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

BRIEF OF BRUCE M. KRAMER *AMICUS CURIAE* IN SUPPORT OF PETITIONER

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I. INTRODUCTION

On June 3, 2015, this Court agreed to answer the following certified question from the United States District Court for the Northern District of Ohio:

> 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)? (certification order at 3).

Professor Kramer believes that Ohio law, precedents from the majority of oil and gas states, and the historical development and construction of the "at the well" lease, mandate that Ohio adopt the "at the well" rule. As detailed below, at the time the "at the well" leases at issue here were agreed to, the near universal construction of such royalty clauses was that the royalties were to be based on the value "at the well" and, if the gas was sold or valued downstream of the well, the lessee could use post-production costs in the netback methodology and fully comply with the royalty clause obligation.

II. INTEREST OF THE *AMICUS*

Bruce M. Kramer is the Maddox Professor of Law Emeritus at Texas Tech University School of Law and the Thomson Visiting Professor of Law at Colorado University School of Law. He is also of counsel to McGinnis, Lochridge & Kilgore, LLP, in Houston, Texas.

Professor Kramer is the co-author of several important books that have become the definitive references for energy lawyers, including two multi-volume treatises, "The Law of Pooling and Unitization" and "Williams and Meyers Oil and Gas Law" (since 1996), as well as the last three editions of the "Manual of Oil and Gas Terms."

Professor Kramer's books and legal articles have been cited as authority in numerous court rulings and appellate opinions, including decisions of the Supreme Courts of Texas, Alaska, Louisiana, Montana, New Mexico, and North Dakota; the United States Court of

Appeals for the Third Circuit; the United States Court of Appeals for the Fifth Circuit; the United States Court of Appeals for the Tenth Circuit; and numerous Federal District Courts. Professor Kramer has prepared papers and spoken at more than 80 continuing education programs for lawyers and other professionals in the oil and gas and real estate/land use industry.

Professor Kramer's particular interest in this case reflects his life-long interest and study of oil and gas law throughout the United States. He has been very active as a teacher, scholar, advocate and expert witness on matters relating to royalty interests. Understanding of oil and gas law cannot be divorced from its jurisprudential beginnings and in a case such as this it is critical to the outcome that the Court be aware of the historical antecedents of the evolution of royalty clauses found in oil and gas leases, including the substantial change in the way that natural gas has been marketed since the latter part of the 1970s. By apprising the Court of these developments, it is Professor Kramer's intent to assist the Court in responding to the certified question.

Professor Kramer has previously submitted an amicus brief on the issue relating to the use of the netback methodology in calculating royalties where the oil and gas lease provides that the royalty is to be based on proceeds or market value "at the well."[1] A sale downstream of the wellhead will bring a higher price for the natural gas than if sold at the well because transportation, compression, processing, and/or treatment of the natural gas add value. The costs incurred in these processes are commonly referred to as "post production costs." In order to determine the value or the proceeds of the gas "at the well," most states allow the lessor to use the "netback" method to calculate the wellhead value by netting out the post-production costs from the proceeds received downstream. As explained below, the netback method properly values the gas or determines the proceeds from the sale of the gas "at the well" as the leases' express language require. The use of the netback methodology to determine wellhead value or proceeds antedates the dates of the relevant leases in this case. Although the netback

[1] *Kilmer v. Elexco Land Services, Inc.*, 990 A.2d 1147 (Pa. 2010).

methodology continues to this day in most jurisdictions where the language of the lease requires a wellhead value, this amicus brief will focus on the use of the netback methodology that existed at the time of, and earlier than, the dates of the execution of the relevant leases.

This amicus brief is written in support of the position urged by Chesapeake Appalachia, LLC.

III. ARGUMENT

The "at the well" lease has historically been a common lease in Ohio and the United States as a whole. When gas was typically sold at the well, it was simple to determine the "value" or proceeds for royalty calculation and there was no issue with post-production costs because there were no costs that were incurred by the lessee/producer. But as gas began to be sold downstream from the well and post-production costs had to be incurred by the lessee/producer in order to sell the gas for the mutual benefit of lessors and lessees, those costs had to be netted out of the downstream proceeds in order to arrive at a value or the proceeds "at the well."

