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Fair Market Value of Oil and Gas Leases in Forced Pooling Area Established by Terms and Prices Paid in the Area

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FAIR MARKET VALUE OF OIL AND GAS LEASES IN FORCED POOLING AREA ESTABLISHED BY TERMS AND PRICES PAID IN THE AREA

OIL AND GAS LAW-FORCED POOLING ORDER

The Supreme Court of Oklahoma held that sales of leases in a forced pooling area were “open market” transactions, not the result of “condemnation” proceedings, and as such were admissible to establish reasonable market value. Coogan v. Arkla Exploration Co., 589 P.2d 1061 (Okla. 1979).

Forced pooling statutes have been enacted in virtually all oil and gas producing states; as costs of hydrocarbons increase and supplies diminish, their importance has grown. The primary purpose of these statutes is the prevention of waste. Essentially, forced pooling prevents waste by limiting wells to a uniform spacing pattern. Prohibiting excessive drilling not only cuts drilling costs, it also preserves indigenous reservoir pressure. This native reservoir energy can then be utilized to bring minerals to the surface more cheaply.

Forced pooling requires that owners of tracts too small to be entitled to a well permit under applicable spacing rules pool their tracts to form a unit of the required size. They may then elect to participate in the development and exploration costs of the well, in which case they have a lessee’s “working” or “cost bearing” interest, or they may elect to be “carried” without advancing any of the initial costs, in which case they have a lessor’s “royalty interest.”

Coogan v. Arkla Exploration Co. involved two oil and gas owners who elected not to participate in a forced pooling order. After a hearing on the matter the Oklahoma Corporation Commission set a lease bonus of $35 per acre and a 1/8 royalty in lieu of their participation. The commission arrived at these terms on the basis of testimony which established that these had been terms for prior leases in the area.

The owners appealed arguing that terms and prices previously paid in the area were inadmissible to establish fair market value. They asserted that a forced pooling order was in effect a condemnation of

2. For a more complete discussion of the economics of drilling see Shell Oil Co. v. Davidor & Davidor, 315 P.2d 259, 261-62 (Okla. 1957).
a mineral lease, and consequently, the leases Arkla had already purchased were the result of condemnation proceedings. Since condemnation price is incompetent proof of fair market value, appellants claimed the only admissible evidence before the court conclusively established the fair market value to be $100 per acre with a 3/16 royalty.

The Supreme Court of Oklahoma, reviewing the testimony given before the trial examiner, found substantial evidence to uphold the commission's order. Although testimony showed that nearby leases did indeed bring the higher prices claimed, the leases were from three to five miles away from the land in question. As a rule the Oklahoma Corporation Commission looks to the nine sections which surround the land in question when it is trying to determine what prices have been paid in an area. Witnesses stated that they knew of no leases in these nine sections which brought the higher bonus or royalty interest.

The court dealt rather summarily with the issue of condemnation, distinguishing the sales of leases in the area from condemnation proceedings on grounds that lease sales were "open market" transactions, since there was nothing in the record which indicated otherwise.

A condemnation proceeding is the process by which private property is taken for public use without consent of the owner. Although the owner is justly compensated for the taking, he has no choice in the matter. The Supreme Court distinguished the lease sales from condemnation proceedings on the basis of voluntariness, presumably reasoning that those oil and gas owners who did not like the terms under which they would be "carried" could have elected to take a "working interest" instead.

CONCLUSION

Basing oil and gas bonus and royalty value on prices obtained in the immediate area appears to be the accepted method for determining market value. The Supreme Court of Oklahoma can hardly be criticized for following this universally accepted method of measurement.

5. Three-sixteenths is the highest royalty interest paid to a non-cost bearing lessor. Anything higher is cost-bearing. Telephone interview with Bill Chastain, attorney for Oklahoma State Corporation Commission (Oct. 16, 1979).
6. See Texas Oil & Gas Corp. v. Rein, 534 P.2d 1280, 1281 (Okla. 1974; telephone interview with Bill Chastain, attorney for Oklahoma State Corporation Commission (Oct. 16, 1979). Trial examiners always look to the nine sections surrounding the land in question when determining market value.
However, the treatment of lease sales in a forced pooling area as "voluntary" may ignore the realities of the market. Oil and gas owners who find themselves faced with a forced pooling order must make a choice, or the choice will be made for them. In any event, their land will be taken for drilling purposes. Small tract owners find themselves confronted with the expensive prospect of participating in the development and exploration costs of a well, a field they know nothing about, or leasing their mineral rights to the experts, the large oil companies. The vast majority elect to be "carried" with a lessor's royalty interest.  

On the other hand, fugacious minerals are by their nature speculative, and oil and gas companies take all the risks when they assume the lessee's interest. If the companies produce nothing more than a dry hole, they must bear all the losses. The market value of oil and gas leases fluctuates wildly according to current discoveries, and the fair market value can only be determined as the value at the time of taking, not what it might be in the future.  

Oklahoma requires, as do all other states, that "[a]ny orders requiring such pooling shall be made after notice and hearing, and shall be upon such terms and conditions as are just and reasonable." However the Supreme Court of Oklahoma has held that the "just and reasonable" requirement does not require divulgence of studies showing what the proposed well would produce in the future, or even evidence of data from which that evidence might be determined. A large company is in an excellent position to assess the value of oil and gas leases since it has a host of experts at its disposal. There is little likelihood however that small lease owners would ever be able to obtain such information themselves. 

Although forced pooling appears to be a good solution to a growing problem, it gives rise to a number of problems itself. As forced pooling becomes more of a necessity, there will doubtless be more litigation on the subject. 

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8. UNIFORM EMINENT DOMAIN CODE § 1002(a).