North Dakota Law Review

Volume 85
Number 4 *North Dakota Energy Law: The Production, Conservation, and Regulation of Our State's Diverse Energy Sources*

Article 9

1-1-2009

Oil and Gas Law — Rent or Royalties: North Dakota Joins the Majority of States in Adopting the "At the Well" Rule for Calculating Royalties in Oil and Gas Leases

Lindsey Scheel

Follow this and additional works at: https://commons.und.edu/ndlr

Part of the Law Commons

Recommended Citation

Scheel, Lindsey (2009) "Oil and Gas Law — Rent or Royalties: North Dakota Joins the Majority of States in Adopting the "At the Well" Rule for Calculating Royalties in Oil and Gas Leases," *North Dakota Law Review*: Vol. 85 : No. 4 , Article 9.
Available at: https://commons.und.edu/ndlr/vol85/iss4/9

This Case Comment is brought to you for free and open access by the School of Law at UND Scholarly Commons. It has been accepted for inclusion in North Dakota Law Review by an authorized editor of UND Scholarly Commons. For more information, please contact zeineb.yousif@library.und.edu.

OIL AND GAS LAW—RENT OR ROYALTIES: NORTH DAKOTA JOINS THE MAJORITY OF STATES IN ADOPTING THE "AT THE WELL" RULE FOR CALCULATING ROYALTIES ON OIL AND GAS LEASES
Bice v. Petro-Hunt, L.L.C., 2009 ND 124, 768 N.W.2d 496

ABSTRACT

In *Bice v. Petro-Hunt, L.L.C.*, the North Dakota Supreme Court expressly announced it joined the majority of states following the "at the well" rule for calculating royalties on oil and gas leases. The "at the well" rule defines the wellhead as the appropriate point for royalty calculation; royalty may be calculated using the comparable sales method or the work-back method. Of the two methods, the comparable sales method is the preferred method for calculating market value. However, when comparable sales evidence is not available, it is appropriate to use the workback method. Following the workback method, lessees begin with the point of sale price received, then deduct reasonable post-production costs to arrive at the market value of oil or gas at the wellhead. Thus, Petro-Hunt properly deducted post-production costs before calculating royalty. In addition, the North Dakota Supreme Court held "free use" lease clauses allowed Petro-Hunt to use residue gas off the leased premises to fuel the central tank batteries because the residue gas was used in furtherance of lease operations. Finally, the court determined Petro-Hunt's deductions for risk-capital and depreciation were not excessive. The *Bice* decision brings stability to an unsettled area of North Dakota law, and the rule is likely to impact future oil and gas lease dealings in the state.

I. FACTS 920
II. LEGAL BACKGROUND 923
  A. THE IMPLIED DUTY TO MARKET 923
  B. THE "AT THE WELL" RULE 924
  C. THE FIRST MARKETABLE PRODUCT DOCTRINE 927
III. ANALYSIS 930
  A. NORTH DAKOTA FOLLOWS THE "AT THE WELL" RULE 930

1. *Majority and Minority Rules* 931
2. *Relevant Case Law* 932
B. "FREE USE" CLAUSES ALLOW RESIDUE GAS USE OFF THE LEASED PREMISES 933
C. DEDUCTIONS FOR RISK-CAPITAL AND DEPRECIATION WERE NOT EXCESSIVE 935
1. *Risk-Capital* 935
2. *Depreciation* 936
a. The 1983 Settlement Agreement 936
b. Salvage Value 937
c. Fair Market Value 938
IV. IMPACT 938
A. LEASE FORMATION INTENTIONS ENFORCED 939
B. LITIGATION AVOIDANCE 940
C. PRACTICAL CONSIDERATIONS 941
V. CONCLUSION 941

I. FACTS

In 1976, Gulf Oil Corporation discovered the Little Knife Field in Dunn, Billings, and McKenzie Counties of North Dakota.[1] During the late 1970s, Gulf Oil Corporation built the Little Knife Gas Plant to treat the gas obtained from the Little Knife wells.[2] A disagreement developed between Gulf Oil Corporation and the Little Knife royalty owners in the early 1980s concerning how gas should be valued for royalty purposes.[3] The parties reached a settlement agreement in 1983.[4] The agreement stated Gulf Oil Corporation and the royalty owners agreed gas royalties "would be determined by adding all of the sources of revenue from the sale of gas and gas products and subtracting from that total certain costs associated with

1. Bice v. Petro-Hunt, L.L.C., 2009 ND 124, ¶¶ 2, 5, 768 N.W.2d 496, 498-99.
2. *Id.* ¶ 2, 768 N.W.2d at 498.
3. *Id.*
4. *Id.*

processing the gas."[5] In 1997, Petro-Hunt acquired the Little Knife Gas Plant and interests in the field.[6]

The Little Knife Field produced sour gas, which was not a marketable product.[7] Petro-Hunt pumped sour gas from the field and routed the gas to one of three central tank batteries.[8] The batteries separated oil and water from the gas before sending individual streams of gas, oil, and water to the Little Knife Gas Plant; the plant processed the sour gas into marketable sweet gas.[9] The sweet gas was then sold at or downstream of the plant tailgate.[10] Pursuant to its interpretation of the "free use" clauses in its leases, Petro-Hunt used residue gas processed at the Little Knife Gas Plant as fuel for operating the central tank batteries.[11]

Regardless of the royalty clause in each lease, Petro-Hunt calculated royalty payments on the same basis for every royalty owner.[12] Although the language was not identical, the parties agreed the royalty clauses were substantially similar and required royalty calculation "based on the market value of the gas at the well."[13] In 2001, the royalty owners filed suit against Petro-Hunt, claiming underpaid royalties were due because Petro-Hunt deducted post-production costs before calculating royalties.[14] In 2007, the district court granted partial summary judgment for Petro-Hunt on the issue of royalty calculation and determined that the royalties should be calculated under the workback method.[15] The workback method allowed deduction of post-production expenses before royalties were calculated.[16] When discovery was complete, the district court granted Petro-Hunt's summary

---

5. *Id.*

6. *Id.* ¶ 3, 768 N.W.2d at 499. By merging with Gulf Oil Corporation in 1985, Chevron obtained the Little Knife Gas Plant and interests in the Little Knife Field. *Id.* In 1992, Chevron sold the plant and its interests in the field to the William Herbert Hunt Trust Estate. *Id.* Five years later, in 1997, the estate conveyed its interests in the plant and field to Petro-Hunt, L.L.C. *Id.*

7. *Id.* ¶¶ 8, 20, 768 N.W.2d at 500, 502.

8. *Id.* ¶ 22, 768 N.W.2d at 503.

9. *Id.* Other products, including sulfur and butane, were also extracted. *Id.*

10. *Id.* ¶¶ 2, 22, 768 N.W.2d at 498, 503. "Tailgate" is defined as: "[t]he delivery point for residue gas after processing and removal of liquid constituents in a processing plant." HOWARD R. WILLIAMS & CHARLES J. MEYERS, MANUAL OF OIL AND GAS TERMS 1037 (13th ed. 2006).

11. *Bice*, ¶ 22, 768 N.W.2d at 503. Each lease in question contained a "free use" clause. *Id.*

12. *Id.* ¶ 4, 768 N.W.2d at 499.

