 34

[¶26]If the operator is denied the power or authority to sell the gas of the non-operator, it cannot be said that the operator has [13-21] a duty to sell the gas of the non-operator, particularly if the agreement expressly states there is no obligation on the operator to purchase or market production. 35 The contract provision of an operating agreement that says each party has a right to take its share of the gas is itself an adoption of the legal regime that there is not to be a sharing of revenues from all sales. It does not expressly partition a stream of gas that would otherwise be subject to a type of coownership, but it is an implicit adoption of a theory of the divisibility of the stream of gas. Dean Kuntz recognizes that this has been the common understanding of the joint operating agreement in the industry when he states: "It has generally been assumed that those parties who do take in kind own the gas so taken and that the gas of the party not taking in kind remains in the ground." 36

[¶27]To provide in the joint operating agreement that the operator has the right to purchase is to negate the proposition that there is already a duty to account for any sale. When the joint operating agreement goes so far as to say no party has to share a market with one who does not take in-kind, it is pretty silly to say that the joint operating agreement creates a cotenancy in the gas such that each party must account to one another for each sale. 37

[¶28]To reconcile the apparent contradictions in the provisions of the joint operating agreement, I would make two observations. [13-22] First, the joint operating agreement may state, as does the 1982 AAPL Form 610, that the ownership provision obtains "Unless changed by other provisions...." The provision for taking in kind and separately disposing of each owner's share is such a change. Secondly, a purpose of the ownership provision is to provide the overall quantum of production to which an owner is entitled and is not an expression of the character of the ownership of each molecule produced, i.e., a tenancy in common. As will be noted, several courts have recognized that balancing in kind is an industry custom; a reading of the joint operating agreement that the ownership paragraph relates to overall quantum produced from the contract area and not to the character of that ownership nor to a duty of any seller to account to all owners for all sales is in accord with the custom and reflects that understanding of the function of the take-in-kind provision of the joint operating agreement. This reading harmonizes the different provisions of the joint operating agreement, and one need not resort to the law of cotenancy for further guidance or for confusion. The "ownership" clause of the joint operating agreement provides the quantum each party is entitled to take when there is production but, in light of the right of each to take in kind, it does not provide the nature of the ownership of each molecule.

[¶29]I do not believe that a non-marketing party should be able to have it both ways. If a non-marketing party takes the position that a joint operating agreement or pooling produces a cotenancy, then the party should not be able to claim that an operator is converting the gas by taking it and selling it, for the operator or any other cotenant would be able to do so. 38 If the non-marketing party takes the position that there is no cotenancy in the gas on production but ownership of separate parts of the gas stream, then the non-marketing party must address whether it breached a duty under the joint operating agreement to take its share of gas in kind. 39 A refusal by a [13-23] non-marketing party to take its share in kind or separately dispose of it may impede the ability of the other owners to market separately their share of production, and could lead to drainage of the reservoir that is subject to the joint operating agreement. If the non-marketing party fails to take its share in kind, what is the operator supposed to do? Surely it could not be expected to shut the well in. 40 To understand the drainage aspect of this, it will be helpful to examine the relation between joint operating agreements and the setting of well allowables by the state.

[b] An Excursion on Allowables

[¶30]Some people apparently believe that a joint operating agreement, pooling agreement, or pooling order establishes some sort of ownership or quasi-ownership right over gas in a reservoir, and this ownership is carried over into the way in which allowables that are set by the state conservation agencies function. This is a misunderstanding of the nature of the rights created by a joint operating agreement, pooling agreement, or pooling order, and of allowables. What a joint operating agreement or pooling establishes is a right to share in gas produced from a well or an area on a specified basis, not an ownership in place.

[¶31]To illustrate, let us hypothesize a reservoir with 10,000 Mcf of gas in place, though in most instances we will have only a vague idea about how much gas actually is underground. We will further imagine that a well is completed to the reservoir capable of producing 10 Mcf per day, and this 10 Mcf per day is the allowable set by the state conservation agency to prevent waste and protect correlative rights. A and B are owners of interests in two leases of two tracts above the reservoir, and A and B are subject to a joint operating agreement or pooling. [13-24] If A is operator of the well and produces 5 Mcf per day, has A produced its own 5 Mcf, leaving 5,000 in the ground for B and only 4,995 for itself, thereby avoiding the question of whose gas was produced? The answer is obvious: there is no cotenancy of anything in the reservoir established by a joint operating agreement involving leases or by a pooling of the right to produce; there is no creation of a right to a share of gas or oil in place by a joint operating agreement or pooling agreement or order. The question then becomes whether A has produced 2.5 Mcf for himself and 2.5 Mcf of B's gas or whether A can sell all production and can balance at a later time in cash or in kind? Reducing the amount produced by A from 10 Mcf per day to 5 Mcf per day does not change the character of the issue of ownership of the gas produced and whether balancing is the most sensible method of resolving the problems of the joint operating agreement and pooling.

[¶32]Furthermore, the allowables of the state are not set as to each owner of a share of the gas produced. They are set in relation to the efficient rate of recovery of the reservoir and for the protection of correlative rights between competing wells in the same reservoir. Thus it is necessary to add an additional dimension to our hypothetical situation. In

addition to the A/B well into the 10,000 Mcf reservoir, there is a second well operated by C. This well also has an allowable of 10 Mcf per day. If A reduces the production of the A/B well to 5 Mcf per day while C is producing 10 Mcf per day, there will be drainage of gas from the A/B unit to the C unit. Is only B's gas being drained? While the A/B well might have some right to make up underages in allowable production, the underages will be subject to cancellation. 41 A as operator will be violating duties [13-25] to his royalty owners and to other working interest owners and probably to B as well if A does not produce the full allowable, given the opportunity to do so. Even B will be better off by A producing 10 Mcf per day and balancing later than by reducing A's takes to 5 Mcf per day and allowing B's share of gas to be drained by C. An operator who reduces takes will end up with a claim by other selling non-operators for loss of reserves from drainage and will still face a claim by the underproducer that whatever sales there were must be shared.

[c] Standards for Measuring Performance of Duties: Good Faith, Prudent Operator, and Fiduciary

[¶33]Articles and cases have discussed whether the standard of conduct owed by an operator to a non-operator is one of good faith, the care of a prudent operator, or a fiduciary duty. Some articles 42 and some cases 43 assert that the operator under a [13-26] joint operating agreement (or pooling agreement or pooling order) owes a fiduciary duty to the non-operators. Their approach seems to be that an operating agreement or pooling is a kind of joint venture and, since some cases have held that joint venturers owe fiduciary duties to one another, therefore the operator of a joint operating agreement or unit owes fiduciary duties to non-operators. Notwithstanding the cases which have used fiduciary language, the fiduciary approach is ill-conceived and leads to results that are patently ridiculous. For example, if Exxon enters into a lease with Joe Farmer under which Exxon has the exclusive right to produce oil and gas from Farmer's land, and Farmer is entirely dependent upon Exxon's efforts, Exxon must act as a prudent operator but is not a fiduciary to the lessor. 44 How can it be supposed that if Exxon enters into a joint operating agreement with Chevron under which Exxon is designated operator, Exxon assumes a set of responsibilities or implied obligations to Chevron that are higher and more onerous than those it owes to Joe Farmer? 45 A small producer of natural gas may be entirely dependent on its gas purchaser for enjoyment of any income from its property, but no one would doubt that the gas purchaser's only obligation under its contract is to perform its duties in good faith. A fiduciary is a person having a "duty, created by his undertaking to act primarily for another's benefit in matters connected with the undertaking." 46 Such a definition hardly describes what parties to a joint operating agreement reasonably contemplate, and a state conservation agency's designation of an operator under a compulsory pooling order cannot be said to require that a force-pooled party must put its own interests aside in favor of another. If neither the oil and gas lease nor the gas purchase contract establishes a fiduciary relationship between the contracting parties, there is far less reason to suppose that the joint operating agreement among [13-27] working interest owners establishes such a relationship. 47 In focusing on the label to be attached to the relationship, it seems to me that much of the discussion seems to miss an essential point, namely, is there a duty at all? 48 To say that one person has a fiduciary responsibility to another is to say that, within the defined relationship, the fiduciary must carry out his responsibilities in a certain manner. The contract itself defines the scope of the relationship to which the fiduciary duty attaches. One must first find whether a

contract imposes a duty upon another party and then inquire whether the fulfillment of that duty is measured by the standard of good faith, of a prudent operator, or of a fiduciary. Determination of the standard should turn first on the terms of the agreement itself when it expresses a standard. The joint operating agreement typically provides that the operator is to conduct all operations in a good and workmanlike manner and shall have no liability to the other parties except as may result from gross negligence or willful misconduct. 49 Even where this clear contract language might be ignored, the court should look to the realities of the relationship between the parties, such as the degree of specificity of the contract, the degree of trust and discretion reposed by one party in the other, and the potential for overreaching by a party in a dominant or special position. In those cases in which a fiduciary duty has been found, the court often could have decided the case simply on the basis of a breach of the terms of the joint operating agreement. 50 A persuasive student [13-28] Comment has urged the courts to follow the sensible approach of calling the operator's duty simply the "operator's duty," rather than fitting it into the category of fiduciary duty. 51 The appropriate duty of the operator then is two-fold: to observe the terms of the operating agreement and to refrain from using his position to the disadvantage of the non-operators. 52 The better view emerging from a growing body of court decisions is that the relationship among the parties to a joint operating agreement is controlled by the terms of the agreement, irrespective of the fiduciary label put on the joint operating agreement by some earlier decisions. These cases include the following: Dime Box Petroleum Corp. v. Louisiana Land and Exploration Co.; 53 True Oil Company v. Sinclair Oil Corporation; 54 Andrau v. Michigan Wisconsin Pipe Line Co.; 55 Tenneco Oil Company v. Bogert; 56 Crosby-Mississippi Resources, Ltd. v. Saga Petroleum U.S. Inc.; 57 Prentice v. Amax Petroleum Corp. 58

[13-29]

[3] Balancing by Custom/Judicial Standard/Statute

[a] Joint Operating Agreement

[¶34]In the few cases that have taken up the issue, the courts have recognized gas balancing as an industry custom, with a stated preference for balancing in kind. 59 Cases from Oklahoma first recognized balancing as an industry custom and as an equitable manner of dealing with the difficulties of split stream sales. 60 A recent case applying Louisiana law has lent further support to balancing in kind under the joint operating agreement and has noted the operator's obligation is simply one of good faith.

