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Oil and Gas—Deductions Under a Proceeds Royalty Lease—Arkansas Puts the Pressure on Lessee. *Hanna Oil & Gas Company v. Taylor*, 297 Ark. 80, 759 S.W.2d 563 (1988).

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NOTES

OIL AND GAS—DEDUCTIONS UNDER A PROCEEDS ROYALTY LEASE—Arkansas Puts the Pressure on Lessee. *Hanna Oil & Gas Company v. Taylor*, 297 Ark. 80, 759 S.W.2d 563 (1988).

On May 5, 1975,¹ Hanna Oil and Gas Company (lessee) executed an oil and gas lease with David Taylor (lessor). Hanna pooled the 80 acre Taylor lease with other land to form a 640 acre production unit. In July 1976 Hanna completed a producing natural gas well on the lease. Pursuant to a gas purchase contract between Hanna and Arkansas Louisiana Gas Company (Arkla), Hanna sold gas produced from the well to Arkla upon delivery into its pipeline. The Arkla contract required Hanna to deliver the gas at a pressure of 500 pounds per square inch.²

For eight years the well produced gas at sufficient pressure so that no compression was necessary for delivery into Arkla's pipeline. Beginning in April 1984, reservoir pressure fell below 500 pounds per square inch due to the withdrawal of gas. Hanna then began compressing gas produced at the well to deliver it at the required pressure.³ However, lessee did not deduct compression costs from the royalty paid to lessor until October 1986. On May 5, 1987, Taylor filed suit in chancery court challenging the deduction of compression costs.

The lease did not specifically mention compression costs.⁴ The applicable royalty clause in the lease contained the following language: "Lessee shall pay Lessor one-eighth of the proceeds received by Lessee at the well for all gas (including all substances contained in

1. Specific date was taken from the lease. *See infra* note 4.

2. Section 8 of the contract gave Arkla the right to require that gas be delivered at contract pressure (500 pounds per square inch). It further provided that Arkla could, but was not obligated to, compress the gas itself and deduct compression costs from the purchase price. Brief for Appellant at 4-5, *Hanna Oil & Gas Co. v. Taylor*, 297 Ark. 80, 759 S.W.2d 563 (1988).

3. 297 Ark. 80, 759 S.W.2d 563. Arkla elected not to provide for compression. Thus, under the contract, Hanna had to compress the gas to make it salable. *Id.*

4. The lease form was a standard oil and gas lease, "AAPL FORM 680" (American Association of Petroleum Landmen Approved Form No. 680), with no significant alterations (copy supplied by Dorsey Ryan, attorney for appellant).

such gas) produced from the leased premises and sold by Lessee.”⁵

The Franklin County Chancery Court, Charleston District, ruled that the lessee was not entitled to deduct a pro rata share of compression costs from royalty payments. The Supreme Court of Arkansas affirmed, holding that a lessee may not deduct compression costs from royalty payments when an oil and gas lease contains a proceeds royalty clause such as this. *Hanna Oil & Gas Co. v. Taylor*, 297 Ark. 80, 759 S.W.2d 563 (1988).

Early oil producers considered natural gas as a waste by-product of oil production.⁶ Around the 1930s, city and community systems began utilizing natural gas as an efficient and inexpensive heating fuel, but the use was primarily local in nature.⁷ It was during this time period that the Arkansas General Assembly recognized the value of natural gas resources and their limited supply by passing a “conservation statute” to prevent the waste of oil and natural gas resources.⁸ The increased demand for petroleum products during World War II induced the creation of pipeline systems from production areas to population centers.⁹ During the postwar era these pipeline systems were converted to the private sector and formed the basis for a complex interstate system to transport natural gas to populated areas for use as a home heating and industrial fuel.¹⁰

In North Arkansas until about 1981 there existed only one purchaser, Arkansas Louisiana Gas Company (Arkla), with pipelines

5. See *supra* note 4. The royalty clause is contained in Paragraph 4 of AAPL Form 680. Following the language construed by the court, the lease also contains the following sentence: “If such gas is used by Lessee off the leased premises or used by Lessee for the manufacture of casinghead gasoline or other products, Lessee shall pay Lessor one-eighth of the prevailing market price at the well for the gas so used.” *Id.*

6. *Exxon Corp. v. Middleton*, 571 S.W.2d 349, 352 (Tex. Civ. App. 1978). In the early days, gas produced as a by-product of oil production was often simply burned off or “flared.” *Id.*

[A]t one time, one could drive for many miles at night through the East Texas Oil Field without turning on the lights of one’s vehicle. From the air, West Texas was said to look as if campfires of all of the armies in the history of the world were burning below.

