ORIGINAL

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 AMICI CURIAE OHIO OIL AND GAS ASSOCIATION, ARTEX OIL COMPANY, ECLIPSE RESOURCES I, L.P., ENERVEST OPERATING, L.L.C., HESS OHIO DEVELOPMENTS, LLC, HILCORP ENERGY COMPANY, NGO DEVELOPMENT CORPORATION, INC., REX ENERGY CORPORATION, AND SIERRA RESOURCES, LLC IN SUPPORT OF DEFENDANT-PETITIONER CHESAPEAKE APPALACHIA, L.L.C.

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STATEMENT OF INTEREST OF AMICI CURIAE

Amici curiae Ohio Oil and Gas Association ("OOGA"), Artex Oil Company, Eclipse Resources I, L.P., EnerVest Operating, L.L.C., Hess Ohio Developments, LLC, Hilcorp Energy Company, NGO Development Corporation, Inc., Rex Energy Corporation, and Sierra Resources, LLC, are participating in this appeal because the Court is addressing the meaning of standard oil-and-gas-lease language that has been widely used in Ohio and other states for decades to determine how royalties should be calculated. Specifically, these clauses identify the wellhead as the location at which the parties have agreed to value gas produced under the lease for purposes of calculating the lessor's royalty share. States that follow the "at the well rule" rely on the plain language of the lease contract and allow parties to agree in their leases that royalties shall be paid on the value of gas ***at the well*** and, if the gas is sold downstream from the well, to determine that wellhead value by deducting post-production costs from the value of downstream sales of gas (commonly called the netback method).

States that follow the marketable product rule ignore plain lease language in which the parties have agreed that royalties shall be paid on the value of gas at the well. Instead, despite the language in the lease indicating the parties' intentions, these states hold that there is an implied covenant to market that requires lessees to (1) pay royalties on the value of gas at locations not identified in the parties' leases and (2) absorb post-production costs incurred to make the gas available to that downstream location. These states have elevated "policy" concerns over the parties' written agreements and intentions, creating new, ***judge-made*** leases, rewritten after the fact for the benefit of lessors.

Amici curiae respectfully submit that the "at the well" rule is the better and correct rule because (i) it gives effect to the parties' written agreements, consistent with established Ohio contract law, and (ii) properly and fairly allocates both the burdens of post-production costs and the benefits of higher gas values that may be realized from downstream sales. Amici curiae support Defendant-Petitioner Chesapeake Appalachia, L.L.C., in asking the Court to adopt the majority "at the well" rule.

Significantly, there are currently tens of thousands of oil and gas wells in Ohio drilled pursuant to innumerable oil and gas leases between landowners and drilling companies. Those leases each contain diverse provisions that control the relationship between the parties—one of the most important of which is the royalty provision. It is critical to the stability and consistency of these parties' relationships that the Ohio courts construe the various lease provisions in accordance with the plain language of the contract. This language has been applied consistently across the country through time-tested rules and methodology, and this application has shaped both lessors' and lessees' contractual expectations for decades in Ohio. Rewriting the parties' lease contracts by implying new lease terms would not only conflict with Ohio law, but would create chaos in an otherwise stable, well-established and legally accepted system.

Amicus curiae OOGA is a state-wide trade association whose 3,100 members are engaged in all aspects of the exploration, development, and production of oil and gas in this State. Its membership includes small independent producers and major energy companies, as well as Ohio contractors, service and supply companies, manufacturers, utilities, accountants, insurers, engineers, and landowners. On behalf of its members, OOGA closely monitors Ohio litigation involving oil and gas law and occasionally participates as an amicus curiae in selected cases that address especially important issues.

Amici curiae Artex Oil Company, Eclipse Resources I, L.P., EnerVest Operating, L.L.C., Hess Ohio Developments, LLC, Hilcorp Energy Company, NGO Development Corporation, Inc., Rex Energy Corporation, and Sierra Resources, LLC, are individually engaged in exploring and developing oil and gas resources in eastern Ohio, both conventional wells and new horizontal shale wells. Collectively, they have oil and gas rights for hundreds of thousands of acres of Ohio land, often under leases that include royalty clauses similar to the royalty language before the Court. These amici curiae have invested billions of dollars to obtain leasehold rights, to explore for oil and gas, and to drill producing wells, and they plan to invest additional billions of dollars in Ohio in the future. Accordingly, they have a vital stake in maintaining the stability and predictability of Ohio oil and gas law.

Oil and natural gas production is an integral part of Ohio's economy, and it has played a central role in Ohio's economic recovery. This industry directly provides more than 17,000 jobs, injecting three-quarters of a billion dollars in salaries and wages into this State each year, and the benefits of that financial investment flow through all sectors of our economy. Plaintiffs-Respondents' proposed interpretation of the standard lease provisions at issue would upset long-settled law and the long-standing expectations of thousands of Ohio landowners and oil and gas lessees.

Amici curiae therefore respectfully ask the Court to adopt the majority "at the well" rule.

ARGUMENT

I. The Certified Question Concerns Plain Language and Common Practices.

Does Ohio follow the "at the well" rule (which permits 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)?

