Volume 49
Issue 2 *Issues 2, 3 & 4*

Article 8

February 1943

Progress in the Law of Oil and Gas

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West Virginia Law Quarterly

and The Bar

Published by the Faculty of the College of Law of West Virginia University, and issued in December, February, April and June of each academic year. Official publication of The West Virginia Bar Association.

Subscription price to individuals, not members of The West Virginia Bar Association, $2.00 per year. To those who are members of the Association the price is $1.00 per year and is included in their annual dues. Single copies, 50 cents.

PROGRESS IN THE LAW OF OIL AND GAS

It is perhaps not an unmixed blessing that the law as to subjacent minerals is seldom static, even under "normal" peacetime conditions. Whether this attribute of continuous change is inherent in the very nature of the subject, or whether (like the weather) it is caused by conditions beyond present human control, one need not say. The essential thing is that modifications in legal doctrine do constantly occur, contemporaneously with improvements in the technical art of production and marketing; and their significance is worthy of note from time to time, either as indicative of substantial progress or because the break with the past has been so marked. In any event, recent developments in the law of oil and gas now deserve comment here, since these are of vital importance to local industry.

1. Statutory Forfeiture for Nonpayment of Delay Rental.

Legal theory as to the rights and liabilities of oil and gas operators is nearly all judge-made; by and large, legislatures have deliberately kept hands off and refrained from disturbing settled rules of property law in this very specialized field of jurisprudence. Lord Coke once maintained that the common law was equal to any social needs; and, on the whole, West Virginia case-law has splendidly justified that prophecy. It is thus of considerable moment that a new statutory regulation has just been enacted regarding nonpayment of delay rentals.[1] Presumably, the measure is designed to benefit lessors under "or" leases and to establish a simple method of terminating such undeveloped leaseholds where rentals are in default, for the "unless" lease would scarcely need such legislative change.[2]

It might be well to review briefly the terms of the new statute. Whenever, under any lease *hereafter executed*, delay rentals have not been duly paid, that undeveloped lease will (substantively) become "null and void" unless proper payment is effected within sixty days from the date of formal demand made by the lessor upon the lessee. The single exception to the rule deals with the case of a *bona fide* dispute between lessor and operator, regarding the amount of rental due. The act then provides (procedurally) that no one may maintain a suit or proceeding in state courts to "enforce or perpetuate" any such lease *heretofore executed*,[3] where the statutory sixty-day default has occurred. A third provision has to do with the formality and service of the sixty-day demand: and, finally, a copy of the termination notice may be filed with the county clerk, the margin of the record of the lease immediately being stamped with the words, "cancelled by notice".

Until this law has been construed by the courts, it would be unwise to hazard any prediction as to the significance of this legislative invasion of oil and gas jurisprudence. On the other hand, the change is manifestly an important one; in the absence of a right of re-entry,[4] the lessor has hitherto been remitted to an action at law for such delay rentals. Assuming no drainage or nearby development, equity could hardly otherwise intervene and declare a forfeiture for mere nonpayment of money,[5] unless all

[1] W. VA. REV. CODE (1931) c. 36 art. 4, § 9a,—enacted by the 1943 legislature as Senate Bill No. 157; passed March 13, 1943, and in effect from passage.

[2] 2 SUMMERS, OIL & GAS (2d ed. 1938) § 452; Snodgrass v. South Penn Oil Co., 47 W. Va. 509, 35 S. E. 820 (1900).

[3] *Cf.* LeSage v. Switzer, 116 W. Va. 657, 182 S. E. 797 (1935); Comment (1936) 42 W. VA. L. Q. 342.

[4] See Castle Brook Carbon Co. v. Ferrell, 76 W. Va. 300, 85 S. E. 544 (1915).

[5] Headley v. Hoopengarner, 60 W. Va. 626, 55 S. E. 744 (1906); Engel v. Eastern Oil Co., 100 W. Va. 301, 303-304, 130 S. E. 491 (1925).

the facts were shown to amount to abandonment.[6] No doubt the thought of the legislature has been increased production: by the terms of the statute, the operator will have to keep up delay-rentals on undeveloped leases, or the lessor may forfeit and lease to someone else. But what the ultimate result may prove to be,—that is another story.