Id.

7. *Id.*

8. 1939 Ark. Acts 105 (now codified at ARK. CODE ANN. §§ 15-72-101 to 110 (1987)). The Act defines “waste” as including “[t]he inefficient . . . operating, or producing of any oil or gas well or wells in a manner which results, or tends to result, in reducing the quantity of oil or gas ultimately to be recovered from any pool in this state.” *Id.* § 15-72-102(9)(A).

9. 571 S.W.2d at 352.

10. *Id.*

that transported gas out of the area.¹¹ Most gas purchase contracts in that area gave Arkla, the purchaser, the right to compress gas (if necessary to meet pipeline pressure requirements) and deduct compression costs from the price paid to the producer.¹² However, because of a general oversupply of gas during the last few years, purchasers often opt not to compress gas in order to purchase it.¹³ Thus, the changing gas economy has left producers (lessees) with the choice of compressing the gas themselves or leaving it in the ground.¹⁴

In Arkansas, an oil and gas lease gives the lessee an option to explore and develop the mineral potential of a tract of land.¹⁵ The primary consideration for the landowner's (lessor's) granting this option is the potential for "risk-free riches in the form of royalty."¹⁶ This lease relationship creates an inherent conflict between lessor and lessee. The lessee must pay for exploration and development, while the "lessor's royalty is calculated as a 'cost-free' share of production."¹⁷

It is well settled that the lessee alone must bear the costs of actual production, including exploration costs, costs of bringing the gas to

11. Affidavit of William R. Walker, President of Stephens Production Company, quoted in Brief for Appellant at 7, *Hanna*, 297 Ark. 80, 759 S.W.2d 563.

12. *Id.* Arkla's purchase contract with Hanna Oil & Gas Company contained such a clause. See *supra* note 2.

13. Affidavit of William R. Walker, *supra* note 11. See also *Hanna*, 297 Ark. at 84-85, 759 S.W.2d at 566 (Hays, J., dissenting).

14. *Hanna*, 297 Ark. at 84-85, 759 S.W.2d at 566 (Hays, J., dissenting).

15. See Wright, *The Arkansas Law of Oil and Gas* (Chapter IV), 10 U. ARK. LITTLE ROCK L.J. 5 (1987-88) [hereinafter Wright IV]. In *Hillard v. Stephens*, 276 Ark. 545, 637 S.W.2d 581 (1982), the Arkansas Supreme Court stated the questionable conclusion that an Arkansas gas lease constitutes a present sale of all the gas in place. Wright, *The Arkansas Law of Oil and Gas* (Chapter I), 9 U. ARK. LITTLE ROCK L.J. 223, 224-25 (1986-87) [hereinafter Wright I]. This statement contradicts Arkansas precedent and probably resulted from the court's confusion of the present sale of lessor's interest with the present sale of all gas in place. Note, *Hillard v. Stephens: Interpretation of Market Price Royalty Provisions in Natural Gas Leases*, 36 ARK. L. REV. 312, 322 (1982).

16. Pierce, *Rethinking the Oil and Gas Lease*, 22 TULSA L.J. 445, 447 (1987). The lessor may also receive consideration in the form of a bonus payment and delay rentals as provided in the lease, but these payments are usually small in comparison to royalties derived from a producing well. *Id.*; Wright IV, *supra* note 15, at 5.

17. Pierce, *supra* note 16, at 458. Professor Kuntz states:

The cause of the conflict in the interests of the lessor and lessee is very simple. The lessee must bear the cost of any operation on the leased premises, whether such operation is in exploration, development, or production; while the lessor derives his benefit from production, free and clear of all costs. It is true that any activity in the exploration, development, and operation of the leased premises involves a risk of loss to both lessor and lessee, but the risk of loss to which the lessor is exposed is negligible in comparison to the risk undertaken by the lessee.

