Supreme Court of Ohio Clerk of Court - Filed April 27, 2015 - Case No. 2015-0545

IN THE SUPREME COURT OF OHIO

REGIS F. LUTZ, et al.,	:	Supreme Court
	:	Case No. 2015-0545
Plaintiffs-Respondents,	:	
	:	On Review of Certified Questions
vs.	:	From the United States District Court,
	:	Northern District of Ohio,
CHESAPEAKE APPALACHIA, L.L.C.,	:	Eastern Division
	:	
Defendant-Petitioner.	:	Case No. 4:09-cv-2256

PRELIMINARY MEMORANDUM OF PETITIONER CHESAPEAKE APPALACHIA, L.L.C. IN SUPPORT OF ACCEPTANCE OF CERTIFIED QUESTION

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I. INTRODUCTION

As oil and gas production has increased in Ohio in recent years, this Court and other Ohio courts have addressed legal issues related to the interpretation of oil and gas leases. This Certification Request from the U.S. District Court for the Northern District of Ohio raises an important issue related to the interpretation of oil and gas leases that requires resolution. On April 6, 2015, the District Court *sua sponte* certified the following question to this Court after the parties filed cross-motions for summary judgment, designating Chesapeake Appalachia, L.L.C. ("Chesapeake") as the moving party:

> Does Ohio follow the "at the well" rule (which permits the deduction of post-production costs) or does it follow some version of the "marketable product" rule (which limits the deduction of post-production costs under certain circumstances)?

Both parties agree that this issue has not been resolved by this Court, and that it presents a potentially-dispositive question of law.

A. The Certified Question Presents an Important Question of Law Regarding "At the Well" Leases

Although this Court has long set forth guiding principles of contractual interpretation, the specific question certified by the District Court has not been resolved. It is well-established that Ohio applies the terms of contracts, including oil and gas leases, as written. *See Harris v. Ohio Oil Co.*, 57 Ohio St. 118, 129, 48 N.E. 502 (1897) ("The rights and remedies of the parties to an oil or gas lease must be determined by the terms of the written instrument . . . .").[1] The question presented here concerns the application of this bedrock principle to specific lease language in the oil and gas context providing that royalties are to be paid based on the value of gas "at the well."

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[1] *See also City of St. Marys v. Auglaize Cnty. Bd. of Commrs.*, 115 Ohio St.3d 387, 2007-Ohio-5026, 875 N.E.2d 561, ¶ 13-21; *Eastham v. Chesapeake Appalachia, L.L.C.*, 754 F.3d 356, 363 (6th Cir.2014); *Stewart v. Chesapeake Exploration, L.L.C.*, 542 Fed.Appx. 468, 469 (6th Cir.2013).

B. "At the Well" Leases Are Common and the "Netback Method" Is Typically Used To Determine a Wellhead Valuation

Many oil and gas leases use such "at the well" language. Although gas can be sold at the well, it is more typical today to sell the gas downstream from the well. Moving the point of sale downstream from the well results in a higher price for the gas (which benefits both the lessor and lessee) but also requires "post-production costs" (*e.g.*, compression of the gas, processing, gathering, and interstate pipeline transportation) to be incurred to physically move the gas from the well to the point of sale. When the lease provides that the royalty is to be calculated "at the well," the "netback method" is typically used to determine an "at the well" value for the gas. Under the netback method, Chesapeake calculates royalties by taking the downstream sales price and allocates a pro rata share of post-production costs incurred to obtain that price. By contrast, Plaintiffs maintain that they are entitled to royalties based on the downstream sales price but should not incur a pro rata (or any) share of the post-production costs incurred to obtain that higher price.

C. Most Oil and Gas Producing States Have Resolved the "At the Well" Question

The dispute between the parties boils down to this question: under Ohio law, when gas is sold at a higher price downstream of the well after post-production costs are incurred, does lease language providing that royalties are to be paid based on the value of the gas "at the well" require payment of royalties based on the value of the gas *at the well* or must royalties be paid based on the value of the gas *downstream of the well*?

This important question of Ohio law has not been resolved by this Court, though it has been addressed and resolved in most major oil and gas producing states, including several of Ohio's neighboring states. Because most states interpret contracts as written, most states to address the issue have held that leases providing that royalties are to be paid based on the value of the gas "at

the well" require payment of royalties based on the value of the gas at the well and endorsed the use of the netback method to determine a wellhead valuation. This has become known as the "at the well" rule. A handful of states have held that, notwithstanding the language of the leases, some or all of the post-production costs cannot be allocated amongst the interests on a pro rata basis. These rules are known as the "marketable product" or "*Tawney*" rules.