13. *Id.*

14. *Id.* ¶ 5. The royalty owners were granted class certification in 2004. *Id.* The class included "[a]ll persons who own, or have owned, any minerals and/or royalty interests or overriding royalty interests located within the Little Knife Field of Dunn, Billings and McKenzie Counties of North Dakota from which gas was processed at the Little Knife Gas Plant." *Id.*

15. *Id.* ¶ 6. The Honorable Zane Anderson of the Billings County District Court Southwest Judicial District partially granted Petro-Hunt's motion for summary judgment on April 30, 2007. Brief of Appellees at 1, 10, *Bice*, 2009 ND 124, 768 N.W.2d 496 (No. 20080265).

16. *Bice*, ¶ 6, 768 N.W.2d at 499.

judgment motion on the remaining issues, which related to the use of residue gas at the central tank batteries and deductions for depreciation and risk-capital.[17] The royalty owners appealed, claiming the grant of summary judgment for Petro-Hunt was erroneous as a matter of law.[18]

On appeal, the royalty owners raised three issues.[19] First, the royalty owners asserted the district court erred in deciding post-production costs could be deducted before calculating royalties.[20] The royalty owners argued the North Dakota Supreme Court should reject the "at the well" rule, which allowed Petro-Hunt to deduct post-production costs before royalty calculation.[21] Instead, the royalty owners asked the North Dakota Supreme Court to adopt the first marketable product doctrine, under which Petro-Hunt could not deduct post-production costs before calculating royalties.[22] Second, the royalty owners claimed the district court erred in finding the "free use" clauses allowed Petro-Hunt to use residue gas off the leased premises without paying royalty on that residue gas.[23] The royalty owners maintained the "free use" clauses only permitted Petro-Hunt to use residue gas on, and not off, the leased premises without cost.[24] Third, the royalty owners contended the district court erred when it concluded Petro-Hunt's deductions for risk-capital and depreciation were not excessive.[25] Affirming the district court's summary judgment decision, the North Dakota Supreme Court adopted the "at the well" rule for calculating royalties on oil and gas leases, held the "free use" clauses authorized Petro-Hunt to use residue gas off the leased premises, and determined Petro-Hunt's deductions for risk-capital and depreciation were proper.[26]

---

17. *Id.* The district court's order granting Petro-Hunt's summary judgment motion was issued on July 30, 2008. Brief of Appellees, *supra* note 15, at 10.

18. *Bice,* ¶ 7, 768 N.W.2d at 499. Professor Owen L. Anderson argued on behalf of the royalty owners before the North Dakota Supreme Court. *Id.* (syllabus). Professor Anderson, Eugene Kuntz Chair in Oil, Gas, and Natural Resources at the University of Oklahoma College of Law, received his Juris Doctor from, and is a former professor of, the University of North Dakota School of Law. The University of Oklahoma College of Law Faculty Pages, http://www.law.ou.edu/faculty/anderson.shtml (last visited Mar. 9, 2010).

19. *Bice,* ¶¶ 10, 22, 28, 768 N.W.2d at 500, 502, 504.

20. *Id.* ¶ 10, 768 N.W.2d at 500.

21. *Id.*

22. *Id.*

23. *Id.* ¶ 22, 768 N.W.2d at 502.

24. *Id.* ¶ 23, 768 N.W.2d at 503.

25. *Id.* ¶ 28, 768 N.W.2d at 504.

26. *Id.* ¶¶ 1, 21, 27, 29, 31, 33, 768 N.W.2d at 498, 502, 504-06.

II. LEGAL BACKGROUND

Bice implicated several important concepts relating to oil and gas law. First, the implied duty to market is summarized to demonstrate the genesis of the majority and minority rules pertaining to the deductibility of post-production expenses when calculating royalty. Next, the development of the "at the well" rule is examined, and the two methods for calculating market value at the well under the majority rule are addressed. Finally, the first marketable product doctrine is considered, including the different approaches that have emerged among the states following the minority rule.

A. THE IMPLIED DUTY TO MARKET

This discussion begins by defining several terms that frequently appear in oil and gas leases. The party entitled to drill and operate wells under a lease is the lessee.[27] The lessor, on the other hand, is the royalty owner.[28] "Production" generally refers to a process of obtaining crude oil or natural gas from a well.[29] The actual point where gas is removed from the ground is known as the "wellhead."[30]

The implied duty to market has long been a part of oil and gas law.[31] Today, the major oil and gas producing states acknowledge the lessee has a duty to market its product, as implied in every oil and gas lease.[32] However, this implied duty to market necessarily gives rise to costs, and the question of which costs a lessee is required to bear has been debated.[33] Often, the central issue in royalty disputes relates to "expenses incurred by the lessee after production passes through the wellhead . . . ."[34]

As a result, two theories, one known as the "at the well" rule and the other as the first marketable product doctrine, have developed.[35] The "at the well" rule and first marketable product doctrine address which party is responsible for expenses incurred after gas reaches the wellhead.[36] While each approach recognizes that the lessee must bear the costs of exploration

---

27. WILLIAMS & MEYERS, *supra* note 10, at 554. Thus, Petro-Hunt was the lessee in *Bice*. *See Bice*, ¶ 3, 768 N.W.2d at 499.

28. WILLIAMS & MEYERS, *supra* note 10, at 554.

29. *Id.* at 814-15.

30. *Id.* at 1143 (citing Schroeder v. Terra Energy, Ltd., 565 N.W.2d 887, 890 (Mich. 1997)).

31. Byron C. Keeling & Karolyn King Gillespie, *The First Marketable Product Doctrine: Just What is the "Product"?*, 37 ST. MARY'S L.J. 1, 20 (2005).

32. Edward B. Poitevent, II, *Post-Production Deductions from Royalty*, 44 S. TEX. L. REV. 709, 713 (2003).

33. *Id.*

34. *Id.*

35. *Id.* at 713, 716-17.

36. *Id.* at 713.

and production, the theories diverge concerning the point at which production ends.[37]

B. THE "AT THE WELL" RULE

The majority of states follow the "at the well" rule, under which the "implied duty to market production does not require a lessee to bear the costs of marketing production alone."[38] In other words, the majority rule provides that costs arising after the gas reaches the wellhead may be shared between the lessee and lessor.[39] The three major oil and gas producing states, Texas, Louisiana, and Mississippi, follow the "at the well" rule.[40] Under the case law of these three states, the "at the well" rule generally provides that the appropriate point for royalty calculation is the wellhead, where the oil or gas is captured from the ground and converted into property.[41] Accordingly, the majority rule provides that post-production expenses, such as dehydration and transportation costs, may be deducted before royalty is calculated.[42]

Wall v. United Gas Public Service Co.,[43] a 1943 Louisiana Supreme Court decision, is an early case in the development of the "at the well" rule.[44] In *Wall*, the lease provided that royalty would be calculated on the "market price."[45] Because the lessee paid transportation and processing costs to sell the gas at a point two miles away from the gas field, the lessee calculated royalty based on the value of the gas at the well, rather than on the amount for which the gas was actually sold.[46] The royalty owner argued, however, that the royalty should have been calculated based on the

---

37. *Id.*

38. *Id.* at 716.