5 E. KUNTZ, A TREATISE ON THE LAW OF OIL AND GAS § 54.2, at 1-2 (1978).

the surface, and costs of activities normally conducted at the well-head.¹⁸ Likewise, it is generally accepted that both lessor and lessee are to share post-production costs,¹⁹ although there is some question as to where the dividing line should be drawn.²⁰ Post-production expenses borne proportionately by lessor and lessee normally include transportation costs, pipeline expenses, gross production and severance taxes, and expenses of making the product salable (e.g., dehydration).²¹

There is a definite split of authority as to whether compression costs are production costs to be borne solely by the lessee/producer or marketing expenses to be proportionately shared by lessor and lessee.²² An apparent majority of authorities and jurisdictions agree that compression costs are post-production expenses or marketing costs which should be shared by the lessor/royalty-owner.²³ In *Martin v. Glass*²⁴ the United States District Court for the Northern District of Texas concluded that compression is a "separate and independent step, once or more removed from production, and as

18. Wright IV, *supra* note 15, at 12-13; 3 E. KUNTZ, *supra* note 17, § 40.5 (1967); H. WILLIAMS & C. MEYERS, *MANUAL OF OIL AND GAS TERMS* 856-57 (7th ed. 1987); Altman & Lindberg, *Oil and Gas: Non-Operating Oil and Gas Interests' Liability for Post-Production Costs and Expenses*, 25 OKLA. L. REV. 363, 365 (1972); Note, *Costs Deductible by the Lessee in Accounting to Royalty Owners for Production of Oil or Gas*, 46 LA. L. REV. 895, 898-99 (1986). Professor Williams includes the following in "costs of production": "(1) Costs of geophysical surveys, (2) Drilling costs, (3) Tangible and intangible costs incurred in testing, completing, or reworking a well, including the cost of installing the Christmas tree, (4) Secondary recovery costs." 3 H. WILLIAMS, *OIL AND GAS LAW* § 645.1 (1988).

19. 3 H. WILLIAMS, *supra* note 18, § 645.2, at 596-607 and cases cited therein; Altman & Lindberg, *supra* note 18; H. WILLIAMS & C. MEYERS, *supra* note 18; Note, *supra* note 18; see also Siefkin, *Rights of Lessor and Lessee with Respect to Sale of Gas and as to Gas Royalty Provisions*, 4 INST. ON OIL & GAS L. & TAX'N 181 (1953). *Contra* M. MERRILL, *COVENANTS IMPLIED IN OIL AND GAS LEASES* § 85 (1940). Dr. Merrill states: "No part of the costs of marketing or of preparation for sale is chargeable to the lessor." *Id.* at 214-15.

20. Professor Kuntz opines that the production function extends until a marketable product has been obtained, but after the product has been rendered marketable, further expenses of improving or transporting the product should be shared by lessor and lessee. 3 E. KUNTZ, *supra* note 17, § 40.5, at 322-55. *But see* 3 H. WILLIAMS, *supra* note 18, § 645.2, at 602 ("Expenses of treatment required to make the mineral product salable" are costs subsequent to production.).

21. See *supra* notes 19-20.

22. Altman & Lindberg, *supra* note 18, at 368.

23. 3 H. WILLIAMS, *supra* note 18, § 645.2, at 596-607; 3A W. SUMMERS, *THE LAW OF OIL AND GAS* § 589 (1958 & Supp. 1989); Note, *supra* note 18, at 906-07; see, e.g., *Scott Paper Co. v. Taslog, Inc.*, 638 F.2d 790 (5th Cir. 1981); *Martin v. Glass*, 571 F. Supp. 1406 (N.D. Tex. 1983), *aff'd*, 736 F.2d 1524 (5th Cir. 1984); *Harding v. Cameron*, 220 F. Supp. 466 (W.D. Okla. 1963); *Merritt v. Southwestern Elec. Power Co.*, 499 So. 2d 210 (La. Ct. App. 1986); *Parker v. TXO Production Corp.*, 716 S.W.2d 644 (Tex. Ct. App. 1986).