[i] Beren v. Harper Oil Co.

[¶35]In Beren v. Harper Oil Co., 61 the parties entered into a joint operating agreement, with each owner having the right to take [13-30] its share of production in kind. The parties engaged in split-stream sales and came out of balance in their sales. The underproduced party brought an action for an accounting and a money judgment. The Oklahoma appellate court ruled that industry custom was for balancing in kind, but that a cash balancing would be appropriate and would be granted when the well is approaching exhaustion. Here, too, the split connection had been eliminated (there was now only one purchaser), and it was not foreseeable that the situation creating the imbalance would be restored. Thus, cash balancing was applied.

[ii] United Petroleum Exploration, Inc. v. Premier Resources

[¶36]In United Petroleum Exploration, Inc. v. Premier Resources, 62 a federal district court had before it motions for summary judgment. The operator of a unit established by the Oklahoma Corporation Commission sold the entire production of the well for a six-month period to its purchaser. Then the plaintiff began selling its 45% share of the production to a different purchaser at a higher price than the defendant operator. The plaintiff demanded a balancing of production for the six-month period by taking gas in kind or through an accounting from the operator based on the current price, i.e., the higher price at which plaintiff was selling gas. The defendant claimed that the unitization required it as operator to sell gas from the well for the benefit of all owners, and tendered to the plaintiff its proportionate share of the proceeds the defendant had received for the six-month period. The court looked to equitable considerations to determine whether an immediate cash balancing or a balancing in kind was required. Here, said the court, the plaintiffs did not have facilities to take the gas within the six-month period and had refused to permit the well to be balanced by the only means then available, payment of a share of the proceeds. The price received by the operator was the fair market price at the time of production. The court ruled in favor [13-31] of defendant for cash balancing based on the price received by defendant. 63

[iii] Pogo Producing Co. v. Shell Offshore, Inc.

[¶37]In Pogo Producing Co. v. Shell Offshore, Inc., 64 Pogo, Shell, and others had signed an operating agreement governing production from a federal Outer Continental Shelf (OCS) lease. The agreement provided in section 10.4: "Any party's failure to timely take or sell its share of gas production shall not prohibit the other party or parties from producing their share of production, provided that non-producing party or parties may recoup or recover their share from future production and/or in cash by suitable agreement." The other lessees sold their gas to Tennessee Gas while Pogo was obligated to sell its gas to United. When production from the lease commenced in July 1982, United was not connected to the lease. The Pogo/United contract was rescinded in January 1985 with no gas having been delivered to United. Pogo began deliveries to Texas Eastern Transmission Corporation in February 1985. Pogo had never signed a gas balancing agreement because Pogo objected to a provision that required an underproduced party who commenced to take "make-up gas" to remit to the operator any difference in value between the makeup gas and the value of the gas when taken by the overproduced party. In June 1987, Shell transferred its interest in the OCS property, and the assignee (the Hughes-Denny group) assumed Shell's rights and obligations under the operating agreement subject to Pogo's right to recover its imbalance. Pogo brought suit against Shell seeking a cash recovery for approximately 2,000,000 Mcf of underproduced natural gas. The trial court concluded that section 10.4 of the Operating Agreement was only an "agreement to agree," and that in the absence of an agreement, the [13-32] custom and usage of the industry required balancing in kind, and dismissed the complaint as there was no reason balancing in kind would be inequitable to either party. The trial judge commented that the rule favoring balancing in kind, as a general matter, discourages an underproduced party from alternatively demanding balancing in cash or in kind as the market favors him. The Fifth Circuit affirmed. The court relied on Amoco v. Thompson 65 to reject Pogo's contention that, under Louisiana law, a court should order cash balancing at the price received by the overproduced party when the underproduced party, through no fault of its own, is shut in without a market for its gas. 66 Under

Louisiana law, the court said, "balancing in kind is the preferred method of remedying underproduction." 67 Although the court acknowledged that some circumstances might make balancing in kind inequitable, there was no support for that in this case, particularly in view of the fact that the property at issue was not nearing depletion. The court rejected Pogo's claim that Shell breached its obligation to perform its duties as an operator in good faith. While Louisiana law imposed a duty on the parties to perform contracts in good faith, there was no evidence that Shell failed to act in good faith. Shell's insistence that Pogo join the gas balancing agreement, to which all other producers had subscribed, was not evidence of bad faith; it showed only that Shell did not agree to Pogo's terms. The court recognized that Pogo could sue either Shell or the Hughes-Denny group for non-performance, but observed that the Louisiana Civil Code permits a third person, even against the will of the obligee, to render performance unless the obligee has an interest in performance only by the obligor. One final point to note is that because under section 10.4 of the operating agreement, the parties made "an [13-33] agreement to agree," Shell could not choose the method of balancing without Pogo's consent. 68

[b] Pooling/Unitization Order

[¶38]Even if the joint operating agreement does not confer upon an operator the duty to market gas for others, perhaps a duty to market may be imposed by the state in the order that pools property rights. In order to ascertain if such a duty has been imposed, it will be necessary to examine the pooling or unitization statute, the pooling order, and/or the regulations of the agency. If the duty is not express, perhaps it may arise by implication from the statute, the pooling order, and/or the regulations.

[i] Oklahoma

[¶39]The most comprehensive program for dealing with gas marketing problems has been established by the Oklahoma legislature in an act passed in 1983. Oklahoma's House Bill 1221, enacted in May 1983, makes operators responsible to all parties in a unit. 69 The Oklahoma Supreme Court upheld the legality of the Act generally in Seal v. Corporation Commission. 70 The Act is directed toward producers rather than purchasers and toward owners within a single well, as opposed to owners of interests between competing wells in a common source of supply. It entitles each owner to share ratably in the revenues generated by the sale of production and creates a type of cotenancy property interest in such proceeds. The operator of each unit must offer each owner of the well an election, prior to the date of first production, whereby the operator seeks to market that owner's ratable share of production or a designated portion of the production. In the event the owner so elects, the operator must seek to market the owner's share at the best [13-34] price and terms available in the area but not at a price or terms less favorable than those received by the operator. Each electing owner has 30 days in which to reject the offer; failure to reject is deemed an acceptance.

[¶40]If an electing owner receives a contract for sale of only his portion of production, the other electing owners having no contract are entitled to share ratably in the revenue from the contract to the extent of their net revenue interest. The Act provides that the amount of gas produced daily from a well is owned by each owner in the well in proportion to each owner's interest in the well, irrespective of who actually produces the gas. Each owner producing and selling or disposing of gas separately must account to the other owners not selling or otherwise disposing of gas and compensate them for their proportionate part of the gas disposed of or sold.

[¶41]In effect, the Act provides for immediate balancing of all proceeds of production from a single gas well from the date of first production on and after the effective date of the Act. It gives the right of ownership of interests in a gas well ratably to each co-owner in the proceeds generated by a well's production as of the moment the gas is reduced to possession consistent with the rule of capture. The Act specifically recognizes the right of working interest owners to enter into gas balancing agreements. 71 However, one commentator has suggested the possibility that a gas balancing agreement that unduly burdens one party may be subject to an attack on the basis that it is void as against the public policy in Oklahoma incorporated in the statute. 72

[¶42]The Supreme Court of Oklahoma found the purpose of the Act to be a proper function of the legislature under the police power of the state to protect correlative rights. Certain rules of the Corporation Commission implementing the Act were found to be beyond the authority of the Act, but this did not [13-35] disturb the general operation of the statutory and regulatory scheme. 73

[¶43]Hoefling has observed that the immediate concerns of HB 1221 have been largely obviated but that the statute may yet create "great potential liability for operators and overbalanced owners who have either ignored it entirely or have only partially complied with its solicitation, notice, and reporting requirements." 74 This has been referred to as a "ticking time bomb." An operator who fails to comply with the statute may be liable to underbalanced, non-selling owners for treble damages plus interest, costs, and attorney fees. 75 Hoefling reports a case in Oklahoma which has awarded such a remedy. He also reports a case in which a non-operator terminated its own contract and made demand to share revenue under the operator's contract. When the operator refused, a federal court held that the refusal was a violation of the Act and that the operator's disposal of the non-operator's share of gas constituted conversion. 76

[ii] Louisiana

[¶44](1) State ex rel. Superior Oil Company v. Texas Gas Transmission Corporation. In State ex rel. Superior Oil Company v. Texas Gas Transmission Corporation, 77 Jones, Texas Gas Exploration Corporation, and others drilled a well, and in 1955 they entered into a contract for the sale of the gas to Texas Gas Transmission Corporation. Superior had leases on adjacent lands. The Commissioner of Conservation in an order effective May 1, 1957 force-pooled the property covered by the gas purchase contract with adjacent property, some of which was subject to Superior's leases. Well costs were fixed by the Commissioner, and all in the unit were responsible for a pro [13-36] rata share. Superior, which had paid its well costs, sought an accounting for its share of production. The court concluded that Superior "is undoubtedly entitled to be reimbursed for the value of its share of gas," 78 but summary process was not authorized because the amounts were not certain, definite, and fixed. 79

