Supreme Court of Ohio Clerk of Court - Filed August 03, 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

MERIT BRIEF OF PETITIONER CHESAPEAKE APPALACHIA, L.L.C.

Daniel T. Donovan (0067833)
(COUNSEL OF RECORD)
Kirkland & Ellis LLP
655 Fifteenth Street, N.W.
Washington, D.C. 20005
Tel: (202) 879-5000
Fax: (202) 879-5200

John K. Keller (0019957)
Vorys Sater Seymour and Pease LLP
52 East Gay Street
Columbus, OH 43215
Tel: (614) 464-6400
Fax: (614) 464-6350

Kevin C. Abbott (0091504)
Nicolle R. Snyder Bagnell (0091442)
Reed Smith LLP
225 Fifth Avenue
Pittsburgh, Pennsylvania 15222
Tel: (412) 288-3804
Fax: (412) 288-3063

Counsel for Petitioner

James A. Lowe (0002495)
(COUNSEL OF RECORD)
Lowe Eklund & Wakefield Co., LPA
1660 West Second Street
610 Skylight Office Tower
Cleveland, OH 44113-1454
Tel: (216) 781-2600
Fax: (216) 781-2610

Robert C. Sanders (*pro hac vice forthcoming*)
Law Office of Robert C. Sanders
12051 Old Marlboro Pike
Upper Marlboro, MD 20772
Tel: (301) 574-3400

Counsel for Respondents

Date: August 3, 2015

TABLE OF CONTENTS

I. INTRODUCTION **1**

II. STATEMENT OF FACTS **3**

A. Plaintiffs' Oil and Gas Leases Require Payment of Royalties Based on the "Market Value" of Gas "At the Well" 3

B. The Dispute Concerns How to Calculate the "Market Value" of Gas "At the Well" When It Is Sold Downstream of the Well 3

C. The Netback Method Calculates the "Market Value At the Well" of Gas Sold Downstream of the Well 5

D. Procedural Background 5

III. ARGUMENT **6**

A. Proposition of Law No. 1: Oil and Gas Leases Are Construed As Written and According to Their Plain Meaning. 7

B. Proposition of Law No. 2: Oil and Gas Leases Are Construed So As To Avoid Rendering Terms Meaningless. 8

C. Proposition of Law No. 3: Under Ohio Law, Leases Providing that Royalties Are to be Paid Based on the "Market Value" of Gas "At the Well" Should Be Applied as Written. 9

1. The Phrase "Market Value" of Gas "At the Well" Is Plain and Unambiguous 9

2. Gas Is Often Sold Downstream from the Wellhead, and the "Netback Method" Is Used to Calculate the Market Value of Gas at the Well 10

3. The "At the Well" Rule Gives Meaning to the "At the Well" Language, Whereas Plaintiffs' Proposed Interpretation Ignores Such Language 12

D. Proposition of Law No. 4: Most States Have Adopted the "At the Well" Rule Because It Gives Meaning To Lease Language Providing that Royalties Are to Be Paid Based on the Market Value of Gas At the Well. 13

1. The Majority of Jurisdictions Have Adopted the "At the Well" Rule 13

2. Most of Ohio's Neighboring States Have Adopted the "At the Well" Rule 14

3. Major Oil and Gas Producing States, Like Texas and Mississippi, Follow the At the Well Rule 18

E. Proposition of Law No. 5: Neither the "Marketable Product" Rule nor the "*Tawney*" Rule Gives Meaning to Contractual "Market Value At the Well" Language. 19

1. The "*Tawney*" Rule Ignores the Lease Language and Has Been Rejected in All But One State 20

2. The "Marketable Product" Rule Ignores Contractual Language and Instead Applies an Extra-Contractual "Policy" Gloss on the Parties' Written Agreement 21

3. The Marketable Product Rule Leads to More Uncertainty 22

4. The Existence of an Implied Duty to Market Does Not Mean Ohio Would Adopt the Marketable Product Rule 23

IV. CONCLUSION 24

TABLE OF AUTHORITIES

Page(s)

Cases

Affiliated FM Ins. Co. v. Owens-Corning Fiberglas Corp
16 F.3d 684 (6th Cir.1994) 9

Alexander v. Buckeye Pipe Line Co.
53 Ohio St.2d 241, 374 N.E.2d 146 (1978) 8

Appalachian Land Co. v. EQT Prod. Co.
E.D.Ky. No. CV 7:08-139-KKC
2012 WL 523749 (Feb. 16, 2012) 20

Atlantic Richfield Co. v. State
214 Cal.App.3d 533 (1989) 14

Aultman Hosp. Assn. v. Community Mut. Ins. Co.
46 Ohio St.3d 51, 544 N.E.2d 920 (1989) 7, 8, 24

Babin v. First Energy Corp.
693 So.2d 813 (La.App.1997). 14

Baker v. Magnum Hunter Prod., Inc.
Ky.App. No. 2012-CA-001016-MR
2013 WL 3235832 (June 28, 2013) 14, 17

Bice v. Petro-Hunt, L.L.C.
2009 ND 124, 768 N.W.2d 496 ..... 14, 22

City of St. Marys v. Auglaize Cty. Bd. of Commrs.
115 Ohio St.3d 387, 2007-Ohio-5026, 875 N.E.2d 561 7