The oil and gas leases that are relevant to this Court's inquiry were all executed in 1970 and contain royalty clause language that one would expect to find in leases executed throughout the United States during that time period. They contain natural gas royalty clauses which create different payment methodologies depending upon what the lessee does with the natural gas. These leases provide that if the gas is sold or used off of the premises, or in the manufacture of gasoline, the lessors are entitled to the "market value at the well of one-eighth of the gas so sold or used," but if the gas is "sold at the well," the royalty is to be "one-eighth of the amount realized from such sale." While market value and amount realized are different, both of the clauses require that a wellhead valuation or a wellhead proceeds amount be used to determine the lessors' royalty payment.

A. Historical Development of Royalty Clauses

From the time of the Drake Well in Pennsylvania to the present day, one of the hallmark features of the oil and gas lease has been the lessor's retention of a royalty interest in the oil and/or gas that would be produced from the leasehold estate. The Drake Well lease provided that the lessor would receive "one-eighth of all oil as collected from the springs in barrels. . . ."[2] The Drake Lease is an example of an "in-kind" royalty provision which reserved to the lessor the right to physically receive the oil in kind. The in-kind delivery obligation is still the most prevalent type of oil royalty clause used in the United States to this date. 3 Patrick H. Martin & Bruce M. Kramer, Williams & Meyers Oil and Gas Law §§ 641-42 (2014) [hereinafter Williams & Meyers].

On the other hand, royalty clauses relating to natural gas production have undergone a number of changes since the latter part of the 19th century. As one oil and gas scholar stated: "In the early days of operations under the oil and gas lease, the primary objective of exploration and drilling operations was the discovery of oil, and it was justifiably regarded as a major misfortune if gas alone were found."[3] This reality is reflected by the use of flat-rate royalty clauses for production from natural gas wells. Such type of flat-rate leases were used in Ohio as early as the 1890's. *Hankey v. Kramp*, 12 Ohio C.C. 95, 5 Ohio Cir. Dec. 439, 1896 Ohio Misc. LEXIS 403. What was also clear was that as there developed a wider market for natural gas, the types of recommended royalty clauses changed to deal with the developments in the marketplace.[4] Thereafter, oil and gas leases started to differentiate between natural gas produced from gas wells and natural gas produced from oil wells because a market developed for the sale of

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[2] Leslie Moses, The Evolution and Development of the Oil and Gas Lease, 2 Sw. Legal Fdn. Inst. on Oil & Gas L.& Tax'n 1, 7 (1951).

[3] 3 Eugene Kuntz, A Treatise on the Law of Oil and Gas 311 (1989 w/2014 Supp.) [hereinafter Kuntz].

[4] A Pennsylvania attorney gave examples of both flat rate and percentage royalty provisions in his legal treatise written in 1898. George Bryan, The Law of Petroleum and Natural Gas with Forms 417, 422 (1898).

casinghead gas which is gas produced from an oil well. Richard Leroy Benoit, Cyclopedia of Oil and Gas Forms 132-33 (1926).[5]

Over time, however, flat-rate royalties were replaced with payment-type royalty provisions for natural gas production. Unlike oil royalty clauses, however, natural gas royalty clauses often were longer, had more variables and dealt with more issues. Natural gas royalty provisions began to specify, among other matters, the point of valuation or the point at which proceeds from the sale of natural gas are to be calculated. In most situations, these clauses used the term "at the well" to describe the point of valuation.[6] It was often the case that natural gas royalty clauses provided, as they do in the relevant leases, for a proceeds or amount realized royalty payment requirement if the natural gas is sold "at the well" and then a "market value" or "market price" "at the well" payment requirement if something else is done with the natural gas including sale or use off of the premises or use in the manufacturing of gasoline. Williams & Meyers, §§643-643.5 (describes various types of natural gas royalty clauses). The regular references to the terms "well" or "wellhead" have, in the absence of other express, contrary language in the lease always referenced the orifice in the ground where the oil or natural gas is going to be produced. Such bifurcated clauses evince a clear intent that the lessor is entitled to either a wellhead value or the proceeds from the sale at the well.