[¶45](2) Proposed Statewide Order 29-Q. With gas shortages in the late 1960s through the early 1980s, there was little occasion to revisit the problem of gas takes in the single well unit. When the gas bubble did appear as an important factor in gas takes in 1982, reliance on the ratable take/common purchaser statute was ruled out as an effective way of dealing with the problems because of the certainty that application of the statute would only lead to lengthy litigation and the likely intervention of the Federal Energy Regulatory Commission. The Commissioner of Conservation at the time (the author) proposed a statewide order in January 1983 and held a public hearing on it on March 23,

1983. Labelled "Proposed Statewide Order 29-Q," the order would have provided that in each order for the unitization of separately owned tracts of land, a paragraph must be included providing that the operator of the unit would have the authority and duty to sell, or otherwise account for, all production from the unit well unless within 90 days from the date of the order or the date of first production from the unit well, whichever was later, any owner wishing to take or sell the production attributable to his interest filed with the Commissioner a declaration of his intent to assume all responsibility for such production after well costs had been accounted for. All existing orders establishing units would have been amended to include the same paragraph, except that April 1, 1983 would have been the date for beginning the ninety-day period. The order would [13-37] have required the operator to adhere to the standard of a reasonably prudent operator in carrying out the terms of the order. Although some small interest owners applauded the proposal for 29-Q, the industry as a whole was very unfavorable at the March 23 hearing and in comments submitted thereafter. Instead of issuing 29-Q, the Commissioner proceeded on a case-by-case basis in several administrative proceedings. 80

[¶46](3) Act 345 of 1984. An act of the Louisiana legislature passed in 1984 provides that the unit operator must account to an unleased landowner within the unit for his share of production from the sale of the unit production. 81 This Act refers only to unleased landowners. It does not indicate that prior to this provision there was no such duty to account to unleased landowners or to others.

[¶47](4) Amoco Production Co. v. Thompson. In Amoco Production Co. v. Thompson, 82 Amoco was the unit operator for 13 producing units in the Morganza Field. Amoco had a gas purchase contract with Columbia Gas Transmission Corporation for Amoco's share of the gas from the field. Columbia also purchased gas from other working interest owners in the units but not under contracts. In 1982, Columbia ceased purchasing gas from others than Amoco in the units, leaving these others without a purchaser. Amoco applied to the Commissioner of Conservation for an order allowing it to market its share of gas [13-38] from the units separately from the non-operators. The then-Commissioner (the author) granted an order allowing non-operators who did not have a balancing agreement to elect to assume full responsibility for marketing their share of natural gas or to authorize the unit operator to market their share of gas. 83 After entry of this order, certain non-operators filed for a rehearing before a new Commissioner of Conservation, defendant Commissioner Herbert Thompson, who rescinded the prior order and issued an order that required Amoco to deliver to each non-operator his share of the proceeds of production in the absence of an agreement to take in kind, and also provided that Amoco and the non-operators would be deemed to have contracted that Amoco would market gas for the others. Amoco filed suit against defendant Thompson seeking that his order be rescinded and the order of the prior Commissioner be reinstated. The trial court rendered what purported to be an interlocutory judgment and remanded certain matters to Commissioner Thompson. The Commissioner issued an amended order requiring Amoco to account to non-marketing owners on the basis of their share of production at the time of sale (with "sale" being defined as the time at which the contract for sale had been entered into), requiring marketing non-operators to account to non-marketing non-operators on the same basis as Amoco, deeming that non-operators had elected to have Amoco market for them for past production and allowing them to elect whether to take gas in kind or have Amoco market for them in the future. The Louisiana

Court of Appeal reversed a trial court judgment affirming Commissioner Thompson's order, vacated and set aside the order of Commissioner Thompson, and remanded the action to the Commissioner for reconsideration in light of the court's holding. The court ruled that the rule of capture had been modified by the conservation statute under units that are formed by the Commissioner of Conservation. In the establishment of a unit, each owner is entitled to the opportunity to recover or receive his or her just and equitable share of production. The gas produced from a compulsory [13-39] unit is initially owned in indivision. 84 This ownership can be the subject of partition. Partition in kind is the preferred method of partition provided for in the conservation law. The Commissioner of Conservation has the authority to modify or deny the right to take in kind. The conservation law authorizes a special species of partition for mineral co-ownership in compulsory units, and the Commissioner has the authority and/or jurisdiction to exercise this power. Because the Commissioner has the power to partition the gas in kind, he must have the power incidental thereto to order balancing; that is, allowing the marketing owners at different times to take 100% of the unit production equal to their just and equitable share at a given point in time. 85 The Commissioner thus has the authority to order an accounting either in kind or in cash, depending on the circumstances, as an incident to the obligation of the [13-40] Commissioner under the conservation law to issue orders affording each owner the right to recover his just and equitable share. The matter was remanded to the Commissioner for determination in light of the authority in him recognized by this opinion. 86

[iii] Mississippi

[¶48]The Fifth Circuit Court of Appeals has rejected a claim that a pooling order of the Mississippi Oil and Gas Board imposes a marketing duty on an operator to royalty owners of another working interest owner in a unit. In Gerard J.W. Bos & Co., Inc. v. Harkins & Co. and Transcontinental Gas Pipe Line Corp., 87 the plaintiff Bos was a royalty owner in a compulsory drilling unit for which the defendant Harkins was the operator. Harkins had a contract for the sale of natural gas with Transco but the lessee of Bos apparently did not. In settlement of a take-or-pay claim, Transco made a payment to Harkins, and Harkins and Transco then terminated their contract. Bos claimed that this settlement caused the well on the unit to be shut down, thereby causing Bos's royalty income to be lost permanently. 88 Bos brought suit in state court but it was removed to federal court. The court rejected Bos' claim that Harkins as operator owed a fiduciary duty to Bos to market for the benefit of Bos.

[¶49]Although the plaintiff contended that Young v. West Edmond Hunton Lime Unit 89 was applicable to its claim, arguing that the order placed Harkins in a position with respect to the royalty owners which prevented Harkins from profiting at their expense, the Fifth Circuit distinguished Young on the ground that the order or plan in Young authorized the defendant to operate the unit and to market the product. The court stated:

[13-41]

[¶50]By contrast, the order in this case authorized the defendant to operate the unit but the order did not authorize the defendant to market the product. That duty was voluntarily assumed by the defendant, presumably with the consent of the other leases, the holders of operating interests. This is a crucial distinction. Assuming, without deciding, that the forced integration and appointment of Harkins as operator imposed on it a fiduciary duty with respect to the royalty owners, that duty is limited by Harkins' authority under the

state's order. In this case, that authority does not include marketing. Therefore, no fiduciary duty with respect to marketing arose from the forced integration. 90

[¶51]The court added that it was unable to envision by what process Bos, the owner of a non-operating royalty interest, acquired rights against persons such as Harkins, who were not its lessees. Having leased to an operator, reserving such rights against it as Bos thought fit, it appeared to the court that it was to that operator Bos should have looked in such circumstances. Since Harkins owed no duty to Bos, it followed that Transco could not be liable to Bos for interfering with the relationship between Bos and Harkins.

[4] Royalty Problems

[a] The Lease Royalty Clause

[¶52]With or without a gas balancing agreement, the problems of payment of royalty when there is a production imbalance in a unit well are difficult. 91 An operating agreement or pooling agreement cannot change the lease obligations of lessee to royalty owner without the royalty owner's consent. 92 Leases [13-42] provide for gas royalty based on the price realized by the lessee or on market value, though it is sometimes quite difficult to tell whether a court will treat the lease as a "proceeds" lease or as a "market value" lease. 93 The judicial treatment of the question of the meaning of market value is a saga much too long to relate here. 94 Even when the lease is a proceeds lease, there can arise questions whether a lessee has fulfilled its obligation to market as a reasonable, prudent operator. 95 There can arise several issues with respect to the quantum of gas on which royalty should be paid.

[i] Payment of Royalty by Overproducer

[¶53]Should an overproducer pay on 1) volume of gas actually sold by that overproducer, 96 or 2) the volume of gas produced by the overproducer that the producer is entitled to take in the absence of any balancing volumes? 97 An overproducer may be [13-43] reluctant to pay royalty on the overproduction volume even though selling it, just as the overproducer may be reluctant to treat such volume as income for tax purposes. 98 This is not simply a matter of greed; it is due in part to the very real possibility of the overproducer having to balance with the underproducer in cash later and then having no practical prospect of recouping an overpayment of royalty to the overproducer's own royalty owner. 99 In a real sense, the overproduction can represent a liability of the overproducer whether there is a gas balancing agreement or not.

[ii] Payment of Royalty by Underproducer

[¶54]Under a "proceeds" type royalty provision of a lease, the underproduced lessee may assert that no royalty is owed as there are yet no proceeds on which to pay royalty. 100 If one [13-44] takes the position that the underproduced working interest owner has no production, then one is faced with the question of lease maintenance. Can the lessee rely on the shut-in royalty clause? This depends on the wording of the clause. There are variations. 101 Some state simply that if gas is not produced, then the lessee may pay shut-in royalty. Others state if the well is shut-in for lack of a market, the lessee may maintain the lease by paying shut-in royalty. Typically, the shut-in payment is much lower than royalty on production would be, whatever the price being received. Leases also provide that the lease may be maintained by other means. Can the underproducer take the position that the operator's actions in producing are operations that maintain the lease even though the lease's shut-in well clause does not apply? Some lessees have been unwilling to pay royalty on take-or-pay payments and settlements. Will we have litigation

over the underproduced lessee who, after receiving a payment for cash balancing from an overproducer, asserts that no royalty is owed on such payments as it is not for production?