Eastham v. Chesapeake Appalachia, L.L.C.
754 F.3d 356 (6th Cir.2014) 8, 13

Estate of Tawney v. Columbia Natural Resources L.L.C.
219 W.Va. 266, 633 S.E.2d 22 (2006) 20

Fawcett v. Oil Producers, Inc. of Kan.
Kan. No. 108,666, 2015 WL 4033549 (July 2, 2015) 21

Foster Wheeler Enviresponse, Inc. v. Franklin Cty. Convention Facilities Auth.
78 Ohio St.3d 353, 678 N.E.2d 519 (1997) 8, 9, 13

Graham v. Drydock Coal Co.
76 Ohio St.3d 311, 667 N.E.2d 949 (1996)..... 8

Harris v. Ohio Oil Co.
57 Ohio St. 118, 48 N.E. 502 (1897)..... 7

Heritage Resources, Inc. v. NationsBank
939 S.W.2d 118 (Tex.1996)..... 10, 11, 14, 18

Iams v. Carnegie Natural Gas Co.
194 Pa. 72, 45 A. 54 (1899)..... 24

Kachelmacher v. Laird
92 Ohio St. 324, 110 N.E. 933 (1915)..... 24

Karabin v. State Auto. Mut. Ins. Co.
10 Ohio St.3d 163, 462 N.E.2d 403 (1984)..... 8

Katzin v. Cent. Appalachia Petroleum
2012 PA Super 10, 39 A.3d 307, 309..... 15

Kelley v. Ohio Oil Co.
57 Ohio St. 317, 49 N.E. 399 (1897)..... 10

Kilmer v. Elexco Land Servs., Inc.
605 Pa. 413, 990 A.2d 1147 (2010)..... passim

Local Marketing Corp. v. Prudential Ins. Co. of Am.
159 Ohio App.3d 410, 2004-Ohio-7001, 824 N.E.2d 122 (1st Dist.)..... 8, 13

Martin v. Glass
571 F. Supp. 1406 (N.D.Tex.1983)..... 11

Mittelstaedt v. Santa Fe Minerals, Inc.
1998 OK 7, 954 P.2d 1203..... 21

Mont. Power Co. v. Kravik
179 Mont. 87, 586 P.2d 298 (1978)..... 14

Myers v. E. Ohio Gas. Co.
51 Ohio St.2d 121, 364 N.E.2d 1369 (1977)..... 7

Nationwide Mut. Fire Ins. Co. v. Guman Bros. Farm
73 Ohio St.3d 107, 652 N.E.2d 684 (1995)..... 7

Petron Dev. Co. v. Washington Cty. Bd.of Equalization
91 P.3d 408 (Colo.App.2003)..... 10

Piney Woods Country Life School v. Shell Oil Co.
726 F.2d 225 (5th Cir.1984) 10, 14, 19

Pollock v. Energy Corp. of Am.
W.D.Pa. No. CV 10-1553, 2012 WL 6929174 (Oct. 24, 2012) 20

Poplar Creek Dev. Co. v. Chesapeake Appalachia, L.L.C.
636 F.3d 235 (6th Cir.2011) ..... passim

Pure Oil Co. v. Kindall
116 Ohio St. 188, 156 N.E. 119 (1927) 9

Ramming v. Natural Gas Pipeline Co. of Am.
390 F.3d 366 (5th Cir.2004) 11

Rogers v. Westerman Farm Co.
29 P.3d 887 (Colo.2001) 21

Schroeder v. Terra Energy, Ltd.
223 Mich.App. 176, 565 N.W.2d 887 (1997) ..... passim

Sternberger v. Marathon Oil Co.
257 Kan. 315, 894 P.2d 788 (1995) 21

Sunoco, Inc. (R & M) v. Toledo Edison Co.
129 Ohio St.3d 397, 2011-Ohio-2720, 953 N.E.2d 285 7

Van Ligten v. Emergency Servs., Inc.
10th Dist. Franklin No. 11AP-901, 2012-Ohio-2994 8

Westfield Ins. Co. v. Galatis
100 Ohio St.3d 216, 2003-Ohio-5849, 797 N.E.2d 1256 ..... 7, 8

Wohl v. Swinney
118 Ohio St.3d 277, 2008-Ohio-2334, 888 N.E.2d 1062 8

Yzaguirre v. KCS Resources, Inc.
53 S.W.3d 368 (Tex.2001) 24

Rules

30 C.F.R. 1206.151 14

Other Authorities

3-6 Williams & Meyers, Oil and Gas Law Section 645.2 20

8-W Williams & Meyers, Oil and Gas Law at W 10

Black's Law Dictionary (10th Ed.2014) 14

Brian S. Wheeler,
Deducting Post-Production Costs When Calculating Royalty: What Does the Lease Provide?, 8 Appalachian J.L. 1, 5-6 (2008) 11, 20, 22

Byron C. Keeling & Karolyn King Gillespie
The First Marketable Product Doctrine: Just What Is the "Product"?
37 St. Mary's L.J. 1, 84-85 (2005) 21

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 (2009) 13

George M. Haley & Eric Maxfield
Postproduction and Marketing Expense Deduction Claims
11 Bus. & Com. Litig. in Fed. Cts. Section 127:80 (3d Ed.) 13

John W. Broomes
Waste Not, Want Not: The Marketable Product Rule Violates Public Policy Against Waste of Natural Gas Resources
63 U. Kan. L. Rev. 149 (2014) 22

Randy Sutton, *Sufficiency of "At the Well" Language in Oil and Gas Leases to Allocate Costs*
99 A.L.R. 5th 415 (2002) 13

William F. Carr & Paul R. Owen
Clear as Crude: Defending Oil and Gas Royalty Litigation
37 Natural Resources J. 695 (1997) 12, 13

I. INTRODUCTION

This Court has accepted the following certified question for review:

> 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)?