B. The Development of the Natural Gas Marketplace

The marketing of gas has changed substantially and on more than one occasion since natural gas was first produced in the Appalachian Basin in the middle of the 19th Century. For the first 100 years of production, natural gas sales were quite limited and occurred either at the

[5] An example of a Carter Oil Co. of West Virginia form lease in 1929 reflected the change in the marketplace for natural gas and products derived from natural gas by having a percentage royalty provision contained therein. R.S. Morrison & Emilio De Soto, Oil and Gas Rights 488-89 (1929).

[6] See Bruce M. Kramer, Royalty Interests in the United States: Not Cut from the Same Cloth, 29 Tulsa L.Rev. 449, 455 (1994).

wellhead or in close proximity thereof. From the 1930s onward through 1978, pipeline infrastructure was installed that allowed for greater markets for natural gas sales but subject to federal regulation that incentivized wellhead sales from the producer to the regulated pipeline. After 1978, deregulation of the industry led to a market where a producer of natural gas could sell the gas anywhere in the United States.

1. Pre-1978 Developments

Natural gas has been produced in the United States since 1815 when it was obtained in connection with a salt well located in Charleston, West Virginia. *See* Kuntz, at § 1.10. Natural gas was used as early as 1863 in East Liverpool, Columbiana County, Ohio for manufacturing purposes. *Id.* In 1866, a gas well was drilled near Kenyon College in Knox County, Ohio where the gas was allowed to escape for several years before it could be put to an economic use. *Id.* Notwithstanding these early efforts to utilize natural gas, for many years natural gas was treated as a waste product. That was reflected in the marketplace by the segregation of oil and natural gas in the oil and gas lease royalty clauses that were prevalent at the time.[7] It was also reflected in the use of a fractional royalty for oil and a fixed rate royalty for any gas produced and sold or used off of the premises. *Id.*

Gas wells in the Appalachian Basin (including Ohio) were inexpensive to drill as the gas tended to be located in reservoirs that were reasonably close to the surface. Two characteristics of natural gas, however, made it difficult to develop markets for its use. The first was the **inability of the producer to store the natural gas on the surface** such as occurred with oil which could be placed in storage tanks near the well. The second was the **inability of the producer to transport the natural gas to the potential customer** through available and economically feasible modes such as those that existed for oil. As stated by Dean Eugene Kuntz, "Although the gas had value, it was difficult to market."[8] Thus, as demonstrated by the early use

[7] *See* Bruce M. Kramer, Interpreting the Royalty Obligation by Looking at the Express Language: What a Novel Idea?, 35 Texas Tech L.Rev. 223, 224-5 (2004).

[8] 3 Kuntz at 311.

of natural gas in Ohio and Pennsylvania, natural gas was produced when the wells were in close proximity to a population center that provided a dependable demand for the natural gas. It was not until the large natural gas reservoirs of the Mid-Continent area (*e.g.,* Texas, Louisiana, Kansas and Oklahoma) were discovered that natural gas production took off. These large reservoirs created an economic climate that could attract the investment needed to construct pipeline systems to carry the natural gas to locations at great distance from the producing areas.

Because the construction of pipelines is very capital-intensive, pipeline transmission lines, like railroads and other "common carriers" tend to create monopoly or oligopoly pricing power. In the years leading up to 1938, states became increasingly sensitive to the growing pricing power of natural gas pipeline companies and thus engaged in a wide range of regulatory devices seeking to protect their citizens.[9]

In a series of cases the Supreme Court of the United States invalidated these state efforts, which led to Congress' enactment of the Natural Gas Act of 1938. 52 Stat. 821, 15 U.S.C. § 717 [hereinafter NGA]. One of the principal purposes of the NGA was to give the federal government, acting through the Federal Power Commission ("FPC"), the needed power to regulate interstate pipelines that the earlier Supreme Court decisions had stripped away. *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591, 609-10 (1944).