Under the "At the Well" Rule, "At the Well" Means At the Well.

For decades, oil and gas lessors and lessees across the country and in Ohio have agreed to calculate the lessor's royalty based on the value of production at the location of the well. This agreement is expressed in such common and unambiguous terms as, ***"at the well," "market value at the well," "at the wellhead"*** or in other plain words of similar import. *See* Section III, *infra*, at 10–11.

Leases in the captioned *Lutz* case are a prime example: "The royalties to be paid by Lessee are: . . . 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 as to gas sold at the wells the royalty shall be one-eighth of the amount realized from such sale."

For decades, the majority "at the well" rule states have accorded such common words their plain and unambiguous meaning to provide the location at which production will be valued for purposes of calculating the lessor's royalty (i.e., ***at the well***). *See* Section III, *infra*, at 10–11.

"At the Well" States Recognize Post-Production Cost Deductions As a Reasonable, Fair Way to Determine Value At the Well.

Dating at least back into the 1930s, the majority "at the well" courts have also endorsed post-production cost deductions under the netback method as a reasonable and fair way to arrive at the value of gas ***at the well***, as provided in the parties' agreements. Post-production costs, generally, are costs incurred after production at the well to prepare and transport gas for sale downstream from the well. Under the netback method, post-production costs are deducted from the downstream value of the gas to arrive at the value of the gas "at the well." In this way, the lessee and lessor share on a *pro-rata* basis in the expenses associated with, and the increased value realized from, downstream sales made possible by the lessee's post-production work. *See* Section II, *infra*, at 4–9.

The Minority Marketable Product Rule Rewrites the Parties' Leases.

Minority marketable-product-rule states (which did exist until 1964, when Kansas became the first), by contrast, do not permit producers to netback post-production costs to arrive at the value of production at the well when calculating royalties, regardless of lease language specifying royalties on values ***at the well***. Instead, marketable-product states require lessees to pay royalties based on post-production values at locations not identified in the parties' agreements, and to shoulder all or some of the costs (depending on the jurisdiction) to prepare and transport the gas from where it is produced at the well to those downstream locations. *See* Section IV, *infra*, at 14–17.

The marketable product rule creates a windfall for lessors by changing the parties' agreed-upon royalty from a share of the production at the well, to a share of gross proceeds realized elsewhere, without the lessor sharing in the post-production costs necessary to achieve that higher value downstream. Though marketable-product-rule states vary widely in their application of the rule to specific costs, they share a common philosophical belief that a broadly construed implied covenant to market and "policy" concerns trump the parties' written agreements. The net effects of the minority marketable product rule are new, ***judge-made*** leases, rewritten after the fact for the benefit of lessors. *See* Section IV, *infra*, at 13–20.

The Majority "At The Well" Rule Is the Better Rule.

The certified question thus asks if and how Ohio will give effect to common ***at the well,*** language found in literally thousands of Ohio oil and gas leases. Amici Curiae submit that Ohio should join the majority of states that accord such common contract terms their plain and ordinary meaning. As addressed herein, this approach is consistent with established Ohio contract law, is fair to all parties, and **promotes consistency and stability across thousands of settled and long-established contractual relationships and transactions**. Respectfully, the alternative is to ignore the parties' written agreement in favor of judicially rewriting thousands of Ohio leases.

II. Post-Production Cost Deductions Are a Standard, Historically Accepted, and Fair Way to Calculate Royalties At the Well.

The majority "at the well" rule is rooted in long-standing and widely-accepted industry practices and norms, is consistent with Ohio law, and with the intent of the parties. The Court should adopt the "at the well" rule.

Post-Production Costs Are Incurred After Production At the Well.

Post-production costs are expenses incurred to prepare gas for and to transport gas to downstream markets after it has been produced at the wellhead. Williams & Meyers, *Manual of Oil and Gas Terms* 947 (10th Ed. 1997) (updated and revised by Patrick H. Martin and Bruce M. Kramer) (distinguishing between expenses of production and post-production costs in defining the term "royalty"); *see also Kilmer v. Elexco Land Servs.*, 990 A.2d 1147, 1157 (Pa. 2009) (noting that expenses of production "do not encompass the costs of getting the product from the wellhead to the point of sale"). Though circumstances vary from case to case and depending on the nature and quality of the gas produced at the well, and the specific market, such work may include compression, dehydration, processing and fractionation, among others. *See* 3-6 Williams & Meyers, Oil and Gas Law, § 645.2 (LexisNexis 2015) (updated and edited by Patrick Martin and Bruce Kramer since 1996) ("*Williams & Meyers*"); *see also* Pearson, *From Extraction to End Use: The Technical Background*, 2003 Rocky Mountain Mineral Law Found., Mineral Law

Series, 1-1, 1-8 to 1-15 (2003) ("*From Extraction to End Use*"). Compression, for example, increases both the pressure and temperature of the natural gas and provides energy for gas to travel long distances. *From Extraction to End Use*, at 1-8. It also reduces the volume that a fixed quantity of gas occupies, allowing more gas to fit into pipelines. *Id.* Gas produced at the well is often saturated with water. Dehydration prevents water condensation and the formation of gas hydrates in pipelines, which affects pipeline performance, and may also be needed to meet specifications of given contracts. *Id.* at 1-9. Processing removes the valuable natural gas liquids from the gas stream. *Id.* at 1-12. Fractionation separates the processed natural gas into separate saleable products that may include propane, butane, ethane, and others. *Id.* at 1-15. All of these improvements, among others, as well as transportation of the gas down the line from the well to market, cost money. These are examples post-production costs. *Williams & Meyers*, § 645.2; *Kilmer*, 990 A.2d at 1157.