For the reasons detailed below, this Court should hold that Ohio follows the "at the well" rule.

The certified question before the Court is how Ohio interprets oil and gas leases requiring natural gas royalties to be based on the "market value" of the gas "at the well," when, as is often the case today, the gas is sold downstream of the well. Selling gas downstream of the well results in a higher sales price for the gas—which benefits lessors and lessees—but also requires post-production costs (such as gathering and transportation from the well to the point of sale) to be incurred to obtain that higher price. The question in this case concerns how these post-production costs should be apportioned amongst lessor and lessee when leases provide that royalties are to be based on the "market value" of the gas "at the well."[1]

This question can be answered by applying the longstanding, bedrock principle of Ohio law providing that Ohio construes leases as written. When the plain language of a lease provides for royalties based on the value of the gas "at the well," Ohio law mandates that courts give effect to that plain language. In this context, that means that royalties are to be based on the "market value" of gas "at the well," a value which can be calculated by the "netback method." The "netback method" is a calculation—used all over the country—that takes the downstream sales price of the gas less the post-production costs to determine the value of gas at the well. Applying the netback method to calculate a wellhead value of the gas results in the parties sharing in both the

[1] This case does not involve the apportionment of production costs—*i.e.*, the costs of drilling and completing the well and operating the well to bring the gas from below ground to the surface. Production costs are typically borne by the lessor alone.

costs and benefits of the higher downstream price on a pro rata basis. Both parties' interests are aligned. This approach, which has been adopted by the majority of gas-producing jurisdictions in the country, is commonly referred to as the "at the well" rule, and should be adopted in Ohio.

Plaintiffs, on the other hand, seek to escape the plain and unambiguous language of their leases. They would have this Court re-write the parties' leases to require the payment of royalties based on the value of the gas at the ***downstream point of sale***, not the value of the gas "at the well." This approach is completely devoid of any contractual support. In fact, it contradicts the express provisions that if gas is sold at the well, the actual sales price controls, and if gas is ***not*** sold at the well, the royalty is based upon "market value" of the gas "at the well." Ignoring the lease language, plaintiffs urge the Court to adopt a variant of a rule adopted by a minority of states—sometimes called the "marketable product" rule—pursuant to which the lease language is disregarded and royalties are paid on the value of gas at the downstream point of sale without netting out post-production costs. Simply put, plaintiffs seek to have Ohio adopt a rule that is not true to the lease language providing that royalties are to be based on the "market value" of gas "***at the well***."

The terms used in these leases are not ambiguous and have clear meanings. Where, as here, the parties agree to calculate royalties based on the "market value" of gas "at the well," then as a matter of long-established Ohio law, that agreement must be honored. The Court should therefore answer the certified question by holding that Ohio follows the "at the well" rule and that the parties' leases are applied according to their plain language.

II. STATEMENT OF FACTS

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 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," unless the gas is sold at the well, in which case the royalty is to be based on the amount realized from the sale. (Ex. 1 ¶ 3.)

The specific language of the relevant leases is this: royalties are to be paid based on "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." (Emphasis added.) (*Id.*)

B. The Dispute Concerns How to Calculate the "Market Value" of Gas "At the Well" When It Is Sold Downstream of the Well

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 bears ***all*** of the costs of drilling a well and bringing the gas to the wellhead. These costs, which are often substantial, are known as "production" costs. The producer also bears all of the risk that the well will not be productive.

For many years, producers sold gas at the wellhead; in the 1950s through early 1990s, at-the-well sales were the predominant (but not exclusive) method by which natural gas was sold. This is why leases entered into before the 1990s—many of which are still in force today, like those at issue here—address both eventualities and provide that when gas is sold "at the well," then royalties are to be based on the "amount realized" from the sale of the gas, but if gas is not sold "at the well," then royalties are nonetheless to be based on the "market value" of the gas "at the well."

(Ex. 1 ¶ 3.) The basic principle is that the royalty should not depend on where the gas is sold—the basis for the royalty is what the gas is worth at the wellhead after the lessee has paid all production costs to get the gas to the surface.

When gas is sold at the well, calculating royalties pursuant to such provisions is straightforward: the value at the well is equal to the sales price. An agreed-upon fraction (or percentage) of that sales price at the wellhead is paid to the lessor as a royalty.

Industry regulations substantially changed in the 1990s, and natural gas producers were able to sell gas downstream and obtain a better price. The downstream sales price of gas is typically greater than the price for gas at or near the wellhead, especially where costs have been incurred to gather and transport the gas to the downstream sales point. By way of analogy, it costs far more to buy a Christmas tree from a market in downtown Columbus than it does to saw down one's own fir tree in the woods outside of Columbus—because when one buys a Christmas tree at the market, it has already been cut down and transported to a convenient location. One can sell the tree in the woods, but the net price is still typically greater when the gas is sold in downtown Columbus, even taking into account the costs to move the tree from woods to city. Similarly, purchasers are willing to pay a higher price for gas after it has been gathered and transported downstream than they are willing to pay if they have to buy the gas at the wellhead and incur those logistics and costs themselves. Moreover, the well operators can generally command a higher price because they can combine and aggregate gas from multiple wells and offer the buyers a larger and more secure volume.