[¶55]Assuming that an underproduced party is to pay royalty even though gas is not being sold by the underproduced party, 102 what should be the value or price at which royalty is paid? Under a "value" royalty provision, the underproduced lessee may pay the lessor a royalty based on the overproducer's price received. If the price goes up when the underproducer actually [13-45] sells its share of the gas, must the lessee pay its royalty owner the difference between the actual sale value and the value used in the earlier royalty payment? 103 If the price goes down when the underproducer actually sells its share of the gas, may the lessee recoup from the royalty owner the difference between the actual sale value and the value used in the earlier royalty payment? When a lessee wishes to have the possibility of recoupment in this latter situation, it may be advisable to include a notice to the royalty owner that royalty payment is being made subject to such a recoupment.

[¶56]As will be noted below, it is possible to have the state make the operator or selling producer or purchaser responsible for payment of royalty to all royalty owners. The problem with this approach is the great potential for fraud and abuse. The unscrupulous nonoperator can create large royalties out of its share of working interest, knowing that someone else will have to bear the burdens of such royalty.

[b] Oklahoma: Weighted Average Rule

[¶57]Under the weighted average rule, each royalty owner in a state-established unit has the right to royalty, based on his proportionate share of the total unit, from each working interest owner who markets production from the unit. In a split stream sale, the lessee who receives the higher price pays all royalty owners on the basis of the price he or she receives, as does the working interest owner who receives a lower price. The result is that the lessor of a lessee who receives a higher price will be paid royalties by all working interest owners, the total of which will be less than one-eighth of what that lessor's lessee is receiving.

[¶58]The case establishing the weighted average rule in Oklahoma was Shell Oil Co. v. Corporation Commission 104 (better known [13-46] as the Blanchard case and thus the Blanchard rule). The Oklahoma pooling statute was read to require that 1/8th of the production or proceeds be shared by each royalty owner in the ratio that his acreage bore to the pooled area. The Corporation Commission had formed a 640-acre spacing unit. Shell and Sun each had 320 acres. Shell had a sale at 15 cents, and Sun had a sale at 17 cents. Shell sold all of the gas from the unit well with Sun's consent. Shell paid royalty to its lessors on one-half of the gas sold. Sun's lessors were paid nothing. Sun's lessors sought clarification of the spacing order from the Commission. The Commission said the order created a tract allocation type of royalty communitization which did not modify or affect contracts between lessors and lessees. The court vacated in part the Commission's clarification and ruled that royalty owners of both Shell and Sun were entitled to royalty on production under the pooling statute. 105 Each selling lessee had to pay to each royalty owner (his own and others) his proportionate 1/8th sold, so Shell had to pay 1/8th to each royalty owner on 15 cents and Sun, when it produced, had to pay 1/8th on 17 cents to each royalty owner.

[¶59]The court analyzed the statute as making a distinction between the 7/8ths working interests and the owners of the royalty interests. The production from the 7/8ths working interest was to be allocated to the lessees as if produced by such lessee from his separately owned tract (tract allocation), but the royalty owners were to share in 1/8th of all production from the well in the proportion that their acreage bore to the entire acreage of the unit. The court ruled: "[T]he royalty so allocated to a lessor is not characterized or considered as if produced on such lessor's acreage by a well drilled thereon." 106 The statute superseded the leases to the extent of the royalty obligation identified by the statute. But there was to be a different treatment of royalty in excess of 1/8th, noted the court.

[¶60]The decision did not answer the question of who was responsible or at what rate for royalty in excess of 1/8th, for overrides, and for production payments. Subsequent decisions made it [13-47] clear that the operator who assumed the lease rights of nonconsenting owners also assumed the obligations of excess royalty and production payments. 107 Subsequent legislation has changed the effect and impact of the Blanchard Rule. 108 The 1983 legislation discussed above supersedes the Blanchard Rule as set forth in the Blanchard decision, but does not alter the basic thrust of the decision that the Oklahoma statute's approach is a weighted average for royalty owners, not a tract allocation basis.

[c] Louisiana/Texas—Tract Allocation

[¶61]Under the tract allocation approach, the production from a unit is allocated to each tract in the unit, and each working interest owner is then responsible for payment of royalty for that tract. The courts of Louisiana and Texas have expressly adopted this tract allocation approach to the obligations of the lessee to pay royalty. Thus, if Tract A and Tract B are leased to X and Y respectively, and the two tracts are then included in a single unit, the production from the unit well will be allocated to the respective tracts with X paying royalty for Tract A and Y paying royalty for Tract B. If X gets $1.00 per MMBtu for gas under its contract, that is the basis on which the royalty on Tract A will be paid, and if Y gets $2.00 per MMBtu for gas under its contract, that is the basis on which the royalty on Tract B will be paid.

[¶62]The landmark case adopting the tract allocation approach in Louisiana was Arkansas-Lousiana Gas Co. v. Southwest Natural Production Co., 109 The plaintiff claimed that the [13-48] drilling unit (pooling) order of the Commissioner of Conservation converted the mineral ownership in the entire unit such that every royalty owner was given a definite interest in each and every foot of gas and every barrel of distillate produced from the well and not merely in that portion allocated to the tract in which the owner had an interest. The court rejected this theory, holding instead that the unitization by the Commissioner:

[¶63]has no other effect than to allocate to each tract its pro rata share of the production from the entire unit...; consequently...the lessees of the tracts contained in the unit are obligated to account to their royalty owners only on the basis of the proceeds realized by them from the marketing of the production thus allocated to the tract, and in accordance with the terms of the individual lease contracts existing between the respective lessors and lessees. 110 The court noted that, under the operating agreement, the operator was to be responsible for accounting to all royalty owners. This responsibility arose from the agreement and not from the order or statute; thus the royalty owners would not be bound

by the provision of the operating agreement and could look to their own lease contract provisions for protection of their rights. Private contractual rights in the leases could only be superseded when they were in conflict with the valid orders of the Commissioner of Conservation. The effect contended for by the plaintiff did not relate to conservation and thus would have been beyond the authority of the Commissioner of Conservation if this were the intent and effect of the order.

[¶64]A Texas court has reviewed the practice in other states and has adopted the Louisiana tract allocation approach in Puckett v. First City National Bank of Midland. 111 The pooling here was accomplished by the lessee of the plaintiffs. There were split stream sales from the pooled tracts, with one lessee selling at interstate prices and another at intrastate prices. In adopting the tract allocation approach, the court distinguished the Blanchard Rule of Oklahoma as being based on a state statute not [13-49] applicable in Texas. Although the Arkansas Louisiana Gas Co. v. Southwest National Production Co. case also involved different statutes and an order of the Commissioner of Conservation, the court found its approach more persuasive and similar to Texas law. While the Texas Mineral Interest Pooling Act was not directly applicable, the court suggested the Texas Act was similar to the Louisiana statute and "arguably adopts the tract allocation method in an involuntary pooled unit." 112 The court observed that in both the Blanchard and the Arkansas Louisiana cases, the courts apparently felt that without the respective statutes, the leases would on their own have required the tract allocation method. The plaintiffs further argued that the cross-conveyance theory of Veal v. Thomason 113 required payment of royalty on a weighted average basis. The court rejected this, noting that Veal concerned necessary parties to litigation, and the lease at issue here expressed an intent not to effect a cross-conveyance as to payment of royalties.

§ 13.04 The Balancing Agreement

[1] Preliminary Concerns

[a] Purpose

[¶65]The purpose of the balancing agreement is to make express the relationship of the parties to an operating agreement and provide the manner in which they are to deal with the fact that each has a right to take the gas from a well. 114 It can overcome the inconsistencies that might be found in other provisions of [13-50] the operating agreement; remove difficulties otherwise posed by state statute or conservation order; avoid the problems posed by uncertainty as to how state and federal courts may deal with unresolved legal questions; and overcome the effects of court decisions that impose requirements that are disadvantageous to marketing or nonmarketing parties. To accomplish these ends, the balancing agreement should address those problems that are anticipated to arise among the parties during the life of the operating rights that are the subject of the agreement. It should be fair and advantageous to all parties to the agreement, taking into account the varied interests that they may have and circumstances to which they may be subject.

[¶66]The gas balancing agreement is best suited to resolve differences among the parties when gas marketing problems occur that are largely outside the reasonable control of the producers, such as the pipeline purchaser of one party declining to take gas for a period. The gas balancing agreement may still contain uncertainties, but it solves more than it creates. 115 Drafting the specific provisions of a gas balancing agreement is like drafting other contracts: it is a matter of attempting to anticipate all the contingencies that may

arise under the agreement and allocating the risk of each contingency to the appropriate party to the agreement. Model gas balancing agreements are being prepared by the American Association of Petroleum Landmen, and the American Petroleum Institute; the Rocky Mountain Mineral Law Foundation committee has completed its Form 6 Gas Balancing Agreement. 116

[b] Coordination with Gas Purchase Contracts

[¶67]Which comes first, the joint operating agreement/gas balancing agreement or the gas purchase contract? Either agreement can precede the other, and in either event it would be desirable that the gas purchase agreement make it clear that the purchaser's rights to take gas are subject to an existing or future gas balancing agreement under which another owner may have a [13-51] right to makeup gas, thereby reducing the volume. Likewise, producers may wish to make it clear that the purchaser's take obligations are to purchase all that a working interest owner has the right to produce, including volumes that may be taken when the seller has the right to overproduce under a gas balancing agreement.