24. 571 F. Supp. 1406.

such is a post-production expense, and the lessee is entitled to a pro rata reimbursement.”²⁵ Some authorities have characterized compression costs as a specific form of transportation costs or their theoretical equivalent.²⁶ Altman and Lindberg submit that there is no rational basis for allowing deduction from royalty payments of pipeline or other transportation costs and yet deny lessee the right to deduct other marketing expenses such as compression costs.²⁷ Siefkin pointedly states:

Here is a well and here is gas at the well head. At this time and place we evaluate that gas for purposes of computing royalty. It is worth what it will bring *at that point in its natural state*, no more, no less If it cannot be sold at the well because of its inferior quality, how can the lessee's duty to 'market' be transposed into a duty to render the gas more valuable than it actually is, all at his expense? . . . To my mind it is at least equally persuasive to insist that the duty to market is confined to the product *in the state in which it is produced at the well*, and does *not* include any duty, at the lessee's sole expense, to increase its value by processing, any more than it includes a duty to transport it free of charge to distant markets.²⁸

A minority of authorities and jurisdictions support the proposition that compression costs are expenses for which the lessee alone should pay.²⁹ Dr. Merrill states: “No part of the costs of marketing or of preparation for sale is chargeable to the lessor. This is supported by the general current of authority.”³⁰ However, Dr. Merrill's claim that his view is supported by the “general current of authority” is persuasively challenged by Altman and Lindberg.³¹ Furthermore, the two Kansas cases which relied on Dr. Merrill's views, *Gilmore v. Su-*

25. *Id.* at 1416.

26. Note, *supra* note 18, at 906.

27. Altman & Lindberg, *supra* note 18, at 368-69.

28. Siefkin, *supra* note 19, at 200-01.

29. M. MERRILL, *supra* note 19; *see, e.g.*, California Co. v. Udall, 296 F.2d 384 (D.C. Cir. 1961); *Gilmore v. Superior Oil Co.*, 192 Kan. 388, 388 P.2d 602 (1964); *Schubach v. Continental Oil Co.*, 193 Kan. 401, 394 P.2d 1 (1964); *cf.* West v. Alpar Resources, Inc., 298 N.W.2d 484 (N.D. 1980) (Lessee was not allowed to deduct costs of removing hydrogen sulfide from sour gas to make it marketable, under a “proceeds of sale” royalty clause. The court considered the removal costs as production costs.); *Warfield Natural Gas Co. v. Allen*, 261 Ky. 840, 88 S.W.2d 989 (1935) (*see infra* note 51 and accompanying text). *Compare* 3 E. KUNTZ, *supra* note 17, § 40.5 (1967). Presumably, Professor Kuntz would deny deduction of compression costs if compression was necessary to render the gas marketable, but allow deduction of costs of compressing gas to merely increase its value. *Id.*; *see supra* note 20.

30. M. MERRILL, *supra* note 19, § 85, at 214-15.

31. Altman & Lindberg, *supra* note 18, at 370-80.

*perior Oil Co.*³² and *Schupbach v. Continental Oil Co.*,³³ have been criticized as contrary to law and conflicting with Kansas precedent.³⁴

Arkansas considered the issue of the deductibility of transportation costs before computing royalty payments in *Clear Creek Oil & Gas Co. v. Bushmaier*.³⁵ The lease construed in *Bushmaier* based royalty payments upon "market price of royalty gas at the wells."³⁶ Because there was no market at the well, the lessee transported gas to industrial customers in Van Buren and Ft. Smith several miles away. The court held that the lessee was entitled to deduct costs from the lessor's royalties for the cost of transportation to carry the gas to the nearest available market.³⁷

In *Parnell, Inc. v. Giller*³⁸ the Arkansas Supreme Court construed a royalty clause in a typical oil and gas lease used as a lease form for commercial brine production. For brine sold at the well, royalty was to be based upon the "amount realized," but for brine sold or used off the premises, royalty was to be based upon the "market value at the well."³⁹ The brine was sold to a chemical company pursuant to a contract which required Parnell (lessee) to deliver raw brine to the plant for bromine extraction and dispose of the spent brine.⁴⁰ Citing *Bushmaier*, the court allowed the lessee to deduct pipeline expenses and disposal costs because both services were "essential to and peculiar to the marketing of the product itself."⁴¹

In *Hillard v. Stephens*⁴² the Arkansas Supreme Court construed a gas lease provision whereby royalty was to be based on the "prevailing market price at [the] well."⁴³ The issue was whether this provision meant that royalty was to be computed from current fluctuating

32. 192 Kan. 388, 388 P.2d 602 (1964).