Indeed, plaintiffs do not (and cannot) dispute the basic economic reality that if the gas is sold at the well, the buyer itself must then incur the post-production costs to gather the gas and transport it to where it will be used (assuming that the buyer can even arrange such services on its

own). In that case, the buyer will pay less for the gas because it will have to absorb the post-production costs. Of course, if gas is sold downstream from the well, the buyer pays more because it is not paying post-production costs. But post-production costs are nevertheless incurred from the wellhead to get the gas to the downstream point of sale. In that case, those costs must be netted out of the sales price in order to arrive at the wellhead value.

C. The Netback Method Calculates the "Market Value At the Well" of Gas Sold Downstream of the Well

When gas is sold downstream, the "netback" (or "workback") method is often used to calculate the value of gas at the well. The netback method determines the value of gas "at the well" by allocating a pro rata share of post-production costs to the royalty interest. Thus, the netback method takes into account that selling the gas downstream from the well results in a higher price than if the gas was sold at the well.

Under the netback method, the post-production costs are shared by the lessor (the mineral owner) and lessee (Chesapeake here) according to their proportional interests unless the lease explicitly says otherwise. In leases providing for a one-eighth royalty of the value of the gas at the well, the royalty is calculated either by: (i) netting all of the post-production costs out of the proceeds from the sale downstream and then paying the lessor a one-eighth royalty on the remaining net amount; or (ii) calculating one-eighth of the sales proceeds and then deducting one-eighth of the total post-production costs. Either way, the royalty is based on the one-eighth of the value of the gas at the well.

D. 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. The only remaining claim here is for breach of contract. In this case, plaintiffs challenge Chesapeake's use of the netback method to calculate the value of the gas at the well. Plaintiffs contend that they should receive royalties based on the higher downstream price without sharing any portion of the post-production costs.

In August 2014, Chesapeake moved for partial summary judgment on certain aspects of plaintiffs' breach of contract claim. Plaintiffs cross-moved for summary judgment in September 2014. 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:

> 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.) The parties filed Preliminary Memoranda in this Court in April 2015. On June 3, 2015, this Court determined that it would answer the certified question as phrased by the District Court.

III. ARGUMENT

This Court should hold that the only interpretation giving meaning to the lease language providing that royalties are to be paid based on the "market value" of gas "at the well" is the interpretation that permits the use of the netback method—the "at the well" rule. This answer flows from longstanding, bedrock principles of Ohio law. Leases, like all written contracts, are applied as written, and all of their terms must be given meaning.

The "at the well" rule is the majority rule among the gas-producing states and has been adopted by numerous courts in neighboring states, including Pennsylvania, Kentucky, and Michigan; major gas-producing states like Texas and Mississippi; and the federal government.

Plaintiffs, on the other hand, urge the adoption of some iteration of the so-called "marketable product" rule. Adoption of that rule, however, would impermissibly re-write the parties' contracts so as to base royalties on a value at the location different than the value "at the well." The "marketable product" rule cannot be squared with fundamental principles of Ohio contract law.

A. <u>Proposition of Law No. 1:</u>

Oil and Gas Leases Are Construed As Written and According to Their Plain Meaning.

It is a bedrock principle of Ohio law that in Ohio, oil and gas leases, like other contracts, are applied as written. *See, e.g.*, *Myers v. E. Ohio Gas. Co.*, 51 Ohio St.2d 121, 125, 364 N.E.2d 1369 (1977) ("It is a legal commonplace that courts, in deciding the rights of parties under a written agreement, including a lease, should give effect to the unambiguously expressed intent of the parties."); *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 * * *."); *see also City of St. Marys v. Auglaize Cty. Bd. of Commrs.*, 115 Ohio St.3d 387, 2007-Ohio-5026, 875 N.E.2d 561, ¶ 18; *Nationwide Mut. Fire Ins. Co. v. Guman Bros. Farm*, 73 Ohio St.3d 107, 108, 652 N.E.2d 684 (1995); *Sunoco, Inc. (R & M) v. Toledo Edison Co.*, 129 Ohio St.3d 397, 2011-Ohio-2720, 953 N.E.2d 285, ¶ 37; *Westfield Ins. Co. v. Galatis*, 100 Ohio St.3d 216, 2003-Ohio-5849, 797 N.E.2d 1256, ¶ 11; *Aultman Hosp. Assn. v. Community Mut. Ins. Co.*, 46 Ohio St.3d 51, 53-54, 544 N.E.2d 920 (1989).