2. REGULATION OF INTERSTATE GAS MARKETING.

Under the Natural Gas Act of 1938, the Federal Power Commission has undertaken regulation of interstate transportation and sale of gas.[7] According to section 6 (a) of this act, the commission's authority extends to investigation and ascertainment of the actual legitimate cost of the natural-gas property and of other facts bearing on the *fair value* of that property.[8] Within the past year or two, the commission has decided to adopt the prudent-investment theory of determining the rate base, and to exclude all well-drilling costs not originally charged up on the books to capital account. Moreover, an administrative policy has been followed of computing accrued depreciation by applying the straight-line service-life method to the book-cost of property, with no consideration given to actual present condition.

In *Hope Natural Gas Company v. Federal Power Commission*,[9] these issues came before the circuit court of appeals for the fourth circuit, on petition for review of commission orders; and the court decided, by a two-to-one vote,[10] that the commission had erred as to each. Prudent-investment cost, it was held, could not alone provide a proper measure of present fair value where (following investment) there had been "a decided change in price levels". And as to the exclusion of well-drilling costs originally charged on the books to expenses, Parker, Circ. J., said:[11]

> "If the property were being condemmed, no one would suggest that items which went into the cost of producing it should not be considered as a part of its cost, whatever method of accounting it had employed. If it were being

[6] Smith v. Root, 66 W. Va. 633 66 S. E. 1005 (1910); Martin v. Consol. Coal & Oil Corp., 101 W. Va. 721, 133 S. E. 626 (1926).
[7] Federal Power Comm. v. Natural Gas Pipeline Co., 315 U. S. 575, 62 S. Ct. 736, 86 L. Ed. 1037 (1942).
[8] 15 U. S. C. A. § 717e (a).
[9] 134 F. (2d) 287 (C. C. A. 4th, 1943), *certiorari granted*, 63 S Ct............, (May 17, 1943).
[10] Soper, Circ. J., concurred in the opinion of Parker, Senior Circ. J. Dobie, Circ. J., dissented in a separate opinion.
[11] 134 F. (2d) 287, 303 (1943).

sold on the basis of cost, no court would exclude such items from consideration. And there is as little ground for excluding them from consideration in a proceeding like this, where value is being determined as a basis for rates which must compensate the company for the gradual sale of its property through use as well as provide a return upon its investment. Certainly if the company had charged to capital investment items which should have been charged to expense, there would be no excuse for not eliminating them in the valuation of the property; and there is as little excuse for not considering as capital investment items erroneously charged to expense. Bookkeeping which does not reflect realities must not be allowed to obscure the real nature of the inquiry."

Finally, the court ruled that the commission could not compute depreciation on the basis of mere formulas, for the determination of present fair value could not be made without due consideration being given to actual physical condition.

The present decision is of considerable importance to the industry, not only because of the discussion as to the rate-base but also for its frank analysis of well-drilling costs. Prior to 1923, there was no requirement under West Virginia law that these costs should be charged to capital investment; and any retroactive penalizing of past bookkeeping practices would seriously concern producers. Furthermore, the straight-line service-life method of depreciation is in conflict with "salvage value" under actual experience. It is accordingly proper to conclude that future oil and gas development here will be affected significantly by this litigation.

3. Equitable Apportionment of Compensation in Lieu of Further Development.

Four years ago, the doctrine of equitable apportionment of oil and gas royalties was explicitly banished from West Virginia case-law.[12] Where land already leased for oil and gas is afterwards subdivided,—through death or sale,— such royalties must belong to the respective owner of the fractional tract on which the producing well may eventually be drilled. It is wholly immaterial whether that well drains other fractional tracts: the other owners are without redress so long as there is reasonable development of the entire leased acreage. That rule of nonapportionment was finally established here after two decades of legal uncertainty.