Post-Production Costs Deductions Under the Netback Methodology Is a Historically Accepted Way to Calculate Royalties.

Where gas was (or is) sold at the well, the royalty calculation under common at the well leases was fairly simple; i.e., the royalty was based on the price paid for the gas in its natural state at the well. *Piney Woods Country Life School v. Shell Oil Co.*, 726 F.2d 225, 231 (5th Cir. 1984). Where gas is sold downstream from the well in an improved or value-added state as a result of post-production costs fronted by the lessee, however, some additional math may be required to calculate the royalty. This is true where the parties have agreed that royalties shall be calculated on the value ***at the well***. *See, e.g.*, the *Lutz* exemplar lease quoted above.

Oil and gas operators have historically used two accepted methods to determine the value of the gas at the well when gas is sold downstream. The first is comparable sales. *See Piney Woods*, 726 F.2d at 237–38. In the absence of comparable sales, operators use the netback methodology whereby the operator simply deducts post-production costs from the value downstream to arrive at the value of the gas at the location specified in the parties' lease—i.e., "at the well." *See, e.g.*, *Ashland Oil Co. v. Phillips Petroleum Co.*, 463 F. Supp. 619, 620 (N.D. Okla. 1978) (offering a good description of the netback method).

Post-Production Cost Deductions Have Been Endorsed by the Courts for Decades.

As an initial matter, it is important to note that post-production cost deductions and the netback method have been a regular and widely accepted part of the oil and gas industry, lexicon, and law, as far back as the 1920s and 30s. *See, e.g. Clear Creek Oil & Gas Co. v. Bushmiaer*, 264 S.W. 830 (Ark. 1924); *Wall v. United Gas Public Serv. Co.*, 152 So. 561 (La. 1934); *Danciger Oil & Refineries v. Hamill Drilling Co.*, 171 S.W.2d 321 (Tex. 1943); *Reed v. Hackworth*, 287 S.W.2d 912 (Ky. Ct. App. 1956); *Matzen v. Hugoton Prod. Co.*, 321 P.2d 576 (Kan. 1958); *Freeland v. Sun Oil Co.*, 277 F.2d 154 (5th Cir. 1960); *Ashland Oil*, 554 F.2d 381; *Montana Power Co. v. Kravik*, 586 P.2d 298 (Mont. 1978); *Scott Paper Co. v. Taslog, Inc.*, 638 F.2d 790 (5th Cir. 1981); *Piney Woods,* 726 F.2d 225; *Old Kent Bank & Trust Co. v. Amoco Production Co.*, 679 F. Supp. 1435 (W.D. Mich. 1988); *Atl. Richfield Co. v. State*, 262 Cal. Rptr. 683, 688 (Cal. Ct. App. 1989); *Schroeder v. Terra Energy, Ltd.*, 565 N.W.2d 887 (Mich. Ct. App. 1997); *Creson v. Amoco Production Co.*, 10 P.3d 853 (N.M. 2000). In fact, the netback method was widely used and accepted for decades, including up through the dates of the leases in this case (1971). *See* Kramer, *Interpreting the Royalty Obligation By Looking At the Express Language: What a Novel Idea?*, 35 Tex. Tech L. Rev. 223, 246, n. 131 (2014) (collecting cases); *see also* Amicus Brief of Bruce M. Kramer , at 16 (hereafter, Kramer Amicus), filed in and relied upon by the Pennsylvania Supreme Court in *Kilmer*, 990 A.2d at 1156 ("In 1979, with the exception of Kansas, all of the states that had discussed the issue of whether the netback methodology could be used came out in favor of allowing the lessee to calculate royalties by taking a downstream price or value and then netting it back to the wellhead through the use of the netback methodology.") (internal citations omitted). And it remains the majority rule. *See* Section III, *infra.*, at 10–12.

To be sure, as discussed in the next section, certain federal regulatory changes in the early 1990s created additional opportunities for local gas producers to sell natural gas into markets away from the well, thus increasing the use of the netback method. But the method itself is not new. Thus, although Plaintiffs want to paint post-production cost deductions as (1) a new invention of the oil and gas industry used to (2) deprive lessors of their royalty share, neither is true.

