THE ATTORNEY GENERAL
OF TEXAS

AUSTIN 11, TEXAS

WILL WILSON
ATTORNEY GENERAL

July 24, 1957

Honorable J. Earl Rudder
Commissioner, General Land
Office
Austin, Texas

Opinion No. WW-196

Re: Whether or not the cost of transporting gas obtained from State leases may be legally deducted from the State's royalty interest in the specific instances as are outlined herein.

Dear Mr. Rudder:

In your letter requesting our opinion dated May 24, 1957, you enclosed three memoranda from an Assistant State Auditor, questioning the legality of certain deductions of various costs involved in the processing and transportation of gas before calculating the royalty due the State. Because of the length of these memoranda, each will not be set out in this opinion in detail, but the pertinent and controlling facts may be summarized as follows:

There are three leases involved, all of which were executed under the authority of Chapter 271, Acts 42nd Leg., 1931 (Art. 5421c, Sec. 10, V.C.S.). The pertinent royalty provision of the statute is as follows:

> "The areas included herein shall be leased for a consideration, in addition to the cash amount bid therefor, of not less than one-eighth (1/8) of the gross production of oil, or the value of the same, that may be produced and saved, and not less than one-eighth (1/8) of the gross production

of gas or the value of the same . . . that may be produced and sold off the area. . . ."

The three leases involved, respectively contain the following covenants in regard to the royalty to be paid the State:

"1. One-eighth of the gross production of gas, or the value of the same,. . ."

"2. As a royalty on residue gas, one-eighth of the value of the gross production, sold or used off the premises. The value of the residue gas to be based upon the highest price paid or offered for residue gas in the general area or that part which accrues to the lessee, whichever is the greater."

"3. As royalty on any gas, including residue gas, sold or used by the lessee for any purpose, one-sixth of the value of such gas to be sold or used, but in no event shall the royalty be based upon a price of less than the highest market price paid or offered for gas in the general area or that part which accrues to the producer, whichever is the greater; . . . ., provided, however, lessee agrees that before any gas containing liquid hydrocarbons, recoverable in commercial quantities is sold or used, it will be run through an adequate oil and gas separator to the end that all liquid hydrocarbons recoverable from the gas by such means will be recovered."

By the provisions of the three leases as shown above, the first allows the State to take possession of its fractional part of the gas produced in kind or to receive from the lessee the value thereof. The second and third provisions do not provide that the State may receive its royalty in kind, but provide that the lessee shall pay the State the cash value. It must be remembered, however, that the language of the statute contols over the terms of the leases, and that such leases can neither diminish nor enlarge the State's royalty interest as set out in the statute.

In each of the three instances upon which your question was based, there was no market at the well site for the gas produced. The State's lessees, in order to market the gas, constructioned various pipelines, compressors and hydrocarbon separators at their own expense and in which the State owns no interest. The royalty paid the State in each instance was based upon the price the producer was paid for the gas at the point such gas was transferred from the producer's pipeline to that of the purchaser, less one-eighth of the total cost of transporting and processing the gas produced between the well site and the place where the purchaser took delivery.

The question which you ask, based upon the above summary of facts, was whether or not the State could legally be charged its pro rata share of the cost of (1) transporting the gas from the well site to the purchaser, and (2) the cost of separating marketable hydrocarbons under the provision of the third lease agreement.

One point that seems clear in any lease executed under Section 10 of Art. 5421c is that where payment of money royalty is accepted by the State, that such payment is to be based upon the "gross production or value of the same" at the place where it is produced and we need not speculate on distinctions within the royalty clauses which do not exist in fact.

It is now generally accepted that the mouth of the well is the proper pricing point for determining the value of royalty gas. <u>Scott v. Steinberger</u>, et al., 213 P. 646 (Kan. 1923); <u>Haynes v. Southwest Natural Gas Co.</u>, 123 F. 2d 1011 (C.C.A. 5th 1942). While no case has been found which specifically defined the term "gross production," the case of <u>Arkansas Natural Gas Co. v. Sartor</u>, 78 F.2d 924 (C.C.A. 5th, cert. den., 296 U.S. 656, 1935) held that "1/8th of the gas produced and sold from premises" meant average price "in the field at the well."