Chesapeake submits that the Court should accept the question certified by the United States District Court and confirm that Ohio applies contracts as written and, thus, that the use of the netback method is an acceptable method of determining the value of the gas "at the well." This would confirm that Ohio, like most oil and gas producing states, follows the "at the well" rule in interpreting oil and gas leases like those at issue here.

D. Resolving the Certified Question Will Bring Certainty to the Parties and Others in the State of Ohio

The underlying putative class action was initiated by certain Ohio landowners alleging they have not been paid all the royalties due under their oil and gas leases. Chesapeake moved for summary judgment and plaintiffs thereafter cross-moved for summary judgment. The primary question presented in the cross-motions is whether or not Ohio is an "at the well" state. After substantial briefing by both parties, Judge Sara Lioi of the U.S. District Court for the Northern District of Ohio certified the question presented here pursuant to Rule 9 of the Ohio Supreme Court's Rules of Practice and stayed the remaining issues until the question is resolved. Resolving whether Ohio is an "at the well" state will allow the District Court to rule on the cross-motions and proceed with the litigation.

Resolving the certified question will also provide guidance and certainty to other industry participants in Ohio. "At the well" leases are common in Ohio and elsewhere, and the use of the netback method is typical practice to determine a wellhead valuation for gas. For that reason, most

other states, including Ohio's neighboring states of Pennsylvania, Kentucky, and Michigan, have addressed the "at the well" issue in recent years, which has helped provide certainty to industry participants and litigants in those states.

II. BACKGROUND

A. Plaintiffs' Oil and Gas Leases Require Payment of Royalties Based on the Market Value of Gas "At the Well"

Plaintiffs are Ohio landowners with interests in oil and gas leases. The leases at issue were entered into with different companies—*i.e.*, not Chesapeake—during the 1960s and 1970s. The leases relevant here provide that royalties are to be paid on the market value of the gas "at the well." Specifically, the relevant leases provide that the royalties to be paid by Lessee on gas "produced from said land and sold or used off the premises . . . , the market value ***at the well*** of one-eighth of the gas so sold or used, provided that on gas sold at the wells the royalty shall be one-eighth of the amount realized from such sale."

B. The Dispute Concerns the Apportionment of "Post-Production Costs"

A brief overview of how gas is produced and sold provides context for the legal question presented here. To produce gas, a producer (like Chesapeake) drills a well and extracts the gas from below ground. There is no dispute in this case that the producer typically bears the costs of drilling a well and bringing the gas to the wellhead. These are known as "production" costs. At times, producers also incur "post-production" costs including, for example, the costs to transport the gas to a downstream market, among other costs. These costs are incurred to seek to increase the value of the gas at the point of sale further downstream. Plaintiffs' claim in this case relates to the apportionment of these post-production costs.

C. Disputes Regarding the Apportionment of Post-Production Costs Arose After Deregulation of the Gas Industry

The apportionment of post-production costs is a relatively recent development and stems from the deregulation of the natural gas industry in the early 1990s. For many years, producers sold gas at the wellhead; in the 1950s through early 1990s, at-the-well sales were the predominant method by which natural gas was sold. This is why many leases entered into before the 1990s provide that royalties are to be based on their price or value of gas "at the well." When gas is sold at the well, calculating royalties pursuant to such provisions is straightforward: an agreed-upon fraction of the sales price or value at the wellhead was paid to the lessor as a royalty. Post-production costs are not apportioned because the gas is sold at the wellhead—*i.e.*, there are ***no*** post-production costs incurred by the producer.

D. Since Deregulation, the Primary Method of Determining a Wellhead Value of Gas Is the "Netback Method"

Industry regulations substantially changed in the 1990s, and natural gas producers were able to sell gas downstream and obtain a better price. When gas is sold downstream, to calculate the value of gas at the well, the "netback" (or "workback") method is often used. The netback method determines the valuation of gas "at the well" by allocating a pro rata share of post-production costs to the royalty interest. As the Pennsylvania Supreme Court explained, the netback method's goal "is to determine the value of the gas when it leaves the ground (hereinafter 'at the wellhead') by deducting from the sales price the costs of getting the natural gas" from the wellhead to the sales point. *Kilmer v. Elexco Land Servs., Inc.*, 605 Pa. 413, 415-16, 990 A.2d 1147 (2010).

Federal regulations explain that the netback method is a "method for calculating [the] market value of gas at the lease," whereby "costs of transportation, processing, or manufacturing

are deducted from the proceeds received for the gas . . . at the first point at which reasonable values for any such [gas] may be determined by a sale." 30 C.F.R. 1206.151.

III. STATEMENT OF THE CASE

A. Procedural Background

In September 2009, Plaintiffs filed this action on behalf of themselves and a putative class of Ohio lessors in the U.S. District Court for the Northern District of Ohio. They allege that Chesapeake or its non-party predecessors underpaid gas royalties due to them under the terms of their leases.