Practices related to the production, sale, transportation and marketing of natural gas throughout the United States were constrained by the existence of federal regulation under the NGA. The NGA retained the then-existing system whereby most natural gas production was sold at the well to the interstate pipeline companies and then re-sold by the interstate pipeline companies to local distribution companies or end users along the pipeline route. The NGA achieved its goals by making natural gas companies that sold gas for resale in the interstate market subject to federal price regulation. *See* 15 U.S.C. § 717. It also required all natural gas

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[9] *See* Robert R. Nordhaus, Producer Regulation and the Natural Gas Policy Act of 1978, 19 Nat.Res.J. 829 (1979). At the time he wrote the cited article, Mr. Nordhaus was general counsel to the Federal Energy Regulatory Commission.

companies covered by the NGA to apply for and receive certificates of public convenience and necessity before they could lawfully enter the natural gas business or construct any significant facility.[10] This certificate power was critical in the development of the industry. It also created a marketplace where the situs of the sale of the natural gas was almost universally considered to be the well or wellhead. In determining whether a certificate should issue for an interstate pipeline the FPC looked at the reserves that would be committed to the pipeline to ensure that the pipeline would be financially successful so as to be able to provide the local distribution company with the lowest price gas. *See* Francis J. Coleman, Jr., FPC Natural Gas Allocation: Curtailment in Context, 50 Tex. L.Rev. 1370, 1376-77 (1972).

Because the FPC demanded adequate reserves, pipelines demanded from the producers long-term contracts for the sale of natural gas at the wellhead.[11] Thus the predominant type of gas purchase contract that existed from the mid-1930s through the mid-1980s was a twenty-year plus or "life of the lease" contract in which the producer/seller dedicated to the gas purchase contract production from existing and/or future leases within a defined geographic area.[12] These long-term gas purchase contracts with sales occurring at the well provided the pipeline/purchaser with the reserves needed to secure a FPC certificate and to get financing to pay for the infrastructure necessary to move the natural gas from the well to the ultimate place of sale.[13] With the exception of the intrastate gas market that developed in the mid-1960s, the near-

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[10] 15 U.S.C. § 717f. *See generally*, Nordhaus, 19 Nat.Res.J. at 830-31; James E. Meeks and Ronald J. Landeck, Area Rate Regulation of the Natural Gas Industry, 1970 Duke L.J. 653, 666-67.

[11] *See* Ben R. Howell, Natural Gas Purchase Contracts, 5 Rocky Mtn. Min.L.Inst. 221 (1960); Ben R. Howell, Gas Purchase Contracts, 4 Inst. of Oil & Gas L. & Tax'n 151 (1953).

[12] *See* William B. Cassin, Gas Purchase Contracts—Enticing a Shy Genie From an Invisible Lamp, 25 Inst. of Oil & Gas L. & Tax'n 27, 42 (1974); Lewis G. Mosburg, Jr., Analysis of Producer Gas Sale Contracts, 17 Okla. L.Rev. 249, 276-78 (1964).

[13] Clyde E. Milligan, Anatomy of a Gas Purchase Contract, 23 Rocky Mtn. Min. L.Inst. 771, 779 (1977).

universal method by which natural gas was sold in the United States was through long-term contracts that either had the sale taking place at the wellhead or possibly in the field if there were field-wide post-production facilities being utilized. This marketplace scenario provided that most natural gas was sold at the well with the pipeline/purchaser paying for most of the post-production costs that would be incurred, if any, to move the gas from the well to an interconnect with the interstate pipeline system and then through the pipeline system to a local distribution company or end user.

In the early 1970s substantial shortages of natural gas on the interstate market required curtailments of delivery obligations by the interstate pipeline companies, *see* W. Jonathan Airey and James S. Teater, Transportation of Direct Sale Natural Gas, 5 East. Min. L. Inst. 17-1, 17-2 (1984), and led to some direct sales by producers to end-users, a substantial departure from the prior, widespread practice of long-term contract sales of natural gas at the wellhead. *Id.* at 17-3 to 17-5. Nonetheless, the prevailing use of long-term contracts for the sale of natural gas continued throughout the 1970s, especially where there was a lack of an intrastate market, caused in large part by the lack of intrastate pipeline facilities except in the states with substantial natural gas production and natural gas consumption. Over 90% of gas produced in the United States in 1973 was interstate gas that was regulated by the FPC.[14]

2. Post-1978 Developments

In the aftermath of the passage of the Natural Gas Policy Act ("NGPA") in 1978, the natural gas marketplace was going through a transition period. The NGPA expanded price regulation to intrastate gas but also set in motion forces that would lead to substantial changes in the way natural gas was marketed.