Post-Production Cost Deductions Are Rooted in History and Context

A little recent history and context is helpful in understanding the issue. For many years, most but not all of the gas produced in the United States was sold at the well under long term contracts into a few large interstate pipeline systems. Unlike oil, which can be stored in tanks at a well site and trucked to a point of sale, gas is difficult to store at the surface and requires extensive and expensive pipelines and infrastructure to market. Generally, the large interstate pipeline companies would come into an area and provide gathering lines to individual wells in exchange for long term delivery contracts. See e.g., *Riedel v. XTO Energy, Inc.*, 257 F.R.D. 494, 501 (E.D. Ark. 2009) (describing historical relationship between local producers and interstate pipelines). Many but not all local producers sold the gas at the well to the interstate pipeline companies, which pipeline companies then served as both transporters ***and*** merchants of the gas to end users. Under this system, which remained the primary (though not exclusive) mechanism to market gas for close to fifty years, the pipeline companies typically bore the responsibility for and the costs of post-production work. There were also individual producers who did market their gas, who did incur post-production costs and who did deduct those costs when calculating royalties. However, for most producers, there were no post-production costs incurred under the old pipeline system and thus no post-production costs deductions for purposes of royalty valuation. For a more fulsome description of the history of the production, marketing and regulation of natural gas and the use of post-production cost deductions in this historical context, see Kramer Amicus.

Over time, concerns developed regarding the power that interstate pipeline companies exercised over production and pricing. *See id.* at 4–13. These concerns lead in the first instance to regulation of the interstate pipeline system, but ultimately in 1992 to deregulation of the system under Federal Energy Regulatory Commission Order No. 636. *See id.* at 4–13; *see also 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, 932 (1992), available at http://www.ferc.gov/legal/maj-ord-reg/land-docs/restruct.asp.

The net effect of Order No. 636 was to end the interstate pipeline companies' role as both the transporter ***and*** merchant of natural gas produced at the well. The Order gave more local producers open access to the interstate pipelines to sell their gas directly to end users, even at great distances. See Kramer Amicus at 10–11 (internal citations omitted).

While these regulatory changes created opportunities for producers to sell gas into new and sometimes distant markets, it also imposed on ***more*** producers that post-production work needed to prepare the gas for market previously handled by the pipeline companies. See *id.* at 13 ("At that point [post deregulation], the producers took on the responsibility for and the expenses involved in the processing, transportation and marketing of natural gas to distant, downstream sales point . . . ."). It thus also increased the use of the netback method to give effect to the parties' many older and existing leases calling for royalty values on production at the well. See *id.*

Post-Production Cost Deductions Are Fair to Both Parties.

The courts have blessed the netback method because there are real economic incentives for both parties to incur post-production costs, and, because the method gives better effect to the parties' bargain. Under "at the well" leases, the parties have agreed to calculate the royalty share on the value of production at the well. However, gas sold downstream in an enhanced condition often commands a value-added higher price than it does in its natural state at the well, so there is an incentive for the operator (and the lessor) to seek the higher value downstream. *See* Pierce, *Exploring the Origins of Royalty Disputes*, 23 Petroleum Acct. & Fin. Mgmt. J. 72, 77–78 (2004) (describing the "Linear Enhancement of Production Value").

The netback method fairly allocates the risks and rewards of the additional work and expenses the operator must incur after production at the well in order to realize that increased value downstream. Under the netback method, the producer and the landowner share on a *pro-rata* basis (typically 7/8 to the lessee and 1/8 to the lessor) in the burdens of the post-production costs ***and*** in the increased downstream value. See Kramer Amicus at 13–14 ("The allocation of post-production expenses merely recognizes that these post-production processes add value to the natural gas far in excess of the value of the natural gas at the wellhead."). The net result is typically a greater value for **both** parties, including a higher net royalty payment for the lessor than she would have enjoyed on the market value of the raw production at the well. In fact, several courts have relied upon this very fair result as further justification for allowing post-production cost deductions. *See*, *Poplar Creek v. Chesapeake Appalachia, L.L.C.*, 636 F.3d 235, 244 (6th Cir. 2011) (applying Kentucky law) ("[T]reatment increases the value of that gas at its final destination."); *Schroeder*, 565 N.W.2d at 894; *Piney Woods*, 726 F.2d at 240; *Merritt v. Sw Elec. Power Co.*, 499 So.2d 210, 213–14 (La. Ct. App. 1986); *Creson*, 10 P.3d at 858–59. The netback method allows the lessor to participate in the increased value of the operator's post-production work, but merely provides that the lessor does not get a cost-free, risk-free ride on that work. Plaintiffs simply want a free ride on the producer's extra work and expenses in contrast to the plain language of the contract.

III. The "At the Well" Rule Honors the Parties' Long-Standing Bargains By Giving Reasonable Effect to the Plain Language in the Parties' Contracts, Consistent with Established Contract Law and Established Oil and Gas Law.

Ohio Law Gives Effect to the Parties' Bargain, as Reflected in the Lease.

Ohio courts have always applied traditional rules of contract interpretation to oil and gas leases. *Harris v. Ohio Oil Co.*, 57 Ohio St. 118, 129, 48 N.E. 502 (1897) (oil and gas leases "are contracts, and the terms of the contract with the law applicable to such terms, must govern the rights and remedies of the parties."). The focus is the intent of the parties, **as reflected in the language of their agreement**. *Skivolocki v. E. Ohio Gas Co.*, 38 Ohio St. 2d 244, 313 N.E.2d 374 (1974), paragraph one of syllabus.