In assessing plain meaning, the court must "look to the plain and ordinary meaning of the language used in the [contract] unless another meaning is clearly apparent from the contents of the [agreement]." *Westfield* at ¶ 11; *Graham v. Drydock Coal Co.*, 76 Ohio St.3d 311, 313-14, 667 N.E.2d 949 (1996). "'Common words appearing in a written instrument will be given their ordinary meaning unless manifest absurdity results, or unless some other meaning is clearly evidenced from the face or overall contents of the instrument.'" *Aultman* at 53-54, quoting *Alexander v. Buckeye Pipe Line Co.*, 53 Ohio St.2d 241, 374 N.E.2d 146 (1978). "When the language of a written contract is clear, a court may look no further than the writing itself to find the intent of the parties," and the contract must be enforced according to its terms. *Westfield* at ¶ 11. A court is "not permitted to alter a lawful contract by imputing an intent contrary to that expressed by the parties." *Id.* at ¶ 12.

B. <u>Proposition of Law No. 2:</u>

Oil and Gas Leases Are Construed So As to Avoid Rendering Terms Meaningless.

Interpreting contracts as written requires that contracts, including oil and gas leases, are interpreted so as to avoid rendering any terms meaningless. *See Foster Wheeler Enviresponse, Inc. v. Franklin Cty. Convention Facilities Auth.*, 78 Ohio St.3d 353, 362-63, 678 N.E.2d 519 (1997); *see also Eastham v. Chesapeake Appalachia, L.L.C.*, 754 F.3d 356, 363 (6th Cir.2014) (applying Ohio law). "[A] contract must be construed in its entirety and in a manner that does not leave any phrase meaningless or surplusage." *Local Marketing Corp. v. Prudential Ins. Co. of Am.*, 159 Ohio App.3d 410, 2004-Ohio-7001, 824 N.E.2d 122, ¶ 8 (1st Dist.); *see also Wohl v. Swinney*, 118 Ohio St.3d 277, 2008-Ohio-2334, 888 N.E.2d 1062, ¶ 22; *Karabin v. State Auto. Mut. Ins. Co.*, 10 Ohio St.3d 163, 166-67, 462 N.E.2d 403 (1984); *Van Ligten v. Emergency Servs., Inc.*, 10th Dist. Franklin No. 11AP-901, 2012-Ohio-2994, ¶ 22 ("A court 'must give meaning to

every paragraph, clause, phrase and word, omitting nothing as meaningless, or surplusage.'"), quoting *Affiliated FM Ins. Co. v. Owens-Corning Fiberglas Corp.*, 16 F.3d 684, 686 (6th Cir.1994).

C. <u>Proposition of Law No. 3:</u>

Under Ohio Law, Leases Providing that Royalties Are to be Paid Based on the "Market Value" of Gas "At the Well" Should be Applied as Written.

The key issue on this appeal is the application of the bedrock rule of Ohio law—that leases are applied as written—to leases providing that royalties are to be paid based on the "market value" of gas "at the well" when gas is not at the well.

This Court should answer this question the same way it answers other issues of contractual interpretation—by applying the lease language itself. This would be consistent with Ohio law and how courts in most other states have answered this specific question. This approach would result in this Court adopting the "at the well" rule to hold that the netback method is an acceptable method of calculating the "market value" of gas "at the well." Adopting this approach is the only one that is consistent with Ohio law requiring leases to be applied according to their plain language. *See Foster Wheeler* at 362-63; *Local Marketing Corp.* at ¶ 8.

1. <u>The Phrase "Market Value" of Gas "At the Well" Is Plain and Unambiguous</u>

As a threshold matter, the key phrase at issue—the "market value" of gas "at the well"—is plain and unambiguous. It has long been the law in Ohio that royalties are typically the lessor's share of "production." *Pure Oil Co. v. Kindall*, 116 Ohio St. 188, 201, 156 N.E. 119 (1927) ("Royalty is a certain percentage of the oil after it is found or produced, or so much per gas well developed and producing gas. Royalty is personal property, and is not realty."). Production occurs at the moment of severance, *i.e.*, the moment that the oil and gas was removed from the ground and

converted from real property to personal property. *See, e.g., Kelley v. Ohio Oil Co.*, 57 Ohio St. 317, 49 N.E. 399 (1897), paragraph one of the syllabus.

The moment of severance is the wellhead. "'[W]ellhead * * * refers to the point at which gas is severed or removed from the ground.'" 8-W Williams & Meyers, Oil and Gas Law at W, quoting *Schroeder v. Terra Energy, Ltd.*, 223 Mich.App. 176, 179, 565 N.W.2d 887 (1997), fn. 1; *see also Petron Dev. Co. v. Washington Cty. Bd. of Equalization*, 91 P.3d 408, 411 (Colo.App.2003) ("The term 'at the wellhead' generally refers to the point at the top or 'head' of the actual well where the mineral product is severed or removed from the ground."), *aff'd*, 109 P.3d 146 (Colo.2005).

Thus, the contractual provision requiring royalties to be paid based on the "market value" of gas "at the well" has a plain and ordinary meaning that must be given effect. *See Heritage Resources, Inc. v. NationsBank*, 939 S.W.2d 118, 122 (Tex.1996) ("Market value at the well has a commonly accepted meaning in the oil and gas industry.").

The market value of gas at the well is the value of gas in its natural state—*i.e.*, before post-production costs like processing and transportation are incurred. *See Piney Woods Country Life School v. Shell Oil Co.*, 726 F.2d 225, 231 (5th Cir.1984) ("Market value at the well means market value before processing and transportation * * *."); *Poplar Creek Dev. Co. v. Chesapeake Appalachia, L.L.C.*, 636 F.3d 235, 244 (6th Cir.2011) ("'[A]t-the-well' refers to gas in its natural state, before the gas has been processed or transported from the well.").