In August 2014, Chesapeake moved for partial summary judgment on certain aspects of plaintiffs' claim, including the claim that Chesapeake breached plaintiffs' contracts by allegedly improperly deducting post-production costs from the royalty payments. Plaintiffs cross-moved for summary judgment in September 2014.

Chesapeake explained in its summary judgment brief that bedrock principles of Ohio contract law—and Ohio law in the oil and gas context, in particular—make clear that Ohio would follow the "at the well" rule and allow the use of the netback method. Ohio courts have long held that oil and gas leases, like contracts, must be applied as written. *See, e.g.*, *Harris*, 57 Ohio St. at 129, 48 N.E. 502. The use of the netback method is the only rule that gives meaning to the contractual language providing that royalties are to be based on the value of gas "at the well."

As Chesapeake explained, although this Court has not addressed this specific question, many other courts have—and most states, including most of Ohio's neighboring states, have held that they follow the "at the well" rule because it gives meaning to the contracts as written. For example, in *Poplar Creek Dev. Co. v. Chesapeake Appalachia, L.L.C.*, 636 F.3d 235, 244 (6th Cir.2011), the U.S. Court of Appeals for the Sixth Circuit, applying Kentucky law, held that "Kentucky follows the 'at-the-well' rule, which allows for the deduction of post-production costs

prior to paying appropriate royalties." The court explained that the "at the well" rule was required under Kentucky law, which requires "the wording of the contract" to be construed "in accordance with its plain meaning." *Id.* at 242. Similarly, the leading case in Michigan held that Michigan also follows the "at the well" rule because it "accord[s] reasonable meaning to the plain language of the contract." *Schroeder v. Terra Energy, Ltd.*, 223 Mich.App. 176, 188-89, 565 N.W.2d 887 (1997). And the Supreme Court of Pennsylvania held that "at the well" language "permit[s] the calculation of royalties at the wellhead, as provided by the net-back method in the Lease." *Kilmer*, 605 Pa. at 430-31, 990 A.2d 1147.[2]

Plaintiffs responded by advocating for a variety of minority rules, mischaracterizing them as a "majority rule," and by claiming that the same result holds regardless of what the lease language is. Plaintiffs also argued that no matter what the lease language is—whether "at the well" or different language—they should prevail. But as Chesapeake pointed out, the language of the contract matters under Ohio law, whereas plaintiffs' approach would make the actual lease language irrelevant—an approach that is irreconcilable with Ohio law.

B. The District Court's Certification Order

The parties briefed summary judgment in Fall 2014 and the District Court stayed further proceedings until the summary judgment motions were decided. In March 2015, the District Court *sua sponte* contacted the parties and indicated that it intended to certify this question of Ohio law, ultimately phrased as follows, to this Court:

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[2] *See also Bice v. Petro-Hunt, L.L.C.*, 2009 ND 124, 768 N.W.2d 496, ¶ 15 (explaining that the "at the well" rule "is the majority rule" and that "[t]he three major oil and gas producing states, Louisiana, Mississippi and Texas follow the 'at the well' rule"); *see generally* George A. Bibikos & Jeffrey C. King, *A Primer on Oil and Gas Law in the Marcellus Shale States*, 4 Tex. J. Oil Gas & Energy L. 155, 169 (2009) ("A majority of oil and gas jurisdictions are known as at-the-well jurisdictions.").

> Does Ohio follow the "at the well" rule (which permits the deduction of post-production costs) or does it follow some version of the "marketable product" rule (which limits the deduction of post-production costs under certain circumstances)?

See Certification Order at 3. Neither party objects to the certification. As the District Court stated, this question presents an issue of Ohio law and may be determinative of the proceedings in the District Court. *Id.* at 2-3. On April 1, 2015, the District Court entered the Certification Order, which was docketed by this Court on April 6, 2015. Although the District Court entered the Certification Order *sua sponte*, it designated Chesapeake as the movant for purposes of S.Ct.Prac.R. 9.03.

IV. DISCUSSION

A. The Certified Question Presents an Important Question That May Be Dispositive of Plaintiffs' Claims

Although this Court has long held that Ohio applies the terms of oil and gas leases as written, *see, e.g.*, *Harris*, 57 Ohio St. at 129, 48 N.E. 502, this Court has not yet resolved the specific question of how "at the well" lease language is to be interpreted. In recent years, this question has been presented and resolved in most major oil and gas states, most notably Pennsylvania and Kentucky. This case presents an opportunity for this Court, at the request of the federal District Court, to resolve the specific question of whether or not Ohio follows the "at the well" rule or a different rule when it comes to calculating royalties pursuant to leases providing that royalties are to be paid based on the value of gas at the well.