39. *Id.*

40. *Id.* at 720. One article lists Montana, California, Kentucky, and New Mexico as states that adhere to the "at the well" rule. Keeling & Gillespie, *supra* note 31, at 51 n.193. Though written in 2005, the article also includes North Dakota among the majority rule states, based on the state case of *Koch Oil Co. v. Hanson*, 536 N.W.2d 702 (N.D. 1995), and the federal decision of *Hurinenko v. Chevron, USA, Inc.*, 69 F.3d 283 (8th Cir. 1995). *Id.* Michigan is described as following the "at the well" rule for leases dated before March 29, 2000. *Id.* The article also suggests Alabama is likely to adopt the majority rule, although no appellate court there had yet addressed the particular issue in a royalty context. *Id.*

41. Poitevent, *supra* note 32, at 720.

42. *Id.* Dehydration involves removing water from the liquid produced at an oil well. WILLIAMS & MEYERS, *supra* note 10, at 247. Transportation costs include "[t]he costs of transporting oil or gas to a market." *Id.* at 1092.

43. 152 So. 561 (La. 1934).

44. *Wall*, 152 So. at 562.

45. *Id.* at 562.

46. *Id.* at 563.

price for which the gas was sold.[47] The *Wall* court held in favor of the lessee and determined that, where the term "market price" is used for royalty calculation, the wellhead is the appropriate point for determining royalty payments.[48] Moreover, the court stated, "[T]he lessee cannot be taxed with the whole cost of marketing the gas and extracting therefrom the gasoline."[49]

In addition, the *Wall* court noted the trial judge, in determining whether the royalty paid was appropriate, had used a workback method by "deduct[ing] from the price received by [the lessee] the expense of piping the gas to the place where it was sold . . . ."[50] While there was no market for the gas at the well, the Louisiana Supreme Court considered well prices from other Louisiana fields to determine whether the royalty paid by the lessee was adequate.[51] The court stated that if such comparable sales information had not been available, the trial judge would have been correct in using a workback approach.[52] That is, the *Wall* court used a comparable sales method to determine the propriety of the royalty paid.[53] The comparable sales method and the workback method remain the two systems for lessees to calculate market value at the well in majority rule states.[54] In short, the *Wall* court allowed the lessee to deduct its transportation and processing costs before calculating royalty and established a preference for the comparable sales method—when comparable sales information is available—over the workback method.[55]

The *Wall* rule was developed further in the 1960 Fifth Circuit Court of Appeals decision of *Freeland v. Sun Oil Co*.[56] The main issue in *Freeland* was whether lessors are expected to "bear any part of the cost of processing [gas.]"[57] The Fifth Circuit, interpreting Louisiana law, determined reasonable processing costs, which are necessary for creating or adding value to gas, may be deducted before royalty calculation.[58] The *Freeland* court further stated that when comparable sales information is not available, the workback method may be used to arrive at a market value of gas at the

47. *Id.*
48. *Id.*
49. *Id.* at 564.
50. *Id.*
51. *Id.* at 564-65.
52. *Id.* at 564.
53. *Id.* at 564-65.
54. Keeling & Gillespie, *supra* note 31, at 31.
55. *Wall*, 152 So. at 564-65.
56. 277 F.2d 154 (5th Cir. 1960).
57. *Freeland*, 277 F.2d at 155.
58. *Id.* at 159.

well.[59] The Fifth Circuit opined, "[I]n the analytical process of reconstructing a market value where none otherwise exists with sufficient definiteness, all increase in the ultimate sales value attributable to the expenses incurred in transporting and processing the commodity must be deducted."[60]

Another significant case in the development of the "at the well" rule is *Piney Woods Country Life School v. Shell Oil Co*.[61] The Mississippi oil and gas leases at issue in *Piney Woods* used the phrase "market value at the well" for measuring royalties.[62] The royalty owners contested Shell's practice of deducting processing costs before calculating royalty.[63] Noting Shell's actions were proper, the Fifth Circuit defined "market value at the well" as "market value before processing and transportation . . . ."[64] Thus, following the Fifth Circuit's definition of the term "market value at the well," production ends when gas reaches the wellhead, enabling lessees to deduct subsequent costs of processing, transporting, and marketing.[65] With this holding, the Fifth Circuit implied its rejection of the contrary first marketable product doctrine.[66]

In summary, the "at the well" rule defines the wellhead as the appropriate point for royalty calculation.[67] Under the "at the well" rule, royalty may be calculated using the comparable sales method or the workback method.[68] Of the two methods, the comparable sales method is the preferred method for calculating market value.[69] Using the comparable sales method, the market value of gas at the wellhead is determined by "averaging the prices that the lessee and other producers are receiving, at the same time and in the same field, for oil or gas of comparable quality, quantity, and availability . . . ."[70] Nonetheless, when comparable sales evidence is not available, it is appropriate to use the workback method.[71] Following the workback method, lessees begin with the point of sale price received, then deduct reasonable post-production costs to arrive at the

---

59. *Id.*
60. *Id.*
61. 726 F.2d 225 (5th Cir. 1984).
62. *Piney Woods*, 726 F.2d at 229.
63. *Id.* at 225.
64. *Id.* at 231.
65. *Id.* at 240.
66. *Id.*; Poitevent, *supra* note 32, at 734 (noting the court's implicit rejection of the minority rule).
67. Poitevent, *supra* note 32, at 720.
68. Keeling & Gillespie, *supra* note 31, at 31-32.
69. *Id.* at 33.
70. *Id.* at 31-32.
71. *Id.* at 33.

market value of oil or gas at the wellhead.[72] Thus, oil companies realize a greater profit in "at the well" jurisdictions because, by deducting post-production costs before royalty is calculated, royalty payments are reduced.[73]

C. THE FIRST MARKETABLE PRODUCT DOCTRINE

The majority of states[74] today follow the "at the well" rule, which allows lessees to calculate royalty based on the value of production at the wellhead as opposed to a downstream location.[75] On the other hand, a minority of states have adopted the view "that a lessee's implied duty to market production requires a lessee to bear the full cost of any steps necessary to transform the gas into a marketable condition . . . ."[76] In other words, the minority rule generally permits a lessee to deduct certain costs from the value of gas only after the lessee has rendered the gas marketable.[77] This minority approach is known as the first marketable product doctrine.[78] Interestingly, the first marketable product states of Kansas, Oklahoma, Colorado, West Virginia, and Arkansas follow different versions of the rule.[79]

Early deviations from the majority rule were apparent in 1964 with the Kansas Supreme Court decisions in *Gilmore v. Superior Oil Co.*[80] and *Schupbach v. Continental Oil Co.*[81] Both cases involved leases which required royalty payments based on "the proceeds [from] the sale [of gas] at the mouth of the well."[82] In each case, the lessee deducted compression costs before calculating the royalty owed.[83] In *Gilmore*, the court relied on

---

72. *Id.* at 32.

73. *See* Poitevent, *supra* note 32, at 716.