33. 193 Kan. 401, 394 P.2d 1 (1964).

34. Altman & Lindberg, *supra* note 18, at 376-79. In reference to the *Gilmore* decision, Summers states: "Though this text was cited, it is believed the case is contrary to the majority rule and lays upon the lessee a financial burden not necessarily a part of the duty to market." 3A W. SUMMERS, *supra* note 23, § 589, at 20 n.18 (Supp. 1989). Likewise, the A.B.A. Section of Mineral and Natural Resources Law, 1964 COMMITTEE REP. 69 states: "This case appears to be contrary to the great weight of opinion, and in fact, cannot be reconciled with established precedent in the State of Kansas." *Id.*

35. 165 Ark. 303, 264 S.W. 830 (1924).

36. *Id.* at 307, 264 S.W. at 832.

37. *Id.*

38. 237 Ark. 267, 372 S.W.2d 627 (1963).

39. *Id.* at 268, 372 S.W.2d at 628.

40. *Id.*, 372 S.W.2d at 627.

41. *Id.* at 269, 372 S.W.2d at 628.

42. 276 Ark. 545, 637 S.W.2d 581 (1982).

43. *Id.* at 547, 637 S.W.2d at 582 (emphasis omitted).

prices or frozen at the price in the lessee/producer's long-term purchase contract with Arkla.⁴⁴ The court in *Hillard* noted that a lessee/producer has an implied immediate duty to market the gas produced.⁴⁵ The court also recognized the importance of long-term gas purchase contracts in discharging lessee's duty to market. Relying heavily on the Oklahoma case of *Tara Petroleum Corp. v. Hughey*,⁴⁶ the Arkansas court adopted a rule favoring the lessee's interest:

when a producer's lease calls for a royalty on gas based on the market price at the well and the producer enters into an arm's-length, good faith gas purchase contract with the best price and term available to the producer at the time, that price is the 'market price' and will discharge the producer's gas royalty obligation [even if the current market price is higher].⁴⁷

The sole issue considered by the Arkansas Supreme Court in *Hanna*, was whether Hanna Oil and Gas Company as lessee/producer was entitled to deduct a pro rata share of its compression costs from David Taylor's (lessor's) royalties.⁴⁸ The applicable royalty clause reads as follows: "Lessee shall pay Lessor one-eighth of the proceeds received by Lessee at the well for all gas (including all substances contained in such gas) produced from the leased premises and sold by Lessee."⁴⁹

The majority first focused on the plain meaning of the word "proceeds" in the royalty clause. Citing the Kentucky case of *Warfield Natural Gas Co. v. Allen*,⁵⁰ the court stated that "'proceeds' generally means total proceeds" unless an agreement provides otherwise.⁵¹ The court added that this interpretation was consistent

44. *Id.* at 549-50, 637 S.W.2d at 583.

45. *Id.* at 550; see Note, *supra* note 15; Wright, *The Arkansas Law of Oil and Gas* (Chapter V), 10 U. ARK. LITTLE ROCK L.J. 699, 716-17 (1987-88).

46. 630 P.2d 1269 (Okla. 1981).

47. 276 Ark. at 551, 637 S.W.2d at 584 (quoting *Tara*, 630 P.2d at 1273).

48. 297 Ark. at 80, 759 S.W.2d at 564.

49. *Id.* at 81, 759 S.W.2d at 564; see *supra* note 4 and accompanying text.

50. 261 Ky. 840, 88 S.W.2d 989 (1935).

51. 297 Ark. at 81, 759 S.W.2d at 564-65. It is questionable that the decision in *Warfield* actually supports the majority's opinion in *Hanna*. In *Warfield* the lessor refused to accept royalty deductions for transportation costs. The Kentucky court's reference to "proceeds" meaning "total proceeds" was apparently only dictum because the court went on to hold:

Nothing was said in the lease about a sale elsewhere and this lease must be held to mean one-eighth of the gross proceeds of a sale of the gas *at the well side*, and that is all for which defendant must account even though it may market the gas elsewhere and get a much greater sum for it.