In 1987 a commentator made the following remarks about the state of the natural gas marketplace:

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[14] Jeb C. Sanford, Natural Gas Policy Act of 1978: Will it Alleviate the Natural Gas Shortage? 11 St. Mary's L.J. 140 (1979) (citing House Comm. on Interstate and Foreign Commerce, National Energy Act, H.R. Rep. No. 95-456 Part IV, 95th Cong., 1st Sess. 87 (1977)).

> From the initiation of federal regulation in the 1930s until very recently the interstate natural gas pipelines, whose essential economic function was and is to transport natural gas from the production to the market areas of the county, have operated as gas merchants as well as transporters. Specifically, the interstate pipelines bought at or near the wellhead (or produced it themselves) and, after the necessary transportation haul, sold this gas to local distribution companies, who, in turn, resold the gas at retail. While there always was some pipeline transportation of gas for distributors or large industrial end-users who had purchased the gas in the field directly from producers, this was very much the exception. Richard A. Solomon, Regulatory Problems for Pipelines and Distributors in the Light of Orders No. 436 and No. 451, 38 Inst. on Oil & Gas L. & Tax'n 7-1 (1987).

It was not until the Federal Energy Regulatory Commission ("FERC") promulgated Order No. 636 in 1992 that the natural gas marketplace drastically changed from that which had been prevalent for over 50 years.[15] Order No. 636 had the effect of de-coupling the interstate pipeline companies' historic role as both merchants and transporters of natural gas.[16] The key element of Order No. 636 insofar as the natural gas marketplace was concerned was the "unbundling" of the pipeline companies' transportation and merchant functions so that producers would have "open access" to the pipelines for the transportation of the natural gas directly to the end-user. *See* Peter W. Goodwin, Gas Sales Transactions after FERC Order No. 636, 44 Inst. on Oil & Gas L. & Tax'n 9-1 (1993).

What Order No. 636 did to the natural gas marketing scenario was revolutionary in nature. In today's world a natural gas producer in Ohio can sell its gas at the wellhead in Ohio, at an inlet valve of a processing facility in the field, at the inlet valve of an interconnect to an interstate pipeline, or anywhere in the United States to a consumer who may take title to the natural gas at the inlet valve to the consumer's facility. Furthermore, the gas purchase and sales contract between the producer and the purchaser will usually be for a short term, renewable in the absence of either party's exercise of a termination option and at a price usually tied to one or

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[15] *See* Pipeline Serviced Obligations and Revisions to Regulations Governing Self-Implementing Transportation Under Part 284 of the Commission's Regulations; and Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol, III F.E.R.C. Stats. & Regs. Para. 39,939 (1992).

[16] See Doane and Spulber, Open Access and the Evolution of U.S. Spot Market for Natural Gas, 37 J. of Law & Economics 477 (1994); Judith Matlock, New Roles of Wellhead, Gathering System and Gas Plant Operators After Order No. 636, 40 Rocky Mtn.Min.L.Inst. 15-1 (1994).

multiple indices of natural gas prices. While the parties to a modern oil and gas purchase and sales contract may specify any point between the wellhead and the ultimate place of use as the point of sale, it is not uncommon for the producer/seller to retain title or ownership of the natural gas until it is well downstream, thus bearing all of the post-production costs needed to get the natural gas to the sales point.

C. Natural Gas Royalty Jurisprudence Prior To 1970

Because all of the leases at issue in this case were executed in 1970, the oil and gas royalty jurisprudence that had been developed prior to then is particularly relevant for the Court to understand the interpretation given to oil and gas royalty clause language. While natural gas royalty litigation has increased in the years since de-regulation of natural gas pricing which led to today's national gas marketing scenario, the issues facing the Ohio Supreme Court in this case have been the subject of litigation long before the development of natural gas from shale formations. At the time that the relevant oil and gas leases were executed, a long and consistent jurisprudence had already developed regarding the use of the netback methodology for royalty calculation in situations where the leases expressly referenced "at the well" or where they did not so reference. The key issues in this case revolve around two related concepts: freedom of contract and the custom and practice of the oil and gas industry as it relates to the point of valuation for calculating royalty obligations. In this case, the four relevant leases specify that the royalty is to be calculated "at the well."