74. Although the "at the well" rule is often called the majority rule, Professor Anderson believes the first marketable product doctrine is the true majority rule. *See* Owen L. Anderson, *Rogers, Wellman, and the New Implied Marketplace Covenant*, ROCKY MTN. MIN. L. FOUND., Special Inst. On Private Oil and Gas Royalties, Paper 13A-1, 13A-24 n.126 (2003). Professor Anderson points out the first marketable product jurisdictions include Arkansas, Colorado, Kansas, Nevada, Oklahoma, West Virginia, Wyoming, and the federal government. *Id.* Thus, it is arguably reasonable to conclude the first marketable product doctrine is the majority rule. *See id.*

75. Keeling & Gillespie, *supra* note 31, at 51.

76. Poitevent, *supra* note 32, at 717.

77. *Id.*

78. Keeling & Gillespie, *supra* note 31, at 51.

79. *Id.* at 79 (discussing the different minority rule approaches in Kansas, Oklahoma, Colorado, and West Virginia); Poitevent, *supra* note 32, at 744 (outlining Arkansas case law on the first marketable product doctrine).

80. 388 P.2d 602 (Kan. 1964).

81. 394 P.2d 1 (Kan. 1964).

82. *Schupbach*, 394 P.2d at 2; *Gilmore*, 388 P.2d at 604.

83. *Schupbach*, 394 P.2d at 4; *Gilmore*, 388 P.2d at 604-05. The lessee installed one large compressor station on the leased premises to compress all the gas produced from the wells. *Gilmore*, 388 P.2d at 604. A compressor station is "[a]n installation in which the pressure of gas

"the most recent authorities on the subject of the duty to prepare for market . . ." and concluded the lessee's implied duty to market required the lessee to bear compression costs because those costs were "necessary to make the gas marketable."[84] Accordingly, in both *Gilmore* and *Schupbach*, the Kansas Supreme Court stated that a lessee may not deduct compression costs before royalty calculation.[85]

In addition to compression costs, minority rule states have considered the deductibility of dehydration and gathering costs.[86] For instance, in a 1992 Oklahoma case, *TXO Production Corp. v. State ex rel. Commissioners of the Land Office*,[87] the lessee deducted compression, dehydration, and gathering costs before calculating royalty.[88] The Oklahoma Supreme Court noted the lessee's implied duty to market obligated the lessee to bear necessary expenses for obtaining a marketable product.[89] Further, because the court determined compression, dehydration, and gathering costs were necessary to arrive at a marketable product, the court held the lessee's deductions for those expenses were inappropriate.[90] Oklahoma's rule was subsequently refined in *Mittelstaedt v. Santa Fe Minerals, Inc.*[91] The *Mittelstaedt* court reiterated its position from *TXO Production Corp.*, that a lessee must shoulder the costs necessary to create a marketable product.[92] Yet, the court concluded that if a marketable product was already obtained, the lessee could properly deduct, before calculating royalty, reasonable post-production costs incurred to enhance the product.[93]

---

is raised for transmission through pipe lines while the gas is cooled, scrubbed and dehydrated." WILLIAMS & MEYERS, *supra* note 10, at 180.

84. *Gilmore*, 388 P.2d at 607. The *Gilmore* court observed, "The only purpose for the compressing station was to put enough force behind the gas to enable it to enter the pipeline *on the lease*. This made the gas marketable and was in satisfaction of the duties of the lessee to do so." *Id.* at 606.

85. *Schupbach*, 394 P.2d at 5; *Gilmore*, 388 P.2d at 607.

86. *See*, *e.g.*, Mittelstaedt v. Santa Fe Minerals, Inc., 954 P.2d 1203, 1205 (Okla. 1998); TXO Prod. Corp. v. State *ex rel.* Comm'rs of the Land Office, 903 P.2d 259, 260 (Okla. 1994). *See supra* note 42 (defining dehydration). Gathering entails "collecting gas at the point of production (the wellhead) and moving it to a collection point for further movement through a pipeline's principal transmission system." WILLIAMS & MEYERS, *supra* note 10, at 434 (quoting N. Natural Gas Co. v. Fed. Energy Regulatory Comm'n, 929 F.2d 1261, 1265 (8th Cir. 1991)).

87. 903 P.2d 259 (Okla. 1994).

88. *TXO Prod. Corp.*, 903 P.2d at 260.

89. *Id.* at 262.

90. *Id.*

91. 954 P.2d 1203 (Okla. 1998).

92. *Mittelstaedt*, 954 P.2d at 1205.

93. *Id.* The *Mittelstaedt* court stated:

> [T]he lessor [royalty owner] must bear a proportionate share of such costs if the lessee can show (1) that the costs enhanced the value of an already marketable product, (2) that such costs are reasonable, and (3) that actual royalty revenues increased in proportion with the costs assessed against the nonworking interest.

Colorado's rule on the deductibility of post-production costs is similar to Oklahoma's approach, as evidenced by the Colorado Supreme Court's decision in *Garman v. Conoco, Inc.*[94] In *Garman*, the court considered whether an overriding royalty interest owner could be required to share in post-production costs.[95] Relying on the implied duty to market, which the court determined was implied in every oil and gas lease,[96] the Colorado Supreme Court held that the lessee alone was obligated to bear the post-production expenses necessary to obtain a marketable product.[97] However, the court pointed out that a lessee could deduct costs incurred to enhance the value of an already marketable product.[98]

Various permutations of the first marketable product doctrine have emerged in the states following the minority rule.[99] Generally, in Kansas, Oklahoma, and Arkansas, a lessee is responsible for all expenses, except transportation costs, to produce a marketable product.[100] Lessees in Colorado and West Virginia, however, usually shoulder transportation costs, in addition to other expenses incurred in creating a marketable product.[101] One author notes a chief criticism of the minority rule "is that it can be difficult to determine when the gas becomes 'marketable,' and the states that have adopted the marketable product rule have provided little guidance."[102] Because there is no defined marketability standard in the first

---

Id.

94. 886 P.2d 652 (Colo. 1994).

95. *Garman*, 886 P.2d at 653. An overriding royalty is "[a]n interest in oil and gas produced at the surface, free of the expense of production, and in addition to the usual landowner's royalty reserved to the lessor in an oil and gas lease." WILLIAMS & MEYERS, *supra* note 10, at 727.

96. *Garman*, 886 P.2d at 659 n.21.

97. *Id.* at 659.

98. *Id.* at 661. Professor Anderson contends the *Garman* court adopted the correct rule. *See generally* Owen L. Anderson, *Royalty Valuation: Should Overriding Royalty Interests and Nonparticipating Royalty Interests, Whether Payable in Value or in Kind, Be Subject to the Same Valuation Standard as Lease Royalty?*, 35 LAND & WATER L. REV. 1, 20 (2000). In support of this viewpoint, Professor Anderson has opined, "Forcing a royalty owner to accept an unmarketable product would convert the royalty owner's interest into a cost-bearing interest in that the royalty owner would have to do something tangible to the product to make it marketable and, in so doing, duplicate the similar facilities of the operator." *Id.*

99. *Compare* Keeling & Gillespie, *supra* note 31, at 79-80 (summarizing the rules in Kansas, Oklahoma, Colorado, and West Virginia), *with* Poitevent, *supra* note 32, at 735-50 (discussing relevant case law in Oklahoma, Arkansas, and Colorado).