[¶68]In order to accomplish balancing among the parties to a joint operating agreement, it will be necessary for each party to have the data regarding production volumes and prices; the gas purchaser will be the person with this information. The gas seller should provide in the purchase agreement that the buyer will furnish all such data necessary upon demand by the seller, including an obligation that it be furnished to the operator. 117

[¶69]One can anticipate that problems will arise from the interrelation between take-or-pay obligations of gas purchase contracts and gas balancing agreements, but efforts to solve them in advance may tax the drafter's ingenuity. 118 For example, can an underproduced party get take-or-pay money from a purchaser who fails to take and also get cash balancing; assuming the purchaser has makeup rights, what if those are lost because of the gas balancing agreement? 119 If a purchaser has made take-or-pay payments and later wishes to make up gas but is prevented from doing so later because another party has overproduced, does the purchaser have any rights where the underproducer has received cash balancing from the overproducer? An attorney advising a client whether to enter into a gas balancing agreement may need to inquire whether being in an [13-52] overproduced status may provide a purchaser with a defense to a take-or-pay claim. That is to say, a producer may be unable to tender gas for delivery if a gas balancing agreement prevents the producer from having the gas available for the purchaser, whether the purchaser is actually capable of taking the gas or not. In fact, a seller of gas may need to be sure that it can have gas for delivery lest it be in breach of a delivery obligation because of a gas balancing agreement.

[¶70]The purchaser of gas should be aware of the potential for strategic behavior by producers in relation to purchasers. For example, Producer 1 might have a contract at $1.00 with a buyer and Producer 2 would have a contract at $2.00 with a different purchaser. Producer 1 and Producer 2 would both be better off letting Producer 2 sell and then cash balancing with Producer 1. Producer 2 would have the use of the money until the balancing had to be made and Producer 1 will enjoy a higher price even though it may be delayed in getting the money. The buyer from Producer 1 will want to concern itself whether the producers are using the gas balancing agreement to disadvantage the purchaser.

[¶71]Many gas purchase contracts require the purchaser to take gas at such a rate that the seller remains in balance within a unit or to prevent drainage. The gas balancing agreement provisions that give recognition to a storage concept and a right to makeup production should not be seen as modifying the gas purchaser's obligations to maintain the seller's balance or to prevent drainage, for the storage is not a "right." So far as the other working interest owners are concerned, each party to the gas balancing agreement has a duty to take the gas.

[¶72]A case taking up the relation between the ratable purchase obligation of a purchaser and the gas balancing agreement is HBOP, Ltd. v. Delhi Gas Pipeline Corp. 120 In this case, the plaintiff claimed that the gas purchaser failed to purchase gas ratably, thereby occasioning drainage. 121 The court noted: "Reserve equity balancing is a common, inherent, vexatious [13-53] accounting problem between split-stream owners." 122 The plaintiff was already out of balance with the other owners when the gas purchase contract was signed. The court reversed a trial court judgment for plaintiff, ruling that the contract provision requiring the purchaser to keep HBOP ratable did not impose a short-term duty requiring the defendant to resolve imbalances between working interest owners. It was instead a three-tiered, descending priority obligation: 1) a continuous obligation to HBOP and others in the field to prevent offset drainage; 2) to retire pre-contract imbalances within a reasonable time; and 3) to cooperate with the operators over the term of the contract to keep HBOP ratable on current purchases between intra-unit wells and between owners within each well. 123

[¶73]Several cases have been litigated in which a party to a gas balancing agreement has claimed "tortious interference" with a gas balancing agreement by a gas purchaser or has asserted a claim of tort arising out of a gas balancing agreement. In Transcontinental Gas Pipe Line Corp. v. American National Petroleum Co., 124 a trial court award of $16,000,000 for tortious interference with a gas balancing agreement was reversed on appeal. Transco had gas purchase contracts with plaintiffs. In response to its market problems, Transco imposed a policy of taking only three percent of gas capacity of each producer who refused to waive any outstanding liability Transco owed for breach of take-or-pay obligations. This policy led to imbalances when Transco failed to take minimum monthly requirements from the plaintiffs. Transco refused plaintiffs' demands to bring them into balance with others in the fields where the wells in question were located, asserting that the parties could be brought into balance just by reallocating payments for gas already taken. The appeals court upheld the trial court award of damages for breach of contract but reversed on the tortious interference claim because exemplary damages were not recoverable for breach of the gas purchase contract and because no actual damage from interference was established. While the [13-54] appeals court did not doubt that Transco used leverage as a party to the gas purchase contracts to interfere tortiously with a gas balancing agreement to which it was not a party, the actual damages to restore the plaintiffs to the position they would have been in had there been no interference would be the difference between what the plaintiffs actually received for their gas and the amount which they would have received had there been no tortious interference. Without evidence showing there was actual damage, the award of exemplary damages for tortious interference could not stand.

[¶74]In Wilkinson v. Mercantile National Bank at Dallas, 125 plaintiffs were working interest owners in a field in Mississippi. They had entered into a gas balancing agreement

with Tomlinson. Tomlinson was selling gas to Transco, but plaintiffs had no contract with Transco. Tomlinson became overproduced under the joint operating agreement and gas balancing agreement because of Transco's takes. Plaintiffs eventually were able to sell gas to Tennessee Gas Pipeline. They brought this suit against the working interest owners who were selling to Transco, alleging that they were entitled to be brought into balance and seeking a declaration they were entitled to all gas remaining in the ground until they were brought back into balance. They also sought a declaration that if the pool became depleted before they came into balance, then Transco should pay them back in kind and, if not receiving gas in kind, the plaintiffs should receive cash balancing from the overproduced parties. Defendant Mercantile National Bank (MBank), which had lent money to Tomlinson, was requested to disgorge all monies given it by Tomlinson attributable to overproduction in order to provide a fund for cash balancing. MBank denied that the chancellor had jurisdiction over it, and the chancellor agreed. The plaintiffs claimed that MBank was guilty of conversion because it refused to recognize plaintiffs' interest in the overproduced gas and in monies received by MBank attributable to overproduction. The Mississippi Supreme Court found that there was jurisdiction under the Mississippi long-arm statute, remanding the case for further proceedings.
[13-55]

[2] Rights of Selling Parties

[¶75]Each gas balancing agreement will expressly provide that where a party to the agreement is unable to take its share of gas production, the other parties may sell all of the gas produced by the area or well subject to the agreement. 126 The general language is permissive, not mandatory. A party should not be forced to overproduce. 127 Likewise, there should be no right to overproduce where another party has a market and wishes to take gas. The gas balancing agreement may expressly provide that the selling party is the owner of the gas sold and that the non-producing party's share of gas is in storage. Is there a duty to take steps to stay in balance? There are reasons why the parties to a gas balancing agreement would want each party to have the duty to take gas rather than a right of storage. One authority has observed: "A party who has a market should not be forced to overproduce against his will. He may want to spread his production out over the life of the well for tax reasons or because he thinks gas prices will rise." 128

[¶76]The gas balancing agreement's function is not to permit or encourage strategic behavior. Clauses can be used to discourage [13-56] such behavior. Most parties will probably want to have the agreement structured so as to encourage parties to take their proportionate share of the gas as it is produced and to encourage makeup in kind rather than in cash when there is an imbalance. 129 That is to say, the gas balancing agreement is not a mechanism to allow the parties to it to engage in market speculation. For example, one party may seek to use short-term contracts to maximize revenue, typically by foregoing takes and becoming underproduced in summer months when the price of gas is low and then making up gas takes in the winter when prices are seasonally higher, thereby diminishing the production and revenue of the other parties. 130 The gas balancing agreement can specify that there is a duty for each party to take its share of gas, and other provisions can encourage the accomplishment of this by discouraging a party from deliberately seeking storage. There should be no right to store gas in the sense of a party choosing to be underproduced when that party could have a market for gas. The overriding purpose of the joint operating agreement is to obtain production, not to prevent

production. No party should be able to defeat this purpose, directly or indirectly, unless all agree to it. As brought out earlier, there is the problem of allowables and drainage by competitive units in the same reservoir. The party with a market who does not wish to be in an overproduced status will be forced into that circumstance or may suffer drainage and cancellation of allowables if a nontaking party insists on having gas stored. This paper avoids using the term "gas storage and balancing agreement" so as to avoid the implication that there is a right to store. 131

[¶77]There is sometimes discussion of a duty of the operator to maintain balance in the unit or under the joint operating [13-57] agreement. 132 It appears doubtful that the operator has such a duty unless it is expressly provided in the joint operating agreement or unit agreement. The operator's duties generally relate to production of oil and gas, not marketing. Each nonoperator has a right to take his share of gas in kind. Were the operator to prevent an exercise of this right in order to maintain balance among the parties, the operator would likely be violating the express right of the nonoperator to take in kind. Indeed, it may be the duty of the operator to permit imbalances to arise. Again, the typical joint operating agreement makes no requirement that the operator purchase or sell the gas of a nonoperator to maintain balance, and the parties to a gas balancing agreement are unlikely to intend to impose such a requirement.

[3] Manner of Calculating Under- and Over-Production

[a] Mcf v. MMBtu

[¶78]Most in-kind balancing has been done on an Mcf basis, 133 but the trend is to use of MMBtu. 134 This corresponds to the use of MMBtu in gas price controls and gas purchase contracts. Balancing on the basis of energy content poses more issues of variables in pricing and on the Btu content of gas actually being measured, but reduces problems associated with off-lease removal of liquids. 135

[13-58]

[¶79]Gas balancing agreements generally provide that liquids will be allocated in proportion to the ownership interests notwithstanding the gas storage. Natural gas liquids are capable of being sold in much the same manner as oil production. Because of this and because the liquids content of production is likely to change during the life of the reservoir, gas balancing agreements generally provide that liquids will be allocated in proportion to the ownership interests notwithstanding the gas storage.

[b] Contract Area, Formation, Unit, or Well by Well?