One of the earliest cases to deal with the issue of where the natural gas stream is to be valued for purposes of calculating the royalty payment obligation is *Scott v. Steinberger*, 113 Kan. 67, 213 P. 646 (1923). Unlike the four leases in our case that specify that the point of valuation is the well, the natural gas royalty clause in *Steinberger* is silent, merely requiring the lessee to pay "the market price for same in cash." *Id.* at 647. In reversing the trial court's decision to calculate the lessor's royalty on the basis of the sales price that was determined downstream of the well, the Kansas Supreme Court instead used the netback methodology to determine that the market price for the natural gas was the sales price less the costs incurred by the lessee to transport the gas off of the lease. *Id.*

This approach was also taken by the Kentucky Supreme Court in *Warfield Natural Gas Co. v. Allen*, 261 Ky. 84, 88 S.W.2d 989 (1935). As with *Steinberger,* the natural gas royalty clause did not contain a specific reference to the well or the mouth of the well. Instead, the clause stated: "The lessee to pay for each gas well from the time and while the gas is marketed the sum of one-eighth of proceeds received from the sale thereof. . . " 88 S.W.2d at 990. Relying on the custom and practice of the industry that most sales of natural gas took place at the well, the court concluded that where the lessee incurred expenses to move the gas from the wellhead to the point of sale, the lessor was only entitled to a royalty calculated on what the proceeds would have been had the sale taken place at the well. In other words, the lessee was entitled to use the netback methodology. Writing about *Steinberger* and *Warfield*, Judge Sneed said: "Even where the well is not designated as the place where the standard is applied, the courts will construe the lease so as to make the well the place of application of the standard. This view is quite in harmony with the nature of the implied covenant to market the gas. **The lessee is under an implied obligation to exercise reasonable diligence in securing a market for the gas discovered. But this does not mean he is to pay all the costs of marketing, nor that he is to process the gas. Expenses incurred in procuring a market must be borne proportionately by the lessor**." [emphasis added][17]

There are other decisions from this era which support Judge Sneed's view that the lessor is only entitled to the proceeds or value of the natural gas as calculated at the wellhead. The

[17] Joseph T. Sneed, Value of Lessor's Share of Production Where Gas Only is Produced, 25 Tex. L.Rev. 641. 643-44 (1947). At the time that he wrote this article Joseph T. Sneed was a professor at the University of Texas Law School. After a distinguished career in both the practice of law and the legal academy he was appointed to the Ninth Circuit Court of Appeals in 1973 where he remained after he attained senior status in 1987. His obituary is found at www.sfgate.com/bayarea/article/Joseph-Sneed-dies-longtime-9th-Circuit-judge-3226653.php.

Louisiana Supreme Court in 1935 in dealing with a royalty clause providing that the lessor is entitled to the market price at the well stated: "The obvious reason why the market price at the well or field where the gas is obtained cannot be said to cover the market price in the parish where the gas is produced is because of the transportation charges which would necessarily augment the market price in the parish above the market price at the well or field." *Sartor v. United Carbon Co.*, 183 La. 287, 289, 163 So. 103, 104 (1935). *See also*, *Kretni Development Co. v. Consolidated Oil Corp.*, 74 F.2d 497 (10th Cir. 1934), *cert. denied*, 329 U.S. 730 (1935) (holding lessee was entitled to use netback methodology after it constructed 90 mile gas pipeline even though lease royalty clause did not use the phrase "at the well"); *Clear Creek Oil & Gas Co. v. Bushmaier*, 165 Ark. 303, 264 S.W. 830 (1930) (holding that market value at the well clause does not entitle lessor to receive royalty based on value after the natural gas has been transported); *Raines v. Kentucky Gas Co.,* 255 S.W. 121 (Ky. 1923) (noting the difference in the marketing of oil and natural gas); *Katschor v. Eason Oil Co.*, 63 P.2d 977, 981 (Okla. 1936) (holding the lessee may use netback methodology to determine market value at the well where natural gas stream is processed off of the lease to produce natural gas liquids and dry gas); *Danciger Oil & Refineries, Inc. v. Hamill Drilling Co.,* 141 Tex. 153, 171 S.W.2d 321, 322-23 (1943) (overriding royalty interest).