100. Keeling & Gillespie, *supra* note 31, at 79-80; Poitevent, *supra* note 32, at 744.

101. Keeling & Gillespie, *supra* note 31, at 80. Professor Anderson notes an arguable difference exists between the Colorado and West Virginia positions. *See generally* Anderson, *supra* note 74, at 13A-22 to -23. While Colorado does not allow deductions until after the product is first marketable, West Virginia does not allow a lessee to take any deductions before the first arm's-length transaction, even if the product is already marketable at the point of the first arm's-length transaction. *See generally id.*

102. Brian S. Wheeler, *Deducting Post-Production Costs when Calculating Royalty: What Does the Lease Provide?*, 8 APPALACHIAN J. L. 1, 10 (2008).

marketable product doctrine, lessees in minority rule jurisdictions are unable to predict with certainty which post-production cost deductions courts will allow.[103] Moreover, critics of the first marketable product doctrine have stated the approach "improperly uses the [implied duty to market] to reach a result different from that which the parties contemplated in the express terms of their lease agreement."[104] Lessors, however, have a very practical reason for favoring the first marketable product doctrine: when lessees are unable to deduct post-production expenses before calculating royalty, lessors enjoy higher royalty payments.[105]

III. ANALYSIS

Justice Crothers authored the opinion in *Bice*, in which Chief Justice VandeWalle, Justice Maring, Justice Kapsner, and Justice Sandstrom joined.[106] The court adopted the "at the well" rule in North Dakota for royalty calculation on oil and gas leases and thus determined Petro-Hunt acted properly in deducting post-production costs from proceeds before calculating royalty.[107] Additionally, the court held the "free use" clauses allowed Petro-Hunt to use residue gas off the leased premises to fuel the central tank batteries because the residue gas was used in furtherance of lease operations.[108] Finally, the court determined Petro-Hunt's deductions for risk-capital and depreciation were not excessive.[109] Therefore, the court affirmed the district court's grant of summary judgment to Petro-Hunt.[110]

A. NORTH DAKOTA FOLLOWS THE "AT THE WELL" RULE

The first issue presented in *Bice* was whether the district court erred in concluding royalties could be calculated after the deduction of post-production costs.[111] The North Dakota Supreme Court was asked to determine whether North Dakota followed the "at the well" rule or the first marketable product doctrine for calculating royalties on oil and gas leases.[112] Before deciding the issue, the North Dakota Supreme Court examined both the majority "at the well" rule and the minority first

103. Poitevent, *supra* note 32, at 759.
104. Keeling & Gillespie, *supra* note 31, at 116-17.
105. *See* Anderson, *supra* note 98, at 20.
106. Bice v. Petro-Hunt, L.L.C., 2009 ND 124, ¶¶ 1, 36, 768 N.W.2d 496, 498, 506.
107. *Id.* ¶ 21, 768 N.W.2d at 502.
108. *Id.* ¶ 27, 768 N.W.2d at 504.
109. *Id.* ¶¶ 29, 31, 33-34, 768 N.W.2d at 504-06.
110. *Id.* ¶ 27, 768 N.W.2d at 504.
111. *Id.* ¶ 10, 768 N.W.2d at 500.
112. *Id.*

marketable product doctrine.[113] After a thorough discussion of each rule, the court analyzed pertinent case law in North Dakota and the Eighth Circuit.[114] Finally, the court ruled on the issue of whether Petro-Hunt could deduct post-production costs before calculating royalty.[115]

1. *Majority and Minority Rules*

The *Bice* court first considered the unresolved nature of the law regarding interpretation of the phrase "market value at the well."[116] The majority of states follow the "at the well" rule, under which "'any costs incurred by the lessee after the [gas] reaches the wellhead . . . may be' deducted before the royalty is calculated."[117] States following the majority rule permitted lessees to use one of two methods for calculating the market value of gas or oil at the well.[118] The first method, known as the comparable sales method, enabled the lessee to average prices received by the lessee and other producers for oil or gas of similar quality, quantity, and availability to determine the market value of gas at the wellhead.[119] The second method, commonly called the work-back method, allowed a lessee to determine the market value of gas at the well by deducting reasonable post-production costs from the price received at a point of sale.[120] While most courts preferred the comparable sales method, the method could not be used if evidence of comparable sales did not exist.[121] The court then considered which states followed the "at the well" rule: Louisiana, Mississippi, and Texas, the three major oil and gas producing states, in addition to California, Kentucky, Montana, and New Mexico.[122]

In contrast, Arkansas, Colorado, Oklahoma, Kansas, and West Virginia adopted the minority rule, known as the first marketable product rule.[123] Under the minority rule, the lessee paid costs incurred in producing a marketable product, after which point additional costs to enhance the marketability of the gas were shared between the lessee and lessor.[124] The primary

113. *Id.* ¶¶ 13-17, 768 N.W.2d at 500-02.
114. *Id.* ¶¶ 17-20, 768 N.W.2d at 502.
115. *Id.* ¶ 21.
116. *Id.* ¶ 13, 768 N.W.2d at 500.
117. *Id.* ¶ 13, 768 N.W.2d at 501 (quoting Poitevent, *supra* note 32, at 716 and Wheeler, *supra* note 102, at 7).
118. *Id.* ¶ 14.
119. *Id.*
120. *Id.*
121. *Id.*
122. *Id.* ¶ 15.
123. *Id.* ¶ 16.
124. *Id.*

problem with the first marketable product rule was the difficulty in ascertaining when the gas became a marketable product.[125] Noting this problem, the *Bice* court observed that even the minority rule states had not set forth a clear standard for establishing when a marketable product was produced.[126] After analyzing both the majority and minority rules, the court turned its attention to controlling and persuasive case law.[127]

2. *Relevant Case Law*

Before *Bice*, North Dakota had not explicitly defined how to calculate royalty based on "market value at the well."[128] Nonetheless, two North Dakota cases were considered.[129] *Amerada Hess Corp. v. Conrad*[130] and *Koch Oil Co. v. Hanson*[131] addressed the issue of how to value oil and gas for purposes of tax assessment. Both decisions announced that the fair market value of oil and gas could be calculated by deducting processing costs from gross sales revenues under the workback method.[132]

The North Dakota Supreme Court next turned its attention to *Hurinenko v. Chevron, USA, Inc.*,[133] an Eighth Circuit decision interpreting North Dakota law.[134] *Hurinenko* involved a dispute between royalty owners and a lessee, where the royalty owners claimed the lessee could not deduct processing costs before calculating royalties.[135] The Eighth Circuit determined that North Dakota law allowed market value at the well to be calculated by subtracting processing costs from gross sales revenues.[136] Moreover, the Eighth Circuit deemed the workback method especially appropriate in *Hurinenko* because "[t]he gas had no readily discernible market value at the well before the incursion of processing costs to separate the compounds."[137] While the *Bice* court noted that federal district court decisions were not binding upon North Dakota courts, such decisions would be respected if they were persuasive and based on sound reasoning.[138]

---

125. *Id.* ¶ 17, 768 N.W.2d at 502.
126. *Id.*
127. *Id.* ¶¶ 18-19.
128. *Id.* ¶ 18.
129. *Id.*
130. 410 N.W.2d 124 (N.D. 1987).
131. 536 N.W.2d 702 (N.D. 1995).
132. *Bice*, ¶ 18, 768 N.W.2d at 502.
133. 69 F.3d 283 (8th Cir. 1995).
134. *Hurinenko*, 69 F.3d at 285.
135. *Id.* at 284-85.
136. *Id.* at 285.
137. *Id.*
138. Bice v. Petro-Hunt, L.L.C., 2009 ND 124, ¶ 19, 768 N.W.2d 496, 502.