This approach requires that contract terms be given their plain, established and accepted meanings, that all words be given effect, and that the Court honors the ***parties'*** bargain. The Court may not rewrite an agreement to fashion a bargain not contemplated by the parties. This is true even if the Court believes the agreement should have been written differently. *Ervin v. Garner*, 25 Ohio St.2d 231, 239–40, 267 N.E.2d 769 (1971).

These **same rules apply** with equal and specific force **to the use of implied covenants** - "the rights of the parties must be determined from their own contract" and "an implied covenant can arise only when there is no expression on the subject" in the parties' agreement. *See*

Kachelmacher v. Laird, 92 Ohio St. 324, 332, 110 N.E. 933 (1950) (construing an oil and gas lease). Ohio parties have entered into countless thousands of oil and gas leases and have ordered their affairs based on the understanding that Ohio courts construe lease provisions in accordance with these established rules of contract construction. Thus, where the parties have specified that royalties should be calculated "at the well" in their lease contract, Ohio law does not permit an implied covenant to market the product to be read into the agreement to re-write the parties' contract.

Courts Agree That "At the Well" Language Has a Clear and Accepted Meaning.

States that employ the same rules of contract construction as Ohio accord the words, *market value at the well, at the wellhead,* and the like their plain, ordinary and historically accepted meanings. For example, in *Poplar Creek*, 636 F.3d at 244, the Sixth Circuit, applying **Kentucky** law, held that the plain meaning of the phrase "at the well" refers to "gas in its natural state, before the gas has been processed or transported from the well," and therefore **permitted the lessor to deduct post-production costs before paying royalties.** *Id.*, citing with approval *Piney Woods*, 726 F.2d 225. In *Piney Woods*, the Fifth Circuit also held that "at the well" means the landowner royalty must be based on the value of untreated gas where it is produced, not at a distant market not identified in the contract. *See id.*

And in *Baker v. Magnum Hunter Prod., Inc.*, Case No. 2012-CA-001016-MR, 2013 Ky. App. Unpub. LEXIS 545, *4–5 (June 28, 2013), the Kentucky Court of Appeals recognized that the phrase "market value at the well" is so well-accepted in the field as permitting post-production cost deductions that even ***Black's Law Dictionary*** **defines "market value at the well"** as **"[t]he value of oil or gas at the place where it is sold, minus the reasonable cost of transporting it and processing it to make it marketable.**" *Id.* "We find the phrase 'market price at the well for gas' to be unambiguous, and therefore hold the leases provide Magnum may deduct reasonable costs of transporting and processing prior to calculating market value from which to pay royalties." *Id.*

Indeed, the prevailing case law clearly and unequivocally recognizes—just it has for decades—that the phrases "at the well," "at the wellhead," or "market value at the well" are unambiguous, established terms in the oil and gas lexicon that permit the deduction of post-production expenses. *See* Section II, *supra*, at p. 5–6 (collecting older cases)*; see also*, *e.g.*, *Martin v. Glass*, 571 F. Supp. 1406, 1411 (N.D. Tex. 1983); *Piney Woods*, 726 F.2d at 240; *Heritage Res. v. Nations Bank*, 939 S.W.2d 118, 122 (Tex. 1995); *Ramming v. Natural Gas Pipeline Co.*, 390 F.3d 366, 372 (5th Cir. 2004); *Bice v. Petro-Hunt, L.L.C.*, 768 N.W.2d 496, 502 (N.D. 2009).

The "At the Well" Rule Also Gives Reasonable Effect to All Lease Language.

The "at the well" rule also accords reasonable meaning to all of the words in the parties' contract. As a **Michigan** court has reasonably observed:

> If the term [at the **wellhead]** is understood to identify the **location** at which the gas is valued for purposes of calculating a lessor's royalties, then the language 'at the wellhead' becomes clearer and has a logical purpose in the contract. In construing 'wellhead' thusly – in a manner that seeks to accord reasonable meaning to the plain language of the contract – we believe that it necessarily follows that to determine the royalty valuation, **postproduction costs must be subtracted from the sales price of the gas where it is subsequently marketed**.

Schroeder, 565 N.W.2d at 894.

The same reasonable rule applies at Ohio law. *See Prudential Ins. Co. v. Corporate Circle*, 103 Ohio App.3d 93, 98, 658 N.E.2d 1066 (8th Dist. 1995) (if one reading of a contract renders terms meaningless or surplusage, and one gives reasonable effect to all contract language, then the court must adopt the latter reading). This Court should adopt the majority "at the well" rule and confirm that Ohio continues to apply traditional rules of contract construction to oil and gas leases and to respect the right to contract.

The "At the Well" Rule Also Puts Lease Language Ahead of Implied Obligations.

As discussed more below, the marketable-product-rule states are criticized for elevating implied obligations and "court-declared public policy" over clear royalty provisions. See Section III, *infra*, at 16–17. This equity-driven approach to implied covenants conflicts with the Ohio approach to implied obligations.