[¶80]A joint operating agreement or pooling may cover numerous wells, different formations, and different categories of gas. If gas balancing is attempted across wells, formations, and categories, balancing may be long delayed and produce inequitable results. 136 Another problem when an operational area is covered by a joint operating agreement is treatment of non-consent operations or wells. Campbell suggests the possibility of use of a separate balancing agreement by the participants in the non-consent operation which would allow two balancing operations; this would be easier to conduct than trying to balance between consent and non-consent operations. 137 There is the problem of different natural gas categories. If one is balancing on a field basis or even a well basis where there are multiple completions within a single well, the gas which is being made-up by an underproducer may be a different category of gas from that the overproducer produced. The balancing gas may be worth less or more than the gas which

had been produced by the overproducer, even though it is the same volume or same energy content.

[¶81]In looking to a unit basis for balancing, one should observe that it is not uncommon for a drilling or spacing unit (or proration unit) to have more than one well on it. This can come [13-59] about through the conservation agency allowing infill drilling. 138 An agency order despacing and respacing to smaller units 139 or larger units 140 can pose problems for balancing. The order could be treated as a balancing event, i.e., in the same manner as a well depletion that triggers cash balancing, unless the parties expressly agree to a carry-over of balancing in kind in the revised unit.

[¶82]If one looks to each well as the basis for balancing, it is necessary to observe that a well may be produced from one formation then recompleted in another. This also may draw the balancing out over a long time. In addition, the quality of the gas may vary from formation to formation, exacerbating the problem of the energy content of the gas referred to previously. The agreement should make it clear the treatment to be given to production from different reservoirs or formations when it is commingled in the wellbore. 141 The most sensible approach this author has seen to choosing the basis for balancing has been to look to the smallest division possible, that is to establish balancing rights with respect to each formation in each well. 142

[13-60]

[c] Duty of Operator/Nonoperators to Maintain Records—Sharing of Information

[¶83]Whatever the basis of calculating imbalances and the manner of balancing, it will be necessary to keep records of production and takes. If there is to be balancing by cash payment at some point, there will also need to be a record of price(s) received for gas that has been produced. Traditionally, the operator has had the responsibility of maintaining records of production, but the operator may not have the data on sales where there have been sales by a nonoperator. The administrative burden of keeping up with production and sales is increasingly complex. 143 Where, for example, a pipeline is performing both merchant and transportation functions for different nonoperator working interest owners from the same well, it is unlikely that the operator will have data on whose gas is being produced. The records showing imbalance would have to come from the pipeline and the nonoperators. In light of the variety of marketing arrangements that may now be made, it is probably desirable to make all parties to the balancing agreement responsible for maintaining records and sharing information. One method would be to require that the information be submitted monthly to the operator. 144 Otherwise, the time for balancing may arrive and the information does not exist that is necessary for determining the amounts for balancing. Disputes are likely to arise upon balancing over the data used, and it may also be desirable to provide for arbitration of these disputes. 145 Another reason for having all data collected on a current basis is that an underproduced party may need sales data of overproducers for calculation of the royalty the underproducer should pay to its [13-61] own royalty owners. Some sellers and purchasers of natural gas may not want to share data on sales, but such sharing will be a necessity for gas balancing to operate.

[d] Adjustments—Operating Costs

[¶84]Each joint operating agreement and gas balancing agreement will generally require all parties to the agreement to contribute their proportionate share of operating costs regardless of the production status of the party, whether under- or overproduced. One case has arisen over the matter of operating costs. In Andrau v. Michigan Wisconsin Pipe

Line Co., 146 the Wyoming court held that under the gas balancing agreement, the operator had the right to foreclose on the working interest of a nonoperator who had not paid costs. There was no fiduciary obligation of the operator that would require the operator to accept the nonoperator's "gas in the bank" in discharge of the debt at $7.50 (average sales price) when the current market value was $2.50.

[4] Method of Balancing—In-Kind and Cash

[a] Periodic

[¶85]There can be benefits of periodic cash balancing quarterly, semiannually, annually, or biennially. Such periodicity would reflect the time value of money and avoid the accrual of liabilities. 147 An underproducer would be less likely with periodic balancing to find that an overproducer has gone bankrupt owing a large amount to the underproducer or has simply abandoned the lease and has said to the underproducer that it can now take in-kind until depletion. For the overproducer, there may be some advantage to periodic balancing in that the overproducer may receive overall a better price for a larger [13-62] quantum of production at a later date. That is, the overproducer can wipe the slate clean at this year's low prices and not have to be subjected to lowered production during makeup up at next year's higher prices. But there are tax disadvantages (see § 13.04[4][d], infra) to periodic balancing. While there is some discussion of periodic balancing in the literature, 148 there is little indication that it is a favored method of balancing. 149

[¶86]A party to a gas balancing agreement may wish to consider incorporating the idea of a "balancing event" in the agreement. When an overproduced party sells or otherwise conveys its interest in the properties subject to the joint operating agreement or becomes insolvent, this event could be treated in the same manner as reservoir depletion. This would make it less likely that the underproduced party will be left with contract claims that are difficult to enforce. The same could be applied to a unit revision whether it be allowing additional wells, changing of unit boundaries, or a change in sand definition.

[b] Make-up Rights

[¶87]The make-up rights of an underproduced party will be limited so that an overproduced party does not entirely lose a stream of production/revenue, since it is necessary for overproducers to continue with their share of operating costs and to pay royalty. 150 A common provision is a 25% limit of the overproduced parties' gas. 151 Notice of intent to make up will [13-63] generally be required. In circumstances where the 25% limit would mean that the underproduced party will never be able to make up in kind, as where the reservoir is nearing depletion, it may be desirable to include an escape mechanism allowing the underproducer to take more, up to and including the full stream of production. 152 A party likely to be overproduced might not want such a provision in a rising market.

[¶88]The gas balancing agreement might have a definition of make-up gas that would express the character of the gas being produced by the underproduced party; this can become important for ultimate cash balancing on depletion. When a party begins taking gas after having no sales for a time, does the make-up consist of catching up on all gas in storage first or only that percentage over the proportion of the gas above the party's normal share? For example, if I am an underproduced 50% working interest owner and my make-up rights allow me to take 50% of the overproducer's share until gas in storage has been made-up, does the 75% of the gas stream I am now taking represent that volume

of gas being taken out of storage or am I taking my current 50% plus making up a volume in storage equal to the volume represented by the additional 25% of the gas stream I am now taking? Assuming the latter treatment, what gas "in storage" is being made up first? Depending on the accounting method adopted for valuing balancing, the difference can be important, as will be seen in the next section of this paper.

[c] Value for Cash Balancing

[¶89]It should be obvious to most people that one is balancing gas volumes or Btus, not values. That is to say, if working interest [13-64] owner A sells his gas for $2.00 and working interest owner B makes up his quantity of gas and sells his make-up gas for $1.00, A and B do not have to balance out what they received for gas. The value for cash balancing is the value to be placed on the gas not made up, not the gas that was made up. The value to be used for cash balancing might be: 1) the price actually received by the overproduced party; 2) the fair market value of the gas not taken by the underproducer; or 3) the price that otherwise would have been received by the underproduced party. 153 The latter two are difficult to administer and are fraught with further problems that are likely to result in litigation; moreover, they also involve a determination of a time for calculation of the value (e.g., fair market value at the time the underproducer should have taken gas or fair market value at the time of depletion). Use of fair market value might lead to a windfall for the underproducer when it is shown to be more than the price received by the overproducer and more than the underproducer could actually have obtained in a sale. 154 Use of fair market value might lead to a windfall for the overproducer when it is shown to be lower than the price actually received by the overproducer. The price actually received can present problems if there is indication of overreaching or self-dealing by the overproduced party, but this may be avoided by specifying use of fair market value in the absence of a bona fide or arm's length contract for sale by the overproducer. 155 The price actually received is presumptively the fairest method [13-65] of calculating the value and the simplest to administer because there will be actual reliable data. 156 Moreover, it certainly should not be objectionable where the underproducer could have sought and obtained its own sale. Nor should the price received be objectionable to the overproduced party when the balancing is at depletion, for in most instances the overproducer will not have foregone any sales because of the accounting to the underproducer. Some agreements use the price received by the overproducer but place a cap on the value so that it does not exceed the amount the underproduced party would have received under the terms of its own gas sales agreement (assuming there was such an agreement), less applicable taxes and royalties if paid. 157 Value could include the time-value of money or interest, but this is seldom employed.

[¶90]The gas balancing agreement may address an accounting method for determining which gas was stored and which was produced using last-in-first-out, first-in-first-out (also referred to as order of accrual), or average basis. 158 The accounting method addresses the problem of gas partly made up in kind and partly subject to cash balancing. Rather than try to describe accounting procedures, I will use my own examples of [13-66] my understanding of how differing accounting methods would operate.

[¶91]Simplified Applications

Month:	Jan.	Feb.	Mar.	Apr.	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.