261 Ky. at 844, 88 S.W.2d at 992 (emphasis added). One writer has gone as far as stating that the general current of authority considers the terms "proceeds" and "net proceeds" as synony-

with the dictionary definition of "proceeds."⁵² Thus, the majority excised the word "proceeds" from the royalty clause, and on the basis of its common meaning, held that the lessee was not entitled to deduct compression costs. Furthermore, the court stated: "If it had been their intention to do so, they would have made some reference to costs, or 'net' proceeds."⁵³

Next, the majority recited the rule that "[a]mbiguities in an oil and gas lease should be construed in favor of the lessor and against the lessee."⁵⁴ The court did not find the lease provision to be ambiguous.⁵⁵ But, the implication is that had the court found the clause ambiguous the result would have been the same.

Finally, the court considered the parties' construction of the agreement by the parties. The fact that Hanna began compressing gas in April 1984 but did not deduct compression costs from royalty payments until October 1986 (two and one-half years later) was "perhaps the most compelling support for [the court's] conclusion that the compression costs are not deductible."⁵⁶

Justice Hays filed a dissenting opinion stressing that the court should construe the royalty clause as a whole, and consider the lease within the proper context of the oil and gas industry. First, Justice Hays observed that the majority focuses on the plain meaning of the word "proceeds," while ignoring the equally crucial term "at the well."⁵⁷ Justice Hays stated: "The term 'at the well' is a term of art describing the place where the royalty is calculated. Here, due to the low pressure of the gas, there would be no sales at the well, and hence no royalties, but for the compression."⁵⁸

mous. Note, *supra* note 18, at 897. More properly stated, authorities generally agree that when proceeds are to be determined *at the well*, costs incurred beyond the wellhead are deductible under a "proceeds" royalty provision. 3 H. WILLIAMS, *supra* note 18, §§ 645.2-646.1, at 596-611.

52. 297 Ark. at 81, 759 S.W.2d at 565.

53. *Id.*

54. *Id.* at 82, 759 S.W.2d at 565 (citing *Bodcaw Oil Co. v. Atlantic Refining Co.*, 217 Ark. 50, 61, 228 S.W.2d 626, 633 (1950)).

55. *Id.*

56. *Id.* The court cited *Skaggs v. Heard*, 172 F. Supp. 813 (S.D. Tex. 1959), for the proposition that the construction placed upon an agreement by the parties is often decisive in construing an instrument.

57. 297 Ark. at 82, 759 S.W.2d at 565 (Hays, J., dissenting).

58. *Id.* at 83, 759 S.W.2d at 565. This view is supported by Professor Williams who explains that the term "at the well" describes the place at which the royalty-owner's share of production (or the proceeds thereof) must be delivered "free of cost." Furthermore, Professor Williams states that construction problems with "proceeds" royalty clauses should occur only when there is no "clear specification as to whether proceeds 'at the well' or proceeds 'at the place of sale' is meant." 3 H. WILLIAMS, *supra* note 18, §§ 645.2-646.1, at 596-611.

Second, Justice Hays discussed the case of *Hillard v. Stephens*,⁵⁹ which the majority did not address. In *Hillard* the court held that a lessee/producer has an immediate duty to market gas produced. The court also encouraged long-term gas purchase contracts as a means of adhering to that duty.⁶⁰ However, in this case, because compression was necessary to meet contract requirements, Justice Hays reasoned that the majority opinion penalizes the lessee for his diligence in securing long-term purchase contracts. "Not only does the majority opinion place financial impediments towards the lessee fulfilling this marketing duty, but the lessee's implied duty to market is transposed into a duty to render the gas more valuable than it actually is."⁶¹

Third, Justice Hays opined that *Clear Creek Oil & Gas Co. v. Bushmaier*⁶² supports the deductibility of compression costs.⁶³ The rationale for this conclusion is that compression costs and transportation costs are both post-production expenses. In fact, compression and transportation are theoretical equivalents in that both are "merely logistical methods by which the gap between production and pipeline are transcended, regardless of whether such gap is measured in inches or miles."⁶⁴ Although the court in *Bushmaier* was construing a "market price" royalty clause, Justice Hays asserted that the terms "market price," "market value," and "proceeds" merely set the basis from which the royalty is calculated.⁶⁵ Thus, in this case, where the issue is what expenses the lessee may deduct from the basis, the distinction is irrelevant.⁶⁶