This early judicial acceptance of the use of the netback methodology continued over the next 30 years, with the exception of two cases from Kansas in 1964.[18] Even in Kansas, however, the state of the law regarding the interpretation of royalty provisions using an "at the well" point of valuation or point of determining proceeds, was not clear. Besides the *Steinberger* case discussed earlier, there were several Kansas Supreme Court decisions issued both before

[18] *Gilmore v. Superior Oil Co.*, 388 P.2d 602 (Kan. 1964); *Schupbach v. Continental Oil Co.*, 394 P.2d 1 (Kan. 1964). It should be noted that when these two cases were decided and for several years thereafter, there were Kansas Supreme Court decisions that allowed for the use of the netback methodology for royalty clauses containing the terms "at the well" or "at the mouth of the well." John W. Broomes, Waste Not, Want Not: The Marketable Product Rule Violates Public Policy Against Waste of Natural Gas Resources, 63 Kan. L.Rev. 149 (2014).

and after 1964 that applied the netback methodology to determine royalty where the natural gas was sold downstream of the wellhead.[19] In *Matzen v. Hugoton Production Co.*, 182 Kan. 456, 321 P.2d 576 (1958), the natural gas royalty clause did not have a specific reference to royalty being calculated "at the well" but the parties agreed that the proceeds which formed the basis for the payment was to be calculated at the well.[20] Relying on the custom and practice of the industry and acknowledging that there may be an implied covenant to market, the Kansas Supreme Court nonetheless concluded that royalty may be calculated "by deducting from gross proceeds reasonable expenses relating directly to the costs and charges of gathering, processing and marketing the gas. . . ." *Matzen*, 321 P.2d at 463.

Other states uniformly followed the rule that the lessee could use the netback methodology to calculate royalties where the natural gas was sold, delivered or used downstream of the wellhead. For example, in *Reed v. Hackworth*, 287 S.W.2d 912 (Ky. 1956), the Kentucky Supreme Court allowed the lessee to use the netback methodology to calculate royalties through the deduction of the lessee's cost to construct a pipeline to the purchaser's place of business. In *Reed*, as in *Steinberger*, the lease was silent as to the point of valuation or the point at which proceeds were to be calculated, but the court concluded that: "where the lease is silent concerning the place of market and the price, the royalty should be applied to the fair market value of gas at the well." 287 S.W.2d at 913-14. *Accord*: *Lafitte Co. v. United Fuel Co.*, 177 F.Supp. 52 (E.D. Ky. 1959), *aff'd*, 284 F.2d 845 (6th Cir. 1960); *Johnson v. Jernigan*, 475 P.2d 396 (Okla. 1970) (holding off-lease transportation costs may be used in the netback methodology

[19] A number of the earlier cases dealt with the relatively rare circumstance where oil was sold downstream of the wellhead and the lessee was paying the lessor using the netback methodology. *Molter v. Lewis*, 156 Kan. 544,134 P.2d 404, 406 (1943); *Voshell v. Indian Territory Illuminating Oil Co.*, 137 Kan. 160, 19 P.2d 456, 457-58 (1933).

[20] Broomes, *supra* note 18, 63 Kan. L.Rev. at 154-55, takes issue with the claim made in *Gilmore*, 388 P.2d 602 (Kan. 1964), that the parties "stipulated" to a wellhead proceeds royalty calculation but instead merely recognized the longstanding custom and practice of the industry to value or determine proceeds at the well.

calculation even where royalty clause uses the term gross proceeds); *Le Cuno Oil Co. v. Smith*, 306 S.W.2d 190 (Tex. Civ. App. 1957, writ refused) (gathering, compression and dehydration fees may be used in the netback methodology where the sale takes place downstream of the well).

A series of cases arising out of the Panhandle Field in Texas, interpreted oil and gas lease natural gas royalty clauses that all called for either market price, market value or net proceeds at the well.[21] The various opinions emphasized that the royalty provisions of the lease govern the royalty obligation and that where either the value at the well is not known or a lack of proceeds at the well exists, then the netback methodology may be used as a means of carrying out the intent of the parties as expressed in the royalty clause. *Phillips Petroleum Co. v. Johnson*, 155 F.2d at 188.