Price:	$2.00	$2.00	$2.00	$2.00	$1.00	$1.00	$1.00	$1.00	$1.00	$1.00	$1.00
A's Vol.:	100Mcf	100Mcf	100Mcf	100Mcf	100Mcf	25Mcf	25Mcf	25Mcf	25Mcf	25Mcf	25Mcf
B's Vol.:	0 Mcf	0 Mcf	0 Mcf	0 Mcf	0 Mcf	0 Mcf	75Mcf	75Mcf	75Mcf	75Mcf	75Mcf

[¶92](1) When B begins to take gas in July, what gas is B producing?
[¶93](a) Is he producing 75 Mcf that was in storage? or
[¶94](b) Is he producing 25 Mcf from storage and 50 Mcf not in storage?
[¶95](2) Since B was producing some gas from storage, which gas from storage was being produced for purposes of calculating A's ultimate cash liability?
[¶96](a) The last gas put in storage, i.e., July's 50 Mcf? or
[¶97](b) The first gas put in storage, i.e., January's 50 Mcf?
[¶98]Application 1. Assume that we answer both 1 b) and 2 b) affirmatively. B's July production was 25 Mcf from storage, and that is part of the 50 Mcf stored in January. The 25 Mcf makeup of B in August is the remaining 25 Mcf stored in January. The 25 Mcf makeup of B in September is 25 Mcf of the gas stored in February. And so forth. The result of this progression is that on depletion at the end of December, B will get cash balancing for the gas entering storage in April, May, and June with A's actual price received in those months: April 50 Mcf @ $2.00 plus May and June 100 Mcf @ $1.00 for a total of $200 owed by A to B.
[¶99]Application 2. Assume that we answer both 1 b) and 2 a) affirmatively. B's July production was 25 Mcf from storage, and that is part of the 50 Mcf stored in June. The 25 Mcf makeup of B in August is the remaining 25 Mcf stored in June. The 25 Mcf makeup of B in September is 25 Mcf of the gas stored in May. And so forth. The result of this progression is that on depletion at the end of December, B will get cash balancing for [13-67] the gas entering storage in January, February, and March with A's actual price received in those months: 150 Mcf @ $2.00 for a total of $300 owed by A to B.
[¶100]Let's compare the differences here in a falling market as described above. If A and B had both sold equal volumes through the period at the prices shown, they would each receive $800. As shown in Application 1, A receives $950 and B receives $650. As shown in Application 2, A receives $850 and B receives $750. In either instance, B would have been better off producing when B should have produced by taking in kind, assuming of course that the same price was available to both parties.
[¶101]Now let's change the numbers so that we have a rising market.

Month:	Jan.	Feb.	Mar.	Apr.	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.
Price:	$1.00	$1.00	$1.00	$1.00	$2.00	$2.00	$2.00	$2.00	$2.00	$2.00	$2.00	$2.00
A's Vol.:	100Mcf	100Mcf	100Mcf	100Mcf	100Mcf	25Mcf	25Mcf	25Mcf	25Mcf	25Mcf	25Mcf	
B's Vol.:	0 Mcf	0 Mcf	0 Mcf	0 Mcf	0 Mcf	0 Mcf	75Mcf	75Mcf	75Mcf	75Mcf	75Mcf	75Mcf

[¶102]Application 3. Again assume that we answer both 1 b) and 2 b) affirmatively. B's July production was 25 Mcf from storage, and that is part of the 50 Mcf stored in January. The 25 Mcf makeup of B in August is the remaining 25 Mcf stored in January. The 25 Mcf makeup of B in September is 25 Mcf of the gas stored in February. And so forth. The result of this progression is that on depletion at the end of December, B will get cash balancing for the gas entering storage in April, May, and June with A's actual price received in those months: April 50 Mcf @ $1.00 plus May and June 100 Mcf @ $2.00 for a total of $300 owed by A to B. B's total revenue: $1200. A's total revenue: $800.

[¶103]Application 4. Again, assume we answer both 1 b) and 2 a) affirmatively. B's July production was 25 Mcf from storage, and that is part of the 50 Mcf stored in June. The 25 Mcf makeup of B in August is the remaining 25 Mcf stored in June. The 25 Mcf makeup of B in September is 25 Mcf of the gas stored in May. And so forth. The result of this progression is that on depletion at the end of December, B will get cash [13-68] balancing for the gas entering storage in January, February, and March with A's actual price received in those months: 150 Mcf @ $1.00 for a total of $150 owed by A to B. B's total revenue: $1050. A's total revenue: $950.

[¶104]Now comparing the differences here in a rising market as described above: If A and B had both sold equal volumes through the period at the prices shown, they would each receive $1000. As shown in Application 3, A receives $800 and B receives $1200. As shown in Application 4, A receives $950 and B receives $1050. In either instance, B would have been worse off producing when B should have produced by taking in kind, assuming of course that the same price was available to both parties. In a rising market, B is better off having left gas in storage under the balancing agreement and A suffers because of B not taking.

[d] Tax Aspects

[¶105]There are tax consequences to gas balancing which are not fully resolved as yet by the Internal Revenue Service (IRS). Two methods of reporting income might be considered. 159 First is the Entitlement Method, where each producer counts as income its ownership percentage of production regardless of what each party takes or sells. 160 The theory appears to be that each party has earned income even though it has been "assigned" to the overproduced party. 161 The method produces [13-69] considerable problems: should interest be imputed? How is the underproduced party's "income" to be valued, especially if the actual sales prices in different years differ markedly? How does an underproduced party pay the taxes if it does not have the money? The second method is the Receipt Method, where each party reports what it actually takes, regardless of ownership percentage. The concept is that the gas balancing agreement effects a partition-in-kind. It is, of course, much simpler, and it is easier to administer. If this method is recognized for federal income tax purposes, the owners each have ownership in distinct groups of molecules. The approach taken by the IRS may depend on the property theory of partition of the state where the gas is produced. If the underproducer pays the royalty owner, then it may reflect that the Entitlement theory is really being followed, that this is the economic substance of the transaction. Likewise, the payment of operating expenses while underproduced may support the Entitlement theory. Parties to a gas balancing agreement may consider agreeing to a consistent reporting method and/or to indemnification for tax liabilities.

[5] Treatment of Imbalance at Depletion or Other Balancing Event

[a] Common Pattern

[¶106]A common pattern in gas balancing agreements is to set a manner for determination of depletion, have the overproduced parties submit statements showing the amount of overproduction and the money received for such overproduction, then have the operator compile a statement showing these amounts. 162 [13-70] The statement is circulated to the parties, and overproducers pay the underproducers the amount owed under the gas balancing agreement. What if an overproducer refuses to pay up? Under most joint operating agreements, the operator is not to be liable for its actions except as may result from gross negligence or misconduct. Should the operator be required to bring suit against the overproduced nonoperator? 163 In most agreements, it is likely that the operator will not assume such burdens, and it will thus be left to underproducers to seek their remedies directly against overproducers.

[¶107]Several cases have arisen which illustrate the operation of a gas balancing agreement and the sort of problems that can be encountered upon depletion in calculating the money owed for balancing, if any.

[b] Chevron v. Belco

[¶108]In Chevron v. Belco, 164 it was held that the owner of a one-eighth royalty who had elected to take royalty in-kind had no [13-71] right to a cash balancing after reservoir depletion when the gas balancing agreement it had entered into provided only for in-kind balancing; the royalty owner had failed to market its share of the gas prior to depletion. Chevron had farmed out an oil and gas lease on federal offshore lands to Belco, reserving a one-eighth overriding royalty. Belco's operations resulted in gas production, which Belco sold to Tennessee Gas Pipeline Company. Chevron elected to take its royalty in kind rather than to accept an offer of payment in cash from Belco. In 1975, Chevron and Belco entered into a balancing agreement. Chevron got an agreement to sell its gas to Tennessee Gas Pipeline also, but it did not receive authority for such sale from the Federal Energy Regulatory Commission until October 1979, four months after the field had stopped producing. Chevron demanded an accounting from Belco for one-eighth of the proceeds of Belco's sales from the field. Belco refused on the ground that the balancing agreement did not provide for such an accounting. The Fifth Circuit held the balancing agreement provided the exclusive means for Chevron and Belco to bring their balance into account, an in-kind taking. The parties did not leave open the possibility that cash balancing might nonetheless be used. The contract itself allocated the risk of depletion to the out-of-balance party. The equitable claim of unjust enrichment cannot supersede the contrary terms of the contract, said the court. The Belco decision has been criticized as an "overly mechanical application of the balancing agreement...." 165

[¶109]The Belco decision was followed in an interesting unreported case that involved a reversal of the typical balancing agreement. [13-72] In Shell Offshore, Inc. v. M. H. Marr, 166 Shell, Marr, and others entered into a joint operating agreement for development of a gas field. Marr put up $3,000,000 for his share of drilling and operation costs. Shell was unable to process all of the gas and was delayed in constructing a gas processing plant. To resolve a dispute over Marr's contribution, Shell advanced Marr $6,000,000 over a two-year period under an agreement that Marr was to pay back that amount from the proceeds of one-half of his working interest in specified wells, with Marr having the option of extinguishing the debt in cash. After the market for gas became

depressed, Shell brought suit contending Marr had to pay the amount in full and that Marr had repudiated the agreement. The court upheld Marr's position that the debt was to be paid only from production (unless Marr elected to pay in cash). If Shell could not recoup the money from production, the loss was to be borne by it alone under the agreement.

[c] Killgore v. Texaco

[¶110]In Killgore v. Texaco, 167 Killgore sued Texaco, the operator of a gas well in which Killgore had a 7.52948% working interest, asserting two claims: damages for Killgore's underproduced share (including damages for delay in the delivery of plaintiff's share), and payment for his share of plant products from the gas. The initial judgment on liability was rendered in 1986 and the damage decision was rendered in 1987. Texaco was receiving an average price between 35 cents and 37 cents per Mcf for the gas from the subject well. The plaintiff's sales were closer to $3.00 per Mcf. For three months, Texaco refused to deliver to Killgore 150% of his allocated share as Killgore's makeup gas under the gas balancing agreement. For failure to make such delivery, Texaco owed Killgore the value that Killgore could have received by selling such gas, the price of which was nearly ten times the Texaco price. Texaco then overdelivered gas for Killgore's account following its failure to deliver or allocate any gas from June to August 1980. The balancing agreement applied the additional make-up "to reduce and pay [13-73] back the total volume of deferred gas." The court applied the overdelivered gas similarly; Texaco was allowed a credit or offset for the overdelivery. Notwithstanding the overdelivery during certain months beyond the requirements of the balancing agreement, Texaco had to fully compensate Killgore for his share of gas remaining unrecovered when the well depleted in 1982. 168 Texaco actually received a weighted average price of 38.7017 cents per Mcf for plaintiff's underproduced share, net of severance tax, and this was the basis for compensation awarded by the court.