2. <u>Gas Is Often Sold Downstream from the Wellhead, and the "Netback Method" Is Used to Calculate the Market Value of Gas at the Well</u>

The next question, then, is how to calculate an at-the-well value of gas when gas is not actually sold at the well. Here, too, the answer is well-established. In such circumstances, to determine the market value of gas at the well—*i.e.*, the value of gas before post-production costs

are incurred—the "netback method" is typically used. *See Heritage Resources*, 939 S.W.2d at 122; Brian S. Wheeler, *Deducting Post-Production Costs When Calculating Royalty: What Does the Lease Provide?*, 8 Appalachian J.L. 1, 5-6 (2008).

Under the netback method, post-production costs incurred to bring the gas downstream are netted against the downstream sales price, yielding the value of gas "at the well." *See Ramming v. Natural Gas Pipeline Co. of Am.*, 390 F.3d 366, 372 (5th Cir.2004) (per curiam) (under the netback method, '"all increase in the ultimate sales value attributable to the expenses incurred in transporting and processing the commodity must be deducted because that is the way to arrive at the value of the gas at the moment it escapes from the wellhead'") (ellipses and brackets omitted), quoting *Martin v. Glass*, 571 F. Supp. 1406, 1413-14 (N.D.Tex.1983). 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); *see also Poplar Creek*, 636 F.3d at 244; *Schroeder*, 223 Mich.App. at 188-90, 565 N.W.2d 887.

A simple example helps illustrates how the netback method works. Assume the price of gas sold downstream is $4.00/mcf, and $1.00/mcf in post-production costs are incurred after the gas is at the wellhead to obtain the $4.00/mcf price downstream. The netback method subtracts the post-production costs ($1.00/mcf) from the downstream sales price ($4.00/mcf) to calculate an "at the well" value of $3.00/mcf. This calculated "at the well" value is then used to calculate royalty payments to lessors, exactly as specified in the leases providing that royalty is to be paid based on the "market value" of gas "at the well."

3. The "At the Well" Rule Gives Meaning to the "At the Well" Language, Whereas Plaintiffs' Proposed Interpretation Ignores Such Language

The "at the well" rule permits the use of the netback method to calculate the market value of gas at the well. It gives meaning to "market value at the well" lease language. (Ex. 1 ¶ 3.)

Plaintiffs' proposal would ignore this language. Plaintiffs assert that Chesapeake is not permitted to net any post-production costs against plaintiffs' royalty payments—*i.e.*, Chesapeake should pay royalties based on the higher downstream sales price, not the market value of the gas at or near the wellhead. (*See* Compl. ¶¶ 62-65.) This, of course, would be paying the market value at a ***downstream point of sale***, not the "***market value at the well***" as the lease requires. (Ex. 1 ¶ 3.)

Such an interpretation of the language thus not only renders the relevant lease language meaningless, but it also expressly contradicts the relevant terms of the leases. *See* William F. Carr & Paul R. Owen, *Clear as Crude: Defending Oil and Gas Royalty Litigation*, 37 Natural Resources J. 695, 706 (1997) (noting that same interpretation as proposed by plaintiffs incorrectly construes a "'net proceeds *at the well*' royalty clause * * * to mean 'gross proceeds *at the tailgate of a downstream processing plant*'" (emphases added)).

Indeed, the lease language itself makes clear that royalties are to be paid based on what the gas is worth at the well—***no matter where the gas is sold***. This provides greater certainty or consistency in knowing how to compute royalties and reflects that royalty owners share in post-production costs after the gas has been produced to the surface by the lessee at no cost to the royalty owner. The lease expressly provides that if gas is sold "at the wells the royalty shall be one-eighth of the amount realized from such sale." (Ex. 1 ¶ 3.) If gas is not sold at the well, the gas is still required to be based on "the market value at the well." (*Id.*) Plaintiffs' interpretation would simply ignore these provisions: it would provide that royalty is to be based on the ***downstream*** value of the gas—not the value of the gas "at the well" as the lease requires. Plaintiffs'

interpretation is inconsistent with Ohio law requiring that leases be applied as written. *See Foster Wheeler*, 78 Ohio St.3d at 362-63, 678 N.E.2d 519; *Eastham*, 754 F.3d at 363 (interpreting contract to avoid "nonsensical" result); *Local Marketing Corp.*, 159 Ohio App.3d 410, 2004-Ohio-7001, 824 N.E.2d 122, at ¶ 8 (language cannot be treated as mere "surplusage"); *see also Schroeder*, 223 Mich.App. at 179-90, 565 N.W.2d 887 (reaching the same conclusion pursuant to Michigan law).

D. <u>Proposition of Law No. 4:</u>

Most States Have Adopted the "At the Well" Rule Because It Gives Meaning to Lease Language Providing that Royalties Are to Be Paid Based on the Market Value of Gas At the Well.

In holding that Ohio follows the "at the well" rule, Ohio would join most oil and gas producing states. A majority of such jurisdictions have adopted the "at the well" rule and endorsed the use of the netback method to determine a wellhead valuation of the gas for leases like those at issue here. *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.").[2]

1. <u>The Majority of Jurisdictions Have Adopted the "At the Well" Rule</u>

Most states have adopted the "at the well" rule—because this rule applies the parties' agreement as written rather than re-writing the terms of the lease. Among the states to have adopted the "at the well" rule are:

- Pennsylvania. *Kilmer v. Elexco Land Servs., Inc.*, 605 Pa. 413, 990 A.2d 1147.