[12] Walker v. West Virginia Gas Corp., 121 W. Va. 251, 3 S. E. (2d) 55 (1939); Note (1939) 46 W. Va. L. Q. 66.

To be sure, there have been minor qualifications to this nonapportionment doctrine. For one thing, delay rentals (prior to development) have always been apportioned, based upon proportionate mineral ownership; and this practice remains unchanged. Another instance has to do with the partnership or joint venture in oil and gas leasing: where owners in severalty unite in a single joint lease of all their lands, equitable division of future royalties is implicit in their action.[13] As between these joint contracting parties, presumably the exact location of the producing wells makes no difference in their respective shares. A third exception of the sort has just arisen in connection with compensation in lieu of further development.

In *Robinson v. Milam*,[14] the plaintiff bought a seventy-acre strip off of a 214-acre tract already leased for oil and gas, the defendant vendor excepting and reserving three-fourths of all subjacent minerals, along with the right to lease plaintiff's undivided one-fourth mineral interest in the seventy acres conveyed. The defendant also covenanted to pay the purchaser the rents and royalties accruing from that one-fourth interest "under such leasing when and as collected." In due course, the lessee operator drilled a producing well into the Oriskany sand on the balance of the 214-acre tract, eighty-six feet from the plaintiff's boundary. Later on, the operator agreed with the defendant to pay certain compensation in lieu of further development of the 214-acre tract, including the plaintiff's seventy acres. The latter then sued for a proportionate share of the royalties from the producer and of the compensation for nondevelopment. The court had little difficulty with the royalties issue: it was held that there could be no equitable apportionment as to these without violating the fixed West Virginia doctrine. However, as to the payments in lieu of development it was decided the plaintiff was properly entitled to a proportionate share.

Thus, compensation in lieu of development is to be treated as analogous to the payment of delay rentals; and upon subdivision of leased land, there must be equitable apportionment. The reasoning of the court is thoroughly sound in this regard, even though that holding now creates another qualification of the firmly-settled nonapportionment rule.

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13 Lynch v. Davis, 79 W. Va. 437, 92 S. E. 427 (1917).

14 Robinson v. Milam, 24 S. E. (2d) 236 (W. Va. 1942); *rehearing denied* March 8, 1943.

4. Ownership of Gas in Coal Seam.

One of the ambiguities in mineral law has to do with leasing gas from coal seams.[15] Assuming the coal is owned in fee, separately and apart from the surface, there is no clear doctrine as to the ownership of the gas horizon that may occur within the coal. Both surface-owner and coal operator have claimed title to the gas; but the courts made little progress heretofore in the solution of the problem.

In *Finsterwald v. Waterford Commercial Bank*,[16] the issue has now come before Ohio courts. A coal owner sued to enjoin oil and gas lessees from trespassing on coal strata owned in fee, and to require the defendants to case off the gas well driven through these seams; and an accounting was sought for all natural gas taken from the plaintiff's property. The court of common pleas found for the coal owner,[17] relying on *Natural Gas Co. v. Ullery*.[18] On review, the court of appeals reversed, holding that the plaintiff's title was limited to coal and could extend to nothing else.[19] The suit was accordingly dismissed. The supreme court of Ohio then refused to permit an appeal to be taken from this judgment.

It would thus seem that an Ohio doctrine is in process of being evolved to the effect that the coal operator owns the coal, and only that. Title to the gas will then remain in the surface owner, even after severance of the fee in the solid minerals. Accordingly, gas leasing must henceforth be the privilege of that surface owner alone. Still one may be permitted a doubt or two as to the wisdom of any such hard-and-fast rule to this effect.

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15 Note (1941) 47 W. Va. L. Q. 211.

16 The opinions are as yet unpublished.

17 Cause No. 17754, Court of Common Pleas of Athens County, Ohio (1941); MSS. opinion.

18 68 Ohio St. 259, 272, 67 N. E. 494 (1902).

19 Court of Appeals for Athens County, Ohio, decided April 6, 1942; MSS. opinion.