In *Kachelmacher*, , for example, the plaintiff claimed that the oil company had failed to sufficiently develop the plaintiff's property and sought forfeiture of the lease for an alleged breach of the implied covenant to develop. 92 Ohio St. 324, 110 N.E. 933. The lease contained a stipulation for the payment of rentals in lieu of drilling. The Court noted, "the rights of the parties must be determined from their own contract[,]" and then rejected the implied covenant claim on the grounds that the subject of the alleged covenant—drilling requirements—was covered by the express terms of the contract. This Court stated unequivocally, "an implied covenant can arise ***only*** when there is no expression on the subject." *Id.* (emphasis added).

More recently in *Hupp v. Beck Energy Corp.*, 2014-Ohio-4255, 20 N.E.3d 732, ¶ 122 (7th Dist.), the court of appeals held that the plaintiff could not resort to an implied covenant to impose obligations on the lessee to develop the property within the initial term of the lease where the lease contained a provision for payment of delay rentals to suspend drilling requirements. The Court stated, "[T]here is no implied covenant of reasonable development that could apply within the 10-year primary term here, as construing the lease to include such a covenant was expressly proscribed by the lease terms." *Id.*

Likewise, relying on an implied covenant to market that is not identified in the lease to require lessees to calculate royalties on gas values at locations would *directly conflict* with specific royalty provisions in the lease calling for royalties on values ***at the well***. *See Ionno v.*

Glen-Gery Corp., 2 Ohio St.3d 131, 133, 445 N.E.2d 504 (1983) (the implied covenant to reasonably develop will only be inferred "where a lease fails to contain any specific reference to the timeliness of development."). This approach is in direct conflict with Ohio law. Ohio does recognize implied covenants in oil and gas leases. However, Ohio law is explicit that where the parties have addressed in plain language in their lease agreement **where** gas will be valued for purposes of calculating the lessor's royalty, Ohio courts should not ignore that language in favor of an implied obligation to value it elsewhere and at a different amount, even if the Court believes it would be more fair to do so. *See, e.g.*, *Ervin*, 25 Ohio St.2d at 239–40, 267 N.E.2d 769.

The majority "at the well" rule puts plain contract language first, consistent with the larger body of historical and present-day oil and gas law and with Ohio contract law. The Court should adopt the "at the well" rule.

IV. The Marketable Product Rule Is At Odds with Established Law, Rewrites the Parties' Bargain in Violation of Ohio Law, and Fosters Inconsistency and Litigation.

The focus on contract language and the ***parties'*** bargain under "at the well" law gives effect to long-standing agreements and understandings and thus promotes stability and consistency across royalty calculations. The marketable product rule, by contrast, has been criticized by commentators and the courts for elevating new and implied obligations over express lease terms and for creating chaos in an otherwise stable, well-established and legally accepted system. These criticisms include that the rule (1) encourages and permits different royalty payments for the same quality and quantity of gas depending on the point at which it is sold downstream; and (2) encourages and permits inconsistent jury verdicts determining whether the same quality gas at the same location is "marketable" or "unmarketable," depending on their interpretation and conception of the facts of each case. Amici Curiae respectfully submit that these criticisms are well-founded and that Ohio will face similar problems if the Court adopts the marketable product rule.

Two Professors and Some Activist Judges Created the Marketable Product Rule.

The marketable product rule owes its origins to two Oklahoma School of Law professors, Maurice H. Merrill and Eugene Kuntz, and to judicial activism. Professor Merrill argued for additional implied covenants in leases to protect royalty owners in lease negotiations and that the implied covenant to market should include the obligation to prepare the product for market, if it was not marketable in its natural form. *See, e.g.*, Wheeler, *Deducting Post-Production Costs When Calculating Royalty: What Does the Lease Provide?*, 8 Appalachian J. L. 1, 12 (2008) (noting that "[t]he reasoning behind using the implied covenant to market to prohibit or limit deductions for certain post-production costs was first enunciated by Professor Maurice Merrill in 1940"). Professor Kuntz is credited with the idea that lessees must bear post-production costs because the lessee's duty of "production" is not complete until a "marketable" product has been created. *See* Kuntz, *A Treatise on the Law of Oil and Gas* (W. H. Anderson Co. 1962).

The Courts Created a New Implied Duty to Create a Marketable Product.

Kansas became the first state to adopt the professors' new theories in *Gilmore v. Superior Oil Co.*, 388 P.2d 602 (Kan. 1964). *Gilmore* involved express royalty language calling for a royalty of "1/8 of the market value of such gas at the mouth of the well[.]" *Id.* at 391. Citing to Merrill's *Covenants Implied in Oil and Gas Leases*, complete with its concerns about overreaching by oil companies, the *Gilmore* Court held for the first time anywhere that lessees have an *implied* obligation to take the gas produced at the well ***and*** to make it "marketable." *Id.* at 393. The Court made little effort to square this new implied obligation with the express lease language calling for a royalty share at the "mouth of the well," as would be required under Ohio law, *see, e.g.*, *Kachelmacher*, 92 Ohio St. 324, or with the established law on the implied covenant to market itself.