The facts of *Hurinenko* were similar to the facts of *Bice*, and the court determined the Eighth Circuit's interpretation of market value at the well was persuasive.[139] The Little Knife Field, like the field in *Hurinenko*, yielded sour gas with no discernible market value at the well.[140] Yet, the *Bice* leases stated royalty was to be calculated based on the market value of gas at the well.[141] Petro-Hunt could not use the comparable sales method to determine the market value of gas at the well because no comparable sales data existed under the facts in the case.[142] Therefore, Petro-Hunt's only option for arriving at a market value for gas at the well was the workback method.[143] The North Dakota Supreme Court then expressly announced it joined the majority of states following the "at the well" rule. Thus, the district court properly found Petro-Hunt could deduct post-production costs before calculating royalty.[144]

B. "FREE USE" CLAUSES ALLOW RESIDUE GAS USE OFF THE LEASED PREMISES

The second issue in *Bice* was whether the district court erred in determining Petro-Hunt could use residue gas off the leased premises without paying royalty on that gas, so long as the gas was used to carry out lease operations.[145] In reaching its decision, the court began by considering the language of the "free use" clauses.[146] Then, the court noted each party's interpretation of the clauses.[147]

First, the leases in question all contained a "free use" clause stating "either the lessees 'shall have the right to use, free of cost, gas, oil and water produced on said land for its operation thereon' or the lessees 'shall have free use of oil, gas and water from said land . . . for all its operations hereunder.'"[148] Petro-Hunt used residue gas processed at the Little Knife

---

139. *Id.* ¶ 20, 768 N.W.2d at 502.
140. *Id.*
141. *Id.*
142. *Id.*
143. *Id.* The court stated:

> Since the contracted for royalty is based on the market value of the gas at the well and the gas has no market value at the well, the only way to determine the market value of the gas at the well is to work back from where a market value exists, meaning using the work-back method, by deducting post-production costs from the plant tailgate proceeds.

Id.

144. *Id.* ¶ 21.
145. *Id.* ¶ 22.
146. *Id.* ¶¶ 26-27, 768 N.W.2d at 503-04.
147. *Id.* ¶ 23, 768 N.W.2d at 503.
148. *Id.* ¶ 22.

Gas Plant to fuel its central tank batteries.[149] At the central tank batteries, oil, gas, and water were treated and divided into separate streams.[150] Because the residue gas was used to render marketable gas, Petro-Hunt argued it was entitled to use the residue gas off of the leased premises without paying royalty on the residue gas under the "free use" clauses.[151] The royalty owners countered that because the residue gas was being used off of the leased premises, Petro-Hunt owed royalties on the gas used to fuel the central tank batteries.[152] That is, the royalty owners interpreted the "free use" clauses to mean Petro-Hunt could only use residue gas free of cost if the residue gas was used on, and not off, the leased premises.[153]

The *Bice* court noted the issue of "[w]hether residue gas can be used off of the leased premises, but in furtherance of the lease operations without paying royalty on that gas under a 'free use' clause is an issue of first impression."[154] The record indicated that functions normally performed at each well site were performed instead at Petro-Hunt's central tank batteries.[155] Petro-Hunt consolidated its facilities into three central tank batteries rather than maintaining a battery at each individual well.[156] Both parties benefitted from the efficiency of the central tank batteries, which resulted in less overall use of gas, a minimum of surface disturbance, and the recovery of hydrocarbons on which the lessors received royalties.[157]

The North Dakota Supreme Court next commented that the royalty owners' interpretation of the "free use" clauses could lead to an absurd result.[158] For instance, if use of residue gas was allowed only on, and not off, the leased premises, those royalty owners with a gas producer's central tank battery on their property would bear the entire burden of the "free use" clauses, despite other royalty owners also benefiting from the central tank battery.[159] Because the record demonstrated the residue gas was used to further the lease operations, the court held the district court properly determined Petro-Hunt could use residue gas off the leased premises without paying royalty on that gas.[160]

---

149. *Id.*
150. *Id.*
151. *Id.* ¶ 23.
152. *Id.*
153. *Id.*
154. *Id.* ¶ 26.
155. *Id.*
156. *Id.*
157. *Id.*
158. *Id.* ¶ 27, 768 N.W.2d at 504.
159. *Id.*
160. *Id.*

C. DEDUCTIONS FOR RISK-CAPITAL AND DEPRECIATION WERE NOT EXCESSIVE

The third and final issue in *Bice* was whether the district court erred in finding Petro-Hunt's deductions for risk-capital and depreciation were not excessive.[161] To begin its analysis, the court considered the royalty owners' claim that, because the Little Knife Gas Plant made a profit every year, no risk existed and therefore a risk-capital charge by Petro-Hunt was not justified.[162] Next, the court examined the royalty owners' contention that Petro-Hunt's depreciation deduction was excessive.[163]

1. *Risk-Capital*

To approach the final issue in *Bice*, the North Dakota Supreme Court first analyzed whether the district court properly found Petro-Hunt's risk-capital charges were commercially reasonable.[164] In support of its claim that Petro-Hunt's risk-capital deduction was excessive, the royalty owners argued that no risk existed because the Little Knife Gas Plant realized a profit every year.[165] Petro-Hunt countered that the 1983 settlement agreement explicitly stated risk-capital deductions could be taken.[166]

The *Bice* court then focused on the 1983 settlement agreement to examine the propriety of Petro-Hunt's risk-capital deductions.[167] The 1983 settlement agreement stated, "the cost of risk-capital shall be six percent on the undepreciated investment in the Little Knife Gas Plant."[168] After determining Petro-Hunt's risk-capital charges were calculated according to the 1983 settlement agreement, the court commented, "the [royalty owners] fail[ed] to explain why the parties to the 1983 settlement agreement are no longer bound by that agreement."[169] In addition, the royalty owners had not demonstrated why a six percent risk-capital charge was excessive.[170] As the party resisting summary judgment, the royalty owners were required to present competent, admissible evidence to demonstrate a genuine issue of

---

161. *Id.* ¶ 28.
162. *Id.*
163. *Id.* ¶ 30, 768 N.W.2d at 505.
164. *Id.* ¶ 28, 768 N.W.2d at 504.
165. *Id.*
166. *Id.*
167. *Id.* ¶ 29.
168. *Id.*
169. *Id.* The royalty owners who signed the 1983 agreement had claimed they were no longer bound by that agreement because, according to the royalty owners, Petro-Hunt breached the terms of the 1983 settlement agreement. Brief of Appellants at 13, *Bice*, 2009 ND 124, 768 N.W.2d 496 (No. 20080265).
170. *Bice*, ¶ 29, 768 N.W.2d at 504.

material fact.[171] Because the royalty owners failed to produce such evidence, the North Dakota Supreme Court determined Petro-Hunt's risk-capital charges were commercially reasonable and allowable as a deduction from sales proceeds before calculating royalty.[172] Thus, the district court's grant of Petro-Hunt's summary judgment motion regarding the risk-capital charge was proper.[173]