Most relevant to our discussion is the Fifth Circuit decision in *Freeland v. Sun Oil Co.*, 277 F.2d 154 (5th Cir. 1960), *cert. denied*, 364 U.S. 826 (1960) that applied Louisiana law. The royalty clause in *Freeland* was essentially the same as the royalty clauses in this case. For gas sold or used off of the premises or in the manufacture of gasoline the lessor was entitled to receive a fractional share of the market value at the well. For gas sold at the well, the lessor was entitled to receive a fractional share of the amount realized from the sale. *Id.* at 157. The natural gas stream was transported off of the lease to a processing facility where the natural gas liquids were separated out and the dry or residue gas returned to the well for re-injection into the producing reservoir. The Fifth Circuit, in applying Louisiana law, said: "In determining the market value of such gas at the well where there is no established criteria of a market, the

[21] *Phillips Petroleum Co. v. Williams*, 158 F.2d 723 (5th Cir. 1946); *Phillips Petroleum Co. v. Bynum*, 155 F.2d 196 (5th Cir. 1946), *cert. denied*, 329 U.S. 714 (1946); *Phillips Petroleum Co. v. Johnson*, 155 F.2d 185 (5th Cir. 1946), *cert. denied*, 329 U.S. 730 (1946); *Phillips Petroleum Co. v. Ochsner*, 146 F.2d 138 (5th Cir. 1944). A related case, *Phillips Petroleum Co. v. Record*, 146 F.2d 485 (5th Cir. 1944) did not have the term "at the well" in the royalty clause but it was treated by the court has requiring the payment of market value at the well. The cases are analyzed in depth at Williams & Meyers, at § 650.2.

Louisiana approach, which is binding on us, is to consider the end product of the extraction process as a factor. But it is a factor in reconstructing the market value at a place where in fact there was no, or little, market and consequently an appropriate deduction must be made." 277 F.2d at 157. What the Fifth Circuit labeled as the reconstruction process is what is today referred to as the netback methodology. Where no market value or market price exists at the well, or where the proceeds received occur downstream of the well, the lease language "at the well" clearly authorizes the lessee to use the netback methodology which will fully comply with express royalty clause language.[22]

The fact that the same type of royalty provision is contained in leases executed in Ohio in 1970 and in Louisiana twenty years earlier is evidence that such provisions were in widespread use both geographically and temporally. The jurisprudence, with the exception of the two Kansas decisions, uniformly allowed the lessee to use the netback methodology as a means of reconstructing the value or the proceeds where the value or proceeds were not determined until a point downstream of the wellhead. Either where the lease specified that value or proceeds were to be measured "at the well" or where there was no specification, almost all of the cases determined that the use of the netback royalty calculation methodology was consistent with either the express language of the lease or the custom and practice of the industry. The relevant leases in this case were not unique; they incorporated language that had been used in oil and gas leases for many decades in both Ohio and the rest of the oil and gas producing jurisdictions. The

[22] *Freeland* cites several Louisiana decisions in support of the proposition that where the value is determined at the well and it is difficult to determine a value at that point, such as where there are no comparable sales, the use of the netback methodology complies fully with the royalty clause obligation. *See Wall v. United Public Service Co.*, 178 La. 908, 152 So. 161 (1934) (where lessee pipes the natural gas two miles from the well, it may use the netback methodology to determine the market value at the well); *Coyle v. Louisiana Gas & Fuel Co.*, 175 La. 990, 144 So. 737 (1932) (where natural gas stream is processed off of the lease to produce gasoline, royalty is only owed on that percentage of the gasoline that the lessee receives after paying the processor).

inclusion of the term "at the well" was intended to place the point of valuation "at the well" and not further downstream as the plaintiffs are asserting in this case.

IV. CONCLUSION

For the reasons set forth above the amicus respectfully requests that the Court consider the historical context in which the relevant oil and gas leases were executed and the near-universal acceptance by the courts that where the terms "at the well" or "at the mouth of the well" were included in a natural gas royalty clause that the lessee could utilize the netback methodology in calculating the royalty owed where the point of valuation or the place where the proceeds were received were downstream of the well.

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