If there is no market at a specific well, evidence which shows the market price for gas at other wells, such gas being utilized in the same manner as the gas from the well in question, is admissible to enable the court to determine market value. <u>Phillips Petroleum Co. v. Bynum</u>, 155 F.2d 196, 199 (C.C.A.5th 1946, cert.den., 329 U.S. 714) and <u>Phillips Petroleum Co. v. Ochsner</u>, 146 F.2d 138 (C.C.A.5th, 1944). That part of the royalty provision in leases number two and three as set out above, which sets out how the value of royalty gas is to be determined, follows closely the method used by the courts in determining such value; and do not otherwise add anything of significance to the lease contract.

There are no cases which have ever held that a lessee must construct facilities for transporting or processing gas without being permitted to charge something back against the lessor. The lessee owes a duty to the lessor to use diligence in marketing the product of the gas well, but no court has ever held that the State or any other lessor is entitled to a free ride to the marketing point. Mr. George Siefkin in Rights of Lessor and Lessee With Respect to Sale of Gas and to Gas Royalty Provisions, 4th Annual Institute on Oil and Gas and Taxation, Southwestern Legal Foundation.

In two successive cases where the principal issue was the method to be used in determining the value of royalty gas where there was no market at the wells, the Fifth Circuit held that the proper royalty in such cases was one-eighth of the proceeds of the actual sale, less a proper credit for the cost of transportation, separation and sale. Phillips Petroleum Co. v. Bynum, supra, and Phillips Petroleum Co. v. Johnson, 155 F.2d 185 (C.C.A.5th cert.den.,329 U.S. 730, 1946). Substantially the same result has been reached in Kretni Development Co. v. Consolidated Oil Corp., 74 F.2d 497 (C.C.A.10th,1934); Katschner v. Eason Oil Co., 63 P.2d 977 (Okla.1936). It will be noted that, although the wording of the royalty clauses in the leases vary somewhat from case to case, the same result has uniformly been reached.

In Danciger Oil & Refining Co. v. Hamill Drilling Co., 141 Tex. 153, 171 S.W.2d 321 (1943) where the issue was whether certain royalty payments provided for in an assignment contract were to be based upon the value of gas produced at the well, or its value after such gas had been processed into other products, the court held that the royalty owner was bound to accept payment out of the value of the gas at the well and was not entitled to have it refined into some other commodity. It is believed this case indicates that the courts in this State would follow the "well head pricing point" rule in the federal cases herein cited, unless the contract clearly showed a contrary intent of the parties.

It, therefore, appears that the State may legally be charged its pro rata share of transportation costs from the well head, which is the pricing point for value of royalty gas, to that point where title to the gas passes to the purchaser. This means that where the value of the gross production of gas is computed from a price paid for such gas at a point not at the well, then in arriving at the royalty to be paid the State, a reasonable charge may be assessed for the use of necessary pipelines and processing equipment. It is our further opinion that the provision in Lease No. 3 cited above, that requires the lessee to remove hydrocarbons, if present in commercial quantities, does not change or affect that point at which the State's royalty interest is computed, and the lessee is entitled to deduct from the royalty paid the State's pro rata share of the expense incurred in the removal of such hydrocarbons.

Because of the wide possible variations between different situations requiring the lessee to build transporting and processing equipment in marketing gas, we are unable to lay down any general rules for assessing such charges against the State, and such charges in each individual case must be determined from the standpoint of accepted accounting principles, to be properly determined by the State Auditor.

SUMMARY

Under all leases executed by the General Land Office under the authority of Chapter 271, Acts 42nd Leg., 1931, where the value of royalty gas is computed on the basis of a purchase price paid for such gas after it has been transported from the well site, the State's lessee may legally deduct from the royalty payments for cost of transportation and processing between the well head and the purchasing point when these costs are computed according to standard and acceptable accounting principles.

Yours very truly,

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