2. *Depreciation*

Next, the court considered the claim that Petro-Hunt's depreciation deductions were excessive.[174] The royalty owners offered three reasons in support of their stance.[175] First, the royalty owners argued the 1983 settlement agreement disallowed a depreciation charge after July 22, 1990.[176] Second, the royalty owners claimed Petro-Hunt depreciated the Little Knife Gas Plant below its salvage value.[177] Third, the royalty owners alleged the fair market value of the plant exceeded the undepreciated amount.[178]

a. The 1983 Settlement Agreement

The royalty owners contended the 1983 settlement agreement prohibited Petro-Hunt from charging depreciation after July 22, 1990.[179] Petro-Hunt asserted its practice of charging depreciation after 1990 was proper because the 1983 settlement agreement did not require all depreciation to occur before July 22, 1990.[180] In response to these arguments, the North Dakota Supreme Court looked to the language of the 1983 settlement agreement.[181] Because the 1983 settlement agreement incorporated by

---

171. *Id.*
172. *Id.*
173. *Id.* at 504-05.
174. *Id.* ¶ 30, 768 N.W.2d at 505.
175. *Id.* ¶¶ 30, 32-34, 768 N.W.2d at 505-06.
176. *Id.* ¶ 30, 768 N.W.2d at 505.
177. *Id.* ¶ 32.
178. *Id.* ¶ 34, 768 N.W.2d at 506.
179. *Id.* ¶ 30, 768 N.W.2d at 505.
180. *Id.*
181. *Id.* A relevant excerpt of the 1983 settlement agreement follows:

> Depreciation on a 13 year straight line method shall be allowed . . . . If at the end of thirteen (13) years from plant start-up (July 22, 1990), or when only 10% of the processed gas is being delivered from Little Knife Field, whichever is earlier, casinghead gas produced from the Little Knife Field is still being processed at the Little Knife Plant, the fair market value of the plant facilities shall be compared to the book value . . . contained in the agreement with the Tax Commissioner and if the fair market value at said time is greater, royalty shall be paid to the then owners on the difference.

Id. ¶ 31.

reference an agreement with the Tax Commissioner, the court reviewed the Tax Commissioner agreement as well.[182]

After analyzing both the 1983 settlement agreement and the Tax Commissioner agreement, the court determined the plain language of neither agreement barred Petro-Hunt from charging depreciation after July 22, 1990.[183] Petro-Hunt annually reviewed the Little Knife Gas Plant's economic status, in accordance with the Tax Commissioner agreement.[184] In sum, the court concluded Petro-Hunt followed the practices described in the agreements in question and therefore depreciation charges were not prohibited after July 22, 1990.[185]

b. Salvage Value

The royalty owners next argued that Petro-Hunt's depreciation charges were excessive because the Little Knife Gas Plant was depreciated below its salvage value.[186] Petro-Hunt, on the other hand, contended $656,818 remained to be depreciated before the plant was depreciated below salvage value.[187] The purchase price of the Little Knife Gas Plant was $6,213,452.[188] Although the royalty owners claimed the plant could not be depreciated below its salvage value of $3,341,357, the royalty owners had failed to consider the "purchase price was net of salvage value because the salvage value had already been deducted from [Petro-Hunt's] purchase price."[189] Furthermore, the royalty owners overlooked Petro-Hunt's depreciable capital investments in the plant, totaling $2,128,352.[190] Therefore, the court determined Petro-Hunt could properly depreciate $8,341,804, the sum of the $6,213,452 purchase price and $2,128,352 capital investments.[191] Petro-Hunt had only depreciated $7,684,986, and $656,818 thus

---

182. *Id.* The Tax Commissioner agreement referred to in the 1983 settlement agreement stated:

> Actual depreciation charges will be based on a schedule using the straight line method over an assumed plant life of 13 years. This 13-year plant life will be subject to review each fiscal year to determine if anything significant has occurred that would warrant a change in the estimated economic life of the plant. If such a change is found to be warranted, the remaining depreciation will be adjusted appropriately.

Id.

183. *Id.*

184. *Id.*

185. *Id.*

186. *Id.* ¶ 32.

187. *Id.*

188. *Id.* ¶ 33, 768 N.W.2d at 505-06.

189. *Id.* ¶ 33, 768 N.W.2d at 506.

190. *Id.* Petro-Hunt made new capital investments to the Little Knife Gas Plant of $2,282,415, of which $2,128,352 could be depreciated. *Id.*

191. *Id.*

remained for depreciation.[192] Because the royalty owners did not dispute these figures, the royalty owners had not demonstrated a genuine issue of material fact existed regarding whether the plant was depreciated below salvage value.[193] As a result, the North Dakota Supreme Court affirmed the district court's finding that Petro-Hunt did not depreciate the Little Knife Gas Plant below its salvage value.[194]

c. Fair Market Value

Finally, the royalty owners asserted Petro-Hunt should not have been allowed to depreciate the Little Knife Gas Plant because the fair market value of the plant was in excess of the undepreciated amount.[195] This claim was based on a provision within the 1983 settlement agreement.[196] Consequently, the royalty owners argued, Petro-Hunt had improperly calculated royalty.[197] Petro-Hunt countered that the royalty owners had not offered evidence to prove the plant's fair market value was above its undepreciated value.[198] The district court granted Petro-Hunt's motion for summary judgment on the matter, finding the royalty owners neglected to provide "any competent admissible evidence" in support of their claim.[199] In reviewing the district court proceedings, the North Dakota Supreme Court stated competent, admissible evidence must be presented by a party opposing summary judgment, and the evidence must show a genuine issue of material fact is in dispute.[200] The royalty owners, in failing to offer evidence that the fair market value of the plant was greater than the undepreciated amount, had not met their burden to resist summary judgment.[201] Thus, the North Dakota Supreme Court affirmed the district court's grant of summary judgment for Petro-Hunt.[202]

IV. IMPACT

With the "at the well" rule in place, parties to North Dakota oil and gas lease agreements can feel confident their intentions at lease formation will

---

192. *Id.*
193. *Id.*
194. *Id.*
195. *Id.* ¶ 34.
196. *Id.* *See supra* note 181 (providing the relevant excerpt of the 1983 settlement agreement).
197. Brief of Appellants, *supra* note 169, at 7.
198. *Bice*, ¶ 34, 768 N.W.2d at 506.
199. *Id.*
200. *Id.*
201. *Id.*
202. *Id.*

be enforced.[203] In addition, the adoption of the majority rule brings stability to an unsettled area of law in North Dakota.[204] By rejecting the minority rule, many problems and inconsistencies associated with the rule will be avoided.[205] Further, the "at the well" rule will likely prevent litigation, thereby conserving resources for both parties and courts.[206] Finally, while *Bice* ultimately benefits oil companies, royalty owners are still protected from lessee abuses under North Dakota law.

A. LEASE FORMATION INTENTIONS ENFORCED

As a general rule in North Dakota, a contract must be construed according to the parties' mutual intentions at the time of contract formation.[207] Some critics of the first marketable product doctrine note inconsistencies within the minority rule can render it "a poorly disguised device to rewrite oil and gas leases in a way that permits royalty owners to participate in downstream activities for which they have shared none of the risks and assumed none of the costs."[208] Moreover, another critic of the first marketable product doctrine states, "Under the [first marketable product doctrine], a lessor's royalty is not based upon the value of the gas when the lease is signed . . . but the value of the gas after it has been enhanced exclusively by the lessee."[209] By adopting the "at the well" rule, the North Dakota Supreme Court acted in accordance with the state's settled law of contract interpretation, requiring a contract to be interpreted according to the parties' intentions at the formation of the contract.[210] As a result, parties to North Dakota oil and gas leases can feel confident their original intentions will be honored should a lease dispute arise and proceed to litigation.[211]

---

203. *Contra* Keeling & Gillespie, *supra* note 31, at 116-17.