Gilmore's expansion of the implied covenant to market marked a substantial deviation from established law. Prior to and since *Gilmore*, the implied duty to market has been understood to merely obligate lessees to market oil or gas produced under a reasonably prudent operator standard. *See Williams & Meyers*, § 645.2 ("In the marketing covenant, the question generally asked by the courts heretofore has been whether the lessee has marketed *as a prudent operator*, looking to the business judgment standards of other similarly situated prudent operators."). And the implied duty to "market" encompasses just two aspects: (1) timing, in that "the lessee owe[s] a duty to market its production, if prudently possible, within a reasonable period of time"; and (2) pricing, in that "the lessee owe[s] a duty to market its production for a reasonable price." Pierce, *The First Marketable Product Doctrine: Just What Is the "Product"?*, 37 St. Mary's L. J. 1, 23 (2005).

In contrast to this traditional—still majority view today—the Kansas Court so enlarged the implied covenant to market as to essentially create a new implied covenant—the implied covenant to create a marketable product. This new covenant, and the formula for its application, imposed upon lessees a raft of new obligations, expenses and *risks* not previously recognized under the law,[1] and certainly not reflected in the parties' agreements.

[1] Putting aside the unsupported expansion of the implied covenant, the Kansas opinions in *Gilmore* and *Schupbach v. Continental Oil Co.*, 394 P.2d 1 (Kan. 1964) (following *Gilmore* and applying expanded implied covenant to market in place of lease requiring royalties on gas at the well) ignored at least four prior Kansas decisions holding that the terms "at the well" or "in the pipeline" authorized the use of the netback method in calculating royalties. *See, e.g.*, *Matzen v. Hugton Prod. Co.*, 321 P.2d 576 (Kan. 1958) (natural gas production, gathering expenses); *Molter v. Lewis*, 134 P.2d 404 (Kan. 1943) (oil production, transportation expenses); *Voshell v. Indian Territory Illum. Oil Co.*, 19 P.2d 456 (Kan. 1933) (oil production, transportation expenses); *Scott v. Steinberger*, 213 P. 646 (Kan. 1923) (oil production, transportation expenses).

Marketable Product Rule States Ignore the Parties' Leases.

Kansas' departure from settled law did not gain any further acceptance ***for nearly three decades***. It was not until 1992 in *Wood v. TXO Production Corp.*, 854 P.2d 880 (Okla. 1992), that Oklahoma became only the second state to adopt the expanded implied duty to market created in *Gilmore*. Like the Kansas court before it, the Oklahoma Court glossed over clear royalty language requiring the lessee to pay the lessor "3/16 at the market price ***at the well*** for the gas sold" and instead held: "We interpret the lessee's duty to market to include the cost of preparing the gas for market." *Id.* at 882.

This indifference to the parties' actual lease language remains a common criticism of marketable product decisions. *See, e.g.*, *Mittelstaedt v. Santa Fe Minerals*, 954 P.2d 1203 (Okla. 1998) (court noted royalty clause for a royalty of "3/16 of the gross proceeds, **at the mouth of the well**, received by lessee for the gas[,]" but relied on the *implied* covenant to market, **standing alone**, to deny post-production costs deductions); *see also*, *Williams & Meyers*, § 645.2 (criticizing *Mittelstaedt*, stating, "The Court seems to treat the implied covenant to market as trumping the express provision limiting the calculation of the royalty to the gross proceeds measured at the mouth of the well."); Kramer, *Interpreting the Royalty Obligation*, 35 Tex. Tech L. Rev. at 257 (criticizing the Colorado Supreme Court's decision to adopt the marketable product rule in *Garman v. Conoco, Inc.*, 886 P.2d 652, 659 (Colo. 1994), for treating the royalty provision as irrelevant to defining the royalty obligation and stating, "the court's sense of justice and fairness leads it to apply the implied covenant to market as the defining principle for determining the lessee's royalty obligation.").

The Kansas reliance on the market product rule has been greatly reduced by the recent Kansas Supreme Court decision in *Fawcett v. Oil Producers, Inc.*, No. 108,666, 2015 Kan. LEXIS 376, at *25 (Kan. July 2, 2015), which allowed deduction of nearly all post-production costs imposed by the modern gas market.

This arguably outcome-oriented approach comes to full fruition in *Estate of Tawney v. Columbia Natural Res., LLC*, 633 S.E.2d 22 (W.Va. 2006), where the West Virginia Supreme Court held that ***all*** manner of "at the well language" is ambiguous as a matter of law. This ruling effectively renders all "at the well" language in the State of West Virginia meaningless surplusage and the parties' actual intent irrelevant. As the leading text notes, the Court's decision in *Tawney* leaves the reader "scratching one's head wondering whether the court was really looking at the bargain struck between the parties or just imposing what it perceived to be a 'fair' and/or 'equitable' result. " *Williams & Meyers*, § 645.2 (criticizing *Tawney*). This approach is also hard to square with Ohio law, which relies on the parties' chosen language to derive the parties' intent.