Finally, Justice Hays pointed out that the construction placed upon the terms by the parties was primarily a function of the dynamic economics of the gas industry, not an affirmative choice on the part of the lessee. When gas was in short supply and/or the price was high, gas purchasers compressed the gas themselves, if necessary, and deducted a portion of the price paid to the supplier. However, gas purchasers now opt not to compress the gas due to an oversupply.⁶⁷ Indeed, it is difficult to reconcile the majority opinion with the fact that if Arkla had opted to compress the gas itself, the lessor would

59. 276 Ark. 545, 637 S.W.2d 581 (1982).

60. See *supra* notes 42-47 and accompanying text.

61. 297 Ark. at 83, 759 S.W.2d at 566 (Hays, J., dissenting).

62. 165 Ark. 303, 264 S.W. 830 (1924).

63. See *supra* notes 25-26, 34-36 and accompanying text.

64. 297 Ark. at 84, 759 S.W.2d at 566 (Hays, J., dissenting) (citing *Altman & Lindberg*, *supra* note 18).

65. *Id.*

66. *Id.*

67. *Id.* at 84-85, 759 S.W.2d at 566. See *supra* notes 11-14 and accompanying text.

have had no choice but to share proportionately in the cost of compression.

The *Hanna* decision introduces a certain amount of confusion into royalty provisions. Because compression costs are normally considered post-production expenses, there is now no clear division in Arkansas between costs that should be borne solely by the lessor and those that should be shared pro rata by the lessor and lessee. For example, a strict interpretation of the *Hanna* opinion suggests that expenses of treatment required to make a mineral product salable, such as dehydration, would not be deductible under some circumstances. Until the Arkansas Supreme Court establishes a clear division between production expenses and post-production expenses, any cost incurred between the wellhead and delivery to the purchaser may be open to dispute.

On the other hand, one might conclude that *Hanna* sets only a narrow precedent due to the emphasis the majority apparently placed on the parties' construction of the lease. If the parties' construction was truly the decisive factor, there may be very few instances for the application of *Hanna* in the future. Nevertheless, lessees would be well-advised to promptly deduct from royalty payments any costs that conceivably may be deductible. Of course, the preferred solution to this problem is for the lease to state explicitly those costs which are to be shared pro rata by lessor and lessee.⁶⁸

In the long run, the *Hanna* decision may be of little benefit to royalty-owners. If the lessee bears all of the compression expenses, it follows that the profitable limit of the wells will be arrived at sooner.⁶⁹ In order to keep an Arkansas gas lease alive pursuant to the standard habendum clause, there must be "production in paying quantities" (*i.e.*, production profitable to the lessee).⁷⁰ If the well is prematurely

68. An example of such a royalty provision is that contained in TXO Production Corp. Form 235 (Rev. 12/88) which states in paragraph 4: "Lessee shall pay . . . to Lessor one-eighth of the net proceeds realized by Lessee for all gas . . . produced from the leased premises and sold by Lessee, less Lessor's proportionate share of taxes and all costs incurred by Lessee in delivering, processing, compressing or otherwise making such gas or other substances merchantable or enhancing the marketing thereof."

69. Altman & Lindberg, *supra* note 18, at 365 n.10.

70. Wright IV, *supra* note 15, at 26; Turner v. Reynolds Metal Co., 290 Ark. 481, 721 S.W.2d 626 (1986). *But cf.* Perry v. Nicor Exploration, Inc., 293 Ark. 417, 738 S.W.2d 414 (1987), in which the Arkansas Supreme Court held that when an oil and gas lease is pooled with other leases to form a production unit, the profitability of the unit as a whole is the determinative factor. See Note, *Perry v. Nicor Exploration, Inc.: Split Stream Sales and Paying Quantities*, 42 ARK. L. REV. 155 (1989) for a discussion of the import of the *Perry* decision.

abandoned, has the royalty-owner's interest been advanced?

G. Alan Perkins