Resolving this unsettled question of Ohio law is significant, both for this case and for other industry participants. This case is a putative statewide class action in which a substantial proportion of the putative class members have leases providing that royalties are to be paid based on the value of gas "at the well." These lessors—including named plaintiffs Regis and Marion Lutz—claim that, despite their lease language providing that royalties are to be paid based on the

value of gas "at the well," they should be paid based on the higher value of the gas downstream of the well without having to bear any share of the costs necessary to obtain that higher value. These lessors claim that Chesapeake's use of the netback method to calculate an "at the well" value constitutes a breach of their leases in violation of Ohio law. A ruling on this specific issue would resolve the primary issue in the underlying case.

B. Resolving the Certified Question Would Provide Guidance and Certainty in Ohio

Moreover, a ruling by the Court on this issue would also provide guidance to the many participants in the oil and gas industry in Ohio. Ohio has become an increasingly important center for oil and gas activity: gas production has more than doubled in Ohio in recent years. There are hundreds of exploration and production companies operating in Ohio, with tens of thousands of wells on land leased by tens of thousands of lessors. Many of Ohio's neighboring states have resolved the "at the well" question in recent years as oil and gas production increased in those states, as in Ohio. For example, the Pennsylvania Supreme Court's 2010 decision holding that Pennsylvania is an "at the well" state has been cited over 100 times according to Westlaw, including in over 25 treatises, law reviews, and practice guides. *Kilmer*, 605 Pa. 413, 990 A.2d 1147. Similarly, the 2011 decision from the U.S. Court of Appeals from the Sixth Circuit, applying Kentucky law and holding that Kentucky is also an "at the well" state, has been cited over 100 times in the past few years. *Poplar Creek*, 636 F.3d 235.

C. It Is Undisputed that the Certified Question Is a Question of Law

Finally, there is no dispute here that the question presented is one of law. The parties agree that the question presented is a pure legal question, as did the District Court. *See* Certification Order at 2 ("The question driving this case is a question of state law."). Moreover, the prior courts to have resolved this same question have made clear that the determination presents a question of

state law. *See, e.g.*, *Kilmer*, 605 Pa. at 418, 990 A.2d 1147 (characterizing question as a "pure legal question of first impression"); *Poplar Creek*, 636 F.3d at 240-41 (explaining that question of whether Kentucky follows the "at the well" rule is a question of law). Moreover, neither party claims that the "at the well" language is ambiguous, or that additional facts or discovery is needed to resolve the question presented.

D. There Is No Controlling Precedent in the Decisions of the Supreme Court of Ohio

Although bedrock principles of Ohio contract law—primarily, the principles that Ohio law requires enforcement of contracts as written and that Ohio law gives meaning to the language of a contract—indicate that Ohio would adopt the majority "at the well" rule, Ohio has not yet addressed the meaning of "at the well" lease language. Neither party uncovered Ohio Supreme Court precedent that addresses this specific issue, and the District Court specifically noted that "[a]lthough neighboring states have addressed the ["at the well" issue], there is no controlling precedent in the decisions of the Ohio Supreme Court." *See* Certification Order at 2.

Plaintiffs may contend that an unpublished 1994 opinion from an intermediate appellate court constitutes a statement of Ohio law on whether Ohio is an "at the well" state. *See Schmidt v. Texas Meridian Resources, Ltd.*, 4th Dist. Washington No. 94CA12, 1994 WL 728059 (Dec. 30, 1994). That is incorrect. Leaving aside that the case is not an opinion of this Court and is unpublished, it expressly did not address the "at the well" rule, the "marketable product" rule, or any other rule. *Id.* at *3. Although the court denied a summary judgment motion in that case, it did so on a bare record and based on factual findings specific to that case—*e.g.*, a finding that the course of dealing between plaintiffs and the original lessee precluded a later lessee from taking deductions, and that the defendant had failed to meet its burden of proof. *See id.* at *4.

Unsurprisingly, then, *Schmidt* has rarely been cited, and never for the proposition that Ohio is not an "at the well" state.

V. CONCLUSION

The District Court was unable to decide the pending cross-motions for summary judgment because the "question driving this case is a question of state law" and there is "no controlling precedent" on the question of whether Ohio is an "at the well" state "in the decisions of the Ohio Supreme Court." *See* Certification Order at 2.

Although this question has been resolved in Ohio's neighboring states in the past several years, most notably in Pennsylvania and Kentucky, Ohio has not yet addressed it.

This Court's resolution of whether Ohio interprets oil and gas leases as written such that the netback method may be used to calculate royalties based on the value of gas "at the well" would be dispositive of many of the claims presented in the District Court and would provide valuable guidance to industry participants in Ohio.

For these reasons, Chesapeake requests that the Court accept the question for review.

DATED: April 27, 2015

Respectfully submitted,

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