[2] *See also* George M. Haley & Eric Maxfield, *Postproduction and Marketing Expense Deduction Claims*, 11 Bus. & Com. Litig. in Fed. Cts. Section 127:80 (3d Ed.) ("A majority of states currently follow the 'at the well' rule regarding the deductibility of postproduction costs."); Randy Sutton, *Sufficiency of "At the Well" Language in Oil and Gas Leases to Allocate Costs*, 99 A.L.R. 5th 415 (2002) ("Most cases have allowed the oil and gas lessee to deduct these costs from royalty payments, allocating postproduction costs to the lessor and lessee, proportionately.").

- Kentucky. *See Poplar Creek*, 636 F.3d at 244; *Baker v. Magnum Hunter Prod., Inc.*, Ky.App. No. 2012-CA-001016-MR, 2013 WL 3235832, at *2 (June 28, 2013).

- Michigan. *Schroeder*, 223 Mich.App. 176, 565 N.W.2d 887.

- Texas. *Heritage Resources*, 939 S.W.2d at 122.

- Louisiana. *Babin v. First Energy Corp.*, 693 So.2d 813, 815 (La.App.1997).

- Mississippi. *Piney Woods Country Life School*, 726 F.2d at 240.

- North Dakota. *See Bice v. Petro-Hunt, L.L.C.*, 2009 ND 124, 768 N.W.2d 496, ¶ 21.

- California. *Atlantic Richfield Co. v. State*, 214 Cal.App.3d 533, 541-42 (1989).

- Montana. *Mont. Power Co. v. Kravik*, 179 Mont. 87, 93-94, 586 P.2d 298 (1978).

The federal government, too, has accepted the "at the well" rule and the netback method for calculating royalties. *See* 30 C.F.R. 1206.151 (regulations explaining 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").

In fact, the "at the well" rule is so well accepted that *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 * * *." *Black's Law Dictionary* (10th Ed.2014).

2. <u>Most of Ohio's Neighboring States Have Adopted the "At the Well" Rule</u>

Most of Ohio's neighboring states—particularly Pennsylvania, Kentucky, and Michigan—have expressly adopted the "at the well" rule. Given that several of these cases were decided recently—and in neighboring states—they warrant brief discussion here.

a. Pennsylvania

In *Kilmer*, 605 Pa. 413, 990 A.2d 1147 (2010), a group of landowners challenged the gas company's practice of calculating royalties at the wellhead and deducting post-production costs.[3] *See id.* at 419-20. In particular, as plaintiffs do here, the *Kilmer* plaintiffs argued that the royalty "calculation should be made at the point of sale rather than the wellhead," such that post-production costs would not be deducted. *Id.* at 420.

The Pennsylvania Supreme Court firmly rejected that argument, holding that Pennsylvania law "permit[s] the calculation of royalties at the wellhead, as provided by the net-back method in the Lease * * *." *Id.* at 430-31. Indeed, the court interpreted the term "royalty" to mean a lessor's share of production minus his pro rata share of post-production costs.[4] *Id.* at 429. As the court explained, this definition makes sense because "use of the net-back method eliminates the chance that lessors would obtain different royalties on the same quality and quantity of gas * * * depending on when and where in the value-added production process the gas was sold." *Id.* at 430. The court also relied on analysis of the history of the oil and gas industry as well as the minority and majority rules in reaching this conclusion. *Id.* at 420-21, 424-26, 428-30.

The *Kilmer* court noted that "[w]hile Landowners present a concern that gas companies may inflate their costs to drive down the royalties paid, we find that claim unconvincing because

---

[3] The Pennsylvania landowners challenged such practices pursuant to the Pennsylvania Guaranteed Minimum Royalty Act ("GMRA"), 58 Pa.Cons.Stat.Ann. 33.3, which requires Pennsylvania oil and gas leases to guarantee the landowner-lessor "at least one-eighth royalty of all oil, natural gas or gas of other designations removed or recovered from the subject real property," *id.*, rather than asserting a breach of contract theory. The court thus addressed the method of calculating royalties in light of the requirements of the GMRA.

[4] Cases following and applying *Kilmer* have relied on this definition of "royalty" to allow the sharing of post-production costs even where the lease does not explicitly spell out these costs or call for deducting them, as the lease in *Kilmer* did. *See, e.g.*, *Katzin v. Cent. Appalachia Petroleum*, 2012 PA Super 10, 39 A.3d 307, 309.

gas companies have a strong incentive to keep their costs down * * *." *Id.* at 430. That incentive is easy to understand: because the lessee pays its proportional share of the post-production costs (usually 7/8ths), it has no reason to unnecessarily increase those costs. The *Kilmer* court thus recognized that the economic interests of a lessor and lessee are perfectly aligned—both want to sell the gas, both want to get the best price, and both want to do so at the lowest cost.