204. *Bice*, ¶¶ 18, 21, 768 N.W.2d at 502.

205. *Cf.* Keeling & Gillespie, *supra* note 31, at 81 (listing flaws in the first marketable product doctrine); Poitevent, *supra* note 32, at 759 (discussing major criticisms of the minority rule); Wheeler, *supra* note 102, at 24 (covering problems with the first marketable product doctrine).

206. *Contra* Wheeler, *supra* note 102, at 1, 25 (noting minority rule states lack a clear standard on the issue of which costs may be deducted before royalty calculation, frequently resulting in litigation).

207. N.D. CENT. CODE § 9-07-03 (2008).

208. Keeling & Gillespie, *supra* note 31, at 104.

209. Wheeler, *supra* note 102, at 26.

210. N.D. CENT. CODE § 9-07-03 (2008).

211. *Contra* Keeling & Gillespie, *supra* note 31, at 104 (asserting the first marketable product doctrine could improperly be used to rewrite oil and gas leases).

B. LITIGATION AVOIDANCE

In *Bice*, the court discussed the unsettled nature of the law as to interpretation of the phrase "market value at the well."[212] When considering the first marketable product doctrine, the North Dakota Supreme Court observed a problem with the minority approach as a lack of consistency relating to the point at which a marketable product is created.[213] The ultimate effect of the first marketable product doctrine is "uncertainty, both to lessees in calculating their royalty payments and to the courts in resolving royalty disputes."[214] Without a uniform approach to royalty valuation, the issue must be determined on an individual basis, resulting in case law that offers little direction to parties confronting a royalty dispute.[215] Because of the conflicting doctrines used throughout the states to calculate royalty, one author believes "[t]he end result will serve only to make domestic exploration and production even less competitive in the world marketplace."[216]

In contrast, by adopting the "at the well" rule, the North Dakota Supreme Court announced a clear standard for royalty calculation.[217] Parties can now be certain North Dakota courts will not consider "market value at the well" an ambiguous term.[218] Further, the *Bice* court stated the appropriate method for determining the market value of gas at the well was the workback method, whereby the lessee may deduct post-production costs from proceeds.[219] Because a large amount of litigation in the field of oil and gas law has focused on the issue of which costs may be deducted before royalty calculation, it is reasonable to assume the court's acceptance of the "at the well" rule will work to prevent some litigation in North Dakota.[220] By avoiding litigation, courts and parties conserve resources.[221] Domestic exploration and production could increase as lessees will be able to remove their focus from litigation and concentrate on competing in the oil and gas

212. Bice v. Petro-Hunt, L.L.C., 2009 ND 124, ¶ 13, 768 N.W.2d 496, 500.

213. *Id.* ¶ 17, 768 N.W.2d at 502.

214. Keeling & Gillespie, *supra* note 31, at 82.

215. Anderson, *supra* note 98, at 20-21.

216. *Id.* at 21.

217. *Bice*, ¶ 21, 768 N.W.2d at 502.

218. *Id.*

219. *Id.* ¶ 20.

220. *Contra* Wheeler, *supra* note 102, at 1 (stating a great amount of litigation has arisen on the issue of which costs may be deducted before royalty calculation).

221. *Contra id.* at 25 (noting lessees in first marketable product jurisdictions do not have a clear standard for deducting costs and, as a result, may face "an endless wave of expensive, burdensome and wasteful litigation").

industry.[222] Should a dispute proceed to trial, however, the "at the well" rule provides greater certainty in predicting an outcome.[223] By implementing the "at the well" rule and approving the workback method, the court resolved a conflicted area of the law, thus providing guidance to lessees, lessors, and North Dakota courts faced with royalty calculation disputes.[224]

C. PRACTICAL CONSIDERATIONS

From a practical standpoint, lessees benefit under the "at the well" rule because they do not bear post-production expenses alone, but rather share these costs with the lessor.[225] By deducting post-production costs before calculating royalty, royalty payments are decreased, and lessees realize greater profits.[226] In the competitive oil and gas industry, it is understandable why lessees would want to take every deduction available to boost their bottom lines.[227] Yet, one critic believes the workback method provides "the lessee . . . an incentive to overstate post-production costs in order to minimize its royalty-payment obligations."[228] However, North Dakota law currently requires lessees to provide lessors with "an information statement that will allow the royalty owner to clearly identify the amount of oil or gas sold and the amount and purpose of each deduction made from the gross amount due."[229] Thus, should lessees try to deduct unreasonable costs, lessors will have notice and can take action.[230]

V. CONCLUSION

In *Bice*, the North Dakota Supreme Court adopted the "at the well" rule for calculating royalties on oil and gas leases.[231] Under the "at the well" rule, lessees are allowed to deduct post-production expenses before royalty is calculated.[232] In addition, the court determined lessees may use residue

---

222. *See* Anderson, *supra* note 98, at 20-21.

223. *See* Keeling & Gillespie, *supra* note 31, at 82 (stating the "net effect of the [first marketable product] doctrine is uncertainty, both to lessees in calculating their royalty payments and to the courts in resolving royalty disputes").

224. *Bice*, ¶ 21, 768 N.W.2d at 502.

225. Poitevent, *supra* note 32, at 716.

226. *See* Owen L. Anderson, *Calculating Royalty: "Costs" Subsequent to Production—"Figures Don't Lie, But . . . ."*, 33 WASHBURN L.J. 591, 601-02 (1994).

227. *Id.*

228. *Id.* at 597.

229. N.D. CENT. CODE § 38-08-06.3 (2008).

230. *See id. See also* N.D. CENT. CODE § 47-16-39.1 to -39.3 (2008) (describing obligations arising with royalty payments); N.D. ADMIN. CODE 43-02-06-01, -03 to -04 (2008) (addressing royalty record requirements).

231. Bice v. Petro-Hunt, L.L.C., 2009 ND 124, ¶ 21, 768 N.W.2d 496, 502.

232. *Id.* ¶ 13, 768 N.W.2d at 501.

gas off the leased premises in furtherance of lease operations without paying royalty on that gas under "free use" clauses.[233] Finally, the North Dakota Supreme Court concluded the lessee's deductions for risk-capital and depreciation were not excessive.[234] The *Bice* decision brings stability to an unsettled area of North Dakota law, and the rule is likely to impact future oil and gas lease dealings in the state.[235]

*Lindsey Scheel**

233. *Id.* ¶ 27, 768 N.W.2d at 504.

234. *Id.* ¶¶ 29, 31, 33-34, 768 N.W.2d at 504-06.

235. *See* discussion *supra* Part IV (discussing the influence *Bice* may have in North Dakota).

*J.D. candidate at the University of North Dakota School of Law. Thank you to my entire family—especially Rod, Jo, and Abby Scheel—for their love, support, and encouragement throughout law school and life. Also, thanks to Jemma, my faithful four-legged friend, who, despite her penchant for paper, never ate a single page while I researched, wrote, and revised this article.