[6] Accounting to Royalty Owners: The Relation of Working Interest Owners to One Another and to Their Royalty Owners

[¶111]Most gas balancing agreements provide that each working interest owner will pay its royalty owners as though the working interest owner were taking its full share of gas and selling it under its own contract. 169 Some agreements provide that the parties actually taking gas and selling it pay the royalty due on the gas. Numerous problems can arise with either approach. If each working interest owner must account separately to its royalty owners, where does an underproducer get the cash and what is the basis of the payment? If the operator were to account to the royalty owners of other owners, might that operator find itself stuck with all the problems of the market value controversies? 170 The issues have adequately been [13-74] framed in an earlier section of this paper. The Oklahoma approach has an appeal since it has a certain simplicity insofar as producers are concerned, though I feel sure that purchasers who have the responsibility for paying royalty to all parties would not find it simple to implement. Advising producers, I would probably conclude that the usual approach of making each working interest owner responsible for all royalty attributable to its interest is a sound one. It makes less likely an assertion that the gas balancing agreement is a third party beneficiary contract giving rise to claims by royalty owners of a nonmarketing working interest owner against marketing working interest owners. It also avoids having the overproducers interpreting the lease provisions of the underproducer. An overproducer might look at the lease of an underproducer, interpret it as a "proceeds" lease, then

conclude no royalty is even owed until the underproducer actually achieves production. Moreover, it has the added aspect that it provides an incentive for underproducers to seek a market.

[¶112]One case has been reported that raises (without resolving) the question of payment of royalty to lessors under a gas balancing agreement. In Frey v. Amoco Production Company, 171 the plaintiffs were royalty owners who sought a share of take-or-pay payments made by a pipeline to the lessee. The plaintiffs further contended that they were entitled to royalty on benefits Amoco received from overproduction under certain balancing agreements with other working interest owners and other "side deals." The court ruled that the plaintiffs' motion for summary judgment on overproduction issues was premature because facts were in dispute whether and to what extent there was overproduction or "side deals" in connection with the agreements.

[7] Storage Charge

[¶113]Some agreements include a charge for the storage of an underproducer's gas. 172 Such a clause can be used to discourage [13-75] strategic behavior, such as deliberately delaying sales in order to speculate on the changing market value of gas. It can be regarded as harsh where the failure to take by the underproducer was not attributable to its own decision-making. 173 One may question whether a party who is likely to be an underproducer has any incentive to sign a gas balancing agreement that features such a provision.

[8] Other Matters

[a] Recordation

[¶114]Recording the joint operating agreement and gas balancing agreement seems like a sensible thing to do. Precisely what it will accomplish, I cannot assert with any confidence. It may provide notice to gas purchasers of the existence of a claim to a share of gas that has not been produced by the underproducer, though the recordation would not indicate the extent of rights that might be asserted. 174 It may preserve some rights in the [13-76] event the operator or an overproducer becomes bankrupt. 175

[b] Refund Obligations

[¶115]The circumstance generally contemplated here is a regulatory requirement of the Federal Energy Regulatory Commission that money paid by a purchaser to a producer be refunded as in excess of an authorized price. Where there has been cash balancing based on a price or value found to be excessive, the overproducer who overpaid the underproducer can recoup that amount. 176

[c] Standard

[¶116]The gas balancing agreement may provide that the operator will carry out the terms of the agreement as would a reasonably prudent operator. This may impose a different standard of care than the one specified by the joint operating agreement. If this is what the parties intend, they perhaps should call attention to the fact that they are specifically seeking to make the gas balancing agreement standard of care prevail over that of the joint operating agreement. 177

§ 13.05 Conclusion

[¶117]With some degree of confidence, I will predict that papers at future institutes will review a greater volume of litigation on gas balancing and gas balancing agreements than this paper has reviewed. The greatest hope of avoiding controversy and litigation over gas balancing agreements will be a model form that becomes an industry standard. The next

best hope would be a suggestion that when you apply for a pooling order, you request a gas balancing paragraph as part of the order. The paragraph would spell out the manner in which balancing would take place. Such an order could allow and require the operator to market all production from the unit unless the parties have entered into a gas balancing agreement. Once the order is [13-77] entered, the operator will be able to market the production without a nonmarketer coming back and revoking the authorization. The nonoperator cannot complain if he had an opportunity to assume responsibility for marketing his own share of gas. Since it is an order of the agency, the operator is likely to gain some immunity from liability, and disputes arising from the order would probably come under the jurisdiction of the agency. The agency could periodically review the actions of the parties under the order and order cash balancing should it be appropriate. Likewise, the agency could provide a mechanism for payment of royalty should that be necessary to protect the correlative rights of any party. It seems that such an order from the state would defeat an effort by the IRS to apply the assignment of income theory for the Entitlement Method of taxing the underproducer. While such an approach may be met with concern that the agency will become enmeshed with marketing of natural gas, I would suggest that once a couple of orders were entered that encouraged a sensible balancing approach, parties would adopt their own agreements or embrace a standard balancing paragraph in pooling orders.

[14-1]

SOMMER V ENERGEN RESOURCES

-CASE DETAIL-

CASE #	CURRENT JUDGE	FILING DATE	COURT
D-117-CV-200700128	GARCIA TIMOTHY L	03/26/2007	TIERRA AMARILLA DISTRICT COURT

-PARTIES TO THIS CASE-

PARTY TYPE	PARTY DESCRIPTION	PARTY #	PARTY NAME
P	PLAINTIFF	1	THE ESTATE OF JOSEPH A SOMMER
		ATTORNEY: KURT A. SOMMER	
P	PLAINTIFF	2	THE JOSEPH A SOMMER REVOCABLE TRUST
		ATTORNEY: KURT A. SOMMER	
P	PLAINTIFF	3	JAS OIL AND GAS COMPANY LLC
		ATTORNEY: KURT A. SOMMER	
D	DEFENDANT	1	ENERGEN RESOURCES CORPORATION

-CIVIL COMPLAINT DETAIL-

COMPLAINT DATE	COMPLAINT SEQ #	COMPLAINT DESCRIPTION	DISP	DISP DATE
03/26/2007	1	OPN: COMPLAINT		

COA SEQ #	COA DESCRIPTION
1	OTHER DAMAGES

PARTY NAME	PARTY TYPE	PARTY #
ENERGEN RESOURCES CORPORATION	D	1
THE ESTATE OF JOSEPH A SOMMER	P	1
THE JOSEPH A SOMMER REVOCABLE TRUST	P	2
JAS OIL AND GAS COMPANY LLC	P	3

JUDGEMENTS	AMOUNT

-REGISTER OF ACTIONS ACTIVITY-

EVENT DATE	EVENT DESCRIPTION	EVENT RESULT	PARTY TYPE	PARTY #	AMOUNT
04/26/2007	ANSWER ANSWER TO COMPLAINT FOR UNFAIR TRAD PRACTICES AND CONVERSION OF PROPERTY, VIOLATION OF THE OIL AND GAS ACT, AND VIOLATION OF THE OIL AND GAS PROCEEDS PAYMENT ACT				
04/26/2007	ENTRY OF APPEARANCE ENTRY OF APPEARANCE MILLER STRATVERT PA ON BEHALF OF ENERGEN RESOURCES CORPORATION				
03/27/2007	SUMMONS RETURN SERVED TO DEFENDANT ON 3-27-07 VIA MAIL/COURIER SERVICE				
03/26/2007	SUMMONS ISSUED TO ENERGEN RESOURCES CORPORATION				
03/26/2007	OPN: COMPLAINT COMPLAINT FOR UNFAIR TRADE PRACTICES AND CONVERSION OF PROPERTY VIOLATION OF THE OIL AND GAS ACT AND VIOLATION OF THE OIL AND GAS PROCEEDS PAYMENT ACT				
03/26/2007	ASM: CIVIL FILING W/ ARBITRAT		P	1	$122.00

-JUDGE ASSIGNMENT HISTORY-

ASSIGNMENT DATE	JUDGE NAME	SEQ #	ASSIGNMENT EVENT DESCRIPTION
03/26/2007	GARCIA TIMOTHY L	1	INITIAL ASSIGNMENT

STATE OF NEW MEXICO
COUNTY OF RIO ARRIBA
FIRST JUDICIAL DISTRICT

THE ESTATE OF JOSEPH A. SOMMER, Deceased, THE JOSEPH A. SOMMER REVOCABLE TRUST, and JAS OIL & GAS CO., LLC a New Mexico limited liability company,

Plaintiffs,

v. **No. D-117-CV-07-128**

ENERGEN RESOURCES CORPORATION, an Alabama corporation,

Defendant.

ORDER STAYING PROCEEDINGS

This matter, having come before the Court on September 21, 2007, pursuant to the Defendant's Motion To Dismiss, Or In The Alternative, To Stay These Proceedings Due To The Primary Jurisdiction Of An Administrative Agency, and the Court being duly advised, it is ORDERED as follows:

1. This proceeding is stayed for a period of ninety days from the date of the hearing.

2. On the application of any of the parties, the stay may be extended by further order of the Court for good cause.

3. Discovery is simultaneously stayed.

4. Defendant's motion, to the extent it seeks dismissal, is denied.

Dated: October 17, 2007.

ORIGINAL SIGNED BY JUDGE TIMOTHY L. GARCIA

Timothy Garcia, District Judge
1st Judicial District Court, Division V

AGREED:

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