The Marketable Product Rule Creates Confusion and Uncertainty.

Further complicating the parties' arrangements, the marketable product jurisdictions disagree as to what constitutes a marketable product. For example, Oklahoma and Kansas hold that the implied duty to market requires the lessee to pay for post-production costs until a marketable product is created, but Colorado and West Virginia hold that a marketable product is achieved only when the product is both physically sufficient **and** in the location of a commercial marketplace to be sold. *See, e.g., Rogers v. Westerman Farm Co.*, 29 P.3d 887, 903 (Colo. 2001) ("marketability includes both a reference to the physical condition of the gas, as well as the ability for the gas to be sold in a commercial marketplace.").

What's more, the courts also hold that whether and when gas is marketable "is a question of fact, to be resolved by a fact finder." *Rogers*, 29 P.3d at 905. These differences and a lack of clear guidance on the question of marketability have drawn significant criticism as transforming the jurisprudence regarding royalty calculations "from consistency to chaos." *See*, *e.g.*, Pierce, *The First Marketable Product Doctrine: Just What Is the "Product"?*, 37 St. Mary's L. J. 1, 30 (2005).

In fact, this very inability of marketable-product jurisdictions to provide a precise definition of "marketability," and the uncertainty and real possibility of inconsistent jury verdicts that comes with it has also led to criticism by the courts. The Supreme Court of **North Dakota cited this inconsistency and ambiguity** in marketable product jurisdictions as one of the several reasons it **rejected the marketable product rule** in *Bice v. Petro-Hunt, L.L.C.*, 768 N.W.2d 496, 502 (N.D. 2009). The Court observed that "[t]he problem that has emerged with the first marketable product doctrine is the difficulty in determining when the gas has become a marketable product. This problem is highlighted by the fact that even the **states which follow the 'marketable product' rule have failed to articulate a clear standard** for determining when a marketable product has been created." *Id.* (internal quotation marks and citation omitted).

The **Pennsylvania** high court also cited consistency as another reason for allowing the use of the netback method in determining the lessors' royalty. The Court observed that, **without using the netback method, lessors could receive "different royalties on the same quality and quantity of gas** coming out of the well depending on when and where in the value-added production process the gas was sold." *Kilmer*, 990 A.2d at 1158.

Further, leaving the question to the jury without any real guidance as to what constitutes a "marketable" product will inevitably lead to inconsistent jury verdicts and burdensome litigation over what constitutes a "marketable" product. "Absent a clear, easily understood point (i.e., the wellhead) where a lessee may begin deducting its costs, a lessee operating in a 'marketable product' jurisdiction 'will be faced with an endless wave of expensive, burdensome and wasteful litigation.'" Wheeler, *Deducting Post-Production Costs When Calculating Royalty: What Does the Lease Provide?*, 8 Appalachian J. L. 1, 24–25 (2008).

A Result in Search of a Theory.

In the end, all of the marketable product cases leave the reader "scratching one's head wondering whether the court[s were] really looking at the bargain struck between the parties or just imposing what [they] perceived to be a 'fair' and/or 'equitable' result." *See Williams & Meyers*, § 645.2 (criticizing *Tawney*). The answer is clearly the latter.

Indeed, unable to find in the parties' lease language the more 'fair' and/or 'equitable' result that the courts were clearly seeking, the marketable product courts, starting with Kansas in *Gilmore* and extending through West Virginia in *Tawney*, have looked past, over and around the actual lease language to *implied* obligations purportedly lurking in the margins of the parties' contracts.

And when those implied obligations proved ineffective to support the desired result, the marketable product courts simply rewrote the law on the implied covenant to market to suit their needs. *See*, *e.g.*, Pierce, *Royalty Jurisprudence: A Tale of Two States*, 49 Washburn L.J. 347, 359 (2010) (criticizing the Colorado decision in *Rogers v. Westerman Farm*) ("Although the court concluded the 'at the well' language was silent regarding the 'allocation of costs,' that conclusion did not explain why it ultimately gave no effect to the 'at the well' language. To explain the nullification of the express 'at the well' language, the court turned to the implied covenant to market, which it held 'controls the lessee's duty to make the gas marketable.' The final step in this rather disjointed metamorphosis was to create the content of the implied covenant that will supplant the 'at the well' language."). The net of all of this judicial activism is uncertainty, inconsistency, and, as the captioned matter bears out, more litigation.

CONCLUSION

For upwards of eighty years, lessors and lessees across the country and in Ohio have used plain, established language to identify the location at which production will be valued for purposes of the lessor's royalty. Again, the sample Lutz lease is a prime example, providing that for gas sold off the premises, the royalty shall be on the "market value at the well." The majority "at the well" rule is the better rule because it gives reasonable effect to this plain language, consistent with Ohio law and with the larger body of established oil and gas law, respects the parties' established bargains and promotes stability and consistency across thousands of long-standing transactions.

Amici Curiae therefore respectfully request that this Court join the majority of states in adopting the "at the well" rule.

Respectfully submitted,

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CERTIFICATE OF SERVICE

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