In fact, if anything, the *Kilmer* court was faced with a closer issue than this Court is faced with here. In *Kilmer*, the court was asked to interpret a statute which did not specify that royalties were to be calculated on the value "at the well." This Court, however, is asked to interpret leases where the parties have ***expressly agreed*** that the royalties must be based on the value at the well. Only the adoption of the "at the well" role accomplishes what the parties agreed to.

b. Kentucky

The leading case applying Kentucky law is *Poplar Creek Development Co. v. Chesapeake Appalachia, L.L.C.*, E.D.Ky. No. CV 08-190-GFVT, 2010 U.S. Dist. LEXIS 74269 (July 2, 2010). There, as here, landowners sued for breach of contract, alleging underpayment of gas royalties. *Id.* at *2-3. Certain leases at issue in *Poplar Creek*, as here, provided that royalties were to be paid on the market value of the gas "at the well." *Id.* Although the Kentucky Supreme Court had not directly answered this question, the federal district court held that such leases permitted post-production cost deductions through the netback method as a matter of law, concluding that "Kentucky courts would interpret the lease provision in this case, requiring Chesapeake to pay royalties based on the gas's value 'at the well,' to unambiguously mean just that--that Chesapeake must pay royalties on the value of the gas at the well, before it has been gathered, treated, or compressed." *See id.* at *17.

The court explained the rationale behind the majority rule, which it subsequently adopted: although the terms of the lease state that "the royalty is to be calculated based on the gas's value 'at

the well,'" "[g]as * * * often is not sold at the well." *Id.* at *5. To give meaning to the "at the well" lease language, the gas's value "at the well" must "equal[] the price in the market where the gas is actually sold minus the costs it takes to get the gas from the well to that market in the form in which it is sold," *id.*, and the leases thus permit post-production cost deductions as a matter of law, *see id.* at *5-6; *id.* at *17.

The Sixth Circuit affirmed the district court's ruling. The Sixth Circuit held that "Kentucky follows the 'at-the-well' rule, which allows for the deduction of post-production costs prior to paying appropriate royalties." *See Poplar Creek Dev. Co. v. Chesapeake Appalachia, L.L.C.*, 636 F.3d at 244. The Sixth Circuit explained that "'at-the-well' refers to gas in its natural state, before the gas has been processed or transported from the well"—meaning that "[t]he gas sold by Chesapeake was therefore not 'sold at the well' within the meaning of the parties' lease" and "Chesapeake was within its rights, under Kentucky law and the parties' agreement, to subtract gathering, compression, and treatment costs before paying royalties on the market value of the gas." *Id.*

Poplar Creek's interpretation of Kentucky law was later confirmed in *Baker v. Magnum Hunter Production., Inc.*, 2013 WL 3235832, at *2 (Ky. Ct. App. June 28, 2013), which held that "at the well" language permitted the deduction of post-production costs.

c. Michigan

In *Schroeder*, 223 Mich.App. 176, 565 N.W.2d 887 (1997), Michigan landowners asserted breach of contract claims similar to plaintiffs' claims here based on similar "at the wellhead" lease language. *See id.* at 179-80.

The *Schroeder* court adopted the "at the well" rule, holding that "to determine the royalty valuation, postproduction costs must be subtracted from the sales price of the gas where it is subsequently marketed." *Id.* at 188-89. The court explained that "the use of the language 'gross

proceeds at the wellhead' by the parties appears meaningless in isolation because the gas is not sold at the wellhead and, thus, there are no proceeds at the wellhead." *Id.* "However, if the term is understood to identify the location at which the gas is valued for purposes of calculating a lessor's royalties," which "accord[s] reasonable meaning to the plain language of the contract[,] * * * it necessarily follows [from the 'at the wellhead' language] that * * * postproduction costs must be subtracted from the sales price of the gas * * *." *Id.*

The court thus found that leases using "at the wellhead" language must permit deduction of post-production costs to give effect to the language in the contract between the parties requiring payment of royalties based on the market value at the well. *See id.*

3. Major Oil and Gas Producing States, Like Texas and Mississippi, Follow the At the Well Rule

Major oil and gas producing states, like Texas and Mississippi, similarly follow the "at the well" rule.

The leading case from Texas is *Heritage Resources*, 939 S.W.2d at 122. The Texas Supreme Court began its analysis in *Heritage* by observing that "[m]arket value at the well has a commonly accepted meaning in the oil and gas industry." *Id.* The court explained that when gas is sold downstream, there are essentially two ways to establish wellhead value: comparable sales, and if such sales are not available, then the netback method. *Id.* The *Heritage* court described the netback method as "involv[ing] subtracting reasonable post-production marketing costs from the market value at the point of sale" to determine the wellhead value. *Id.* Applying those principles, the court held that the lessee was correct in using the netback method to calculate royalties: the leases required the lessee to "pay a royalty based on the market value at the point of sale less the reasonable post-production marketing costs." *Id.* at 123.

The leading case applying Mississippi law is *Piney Woods Country Life School*, 726 F.2d at 231. In *Piney Woods*, the court looked at lease language very similar to the relevant language at issue here and noted that if a lessee sells gas downstream and incurs costs to do so, "he should be compensated for it; the costs of transport are, therefore, deducted from the sale price to arrive at 'value at the well.'" *Id.* at 230. The *Piney Woods* court went on to explain that "[m]arket value at the well means market value before processing and transportation," *id.* at 231, and that "'at the well' refers to gas in its natural state, before the gas has been processed or transported from the well," *id.* at 242. Thus, "[t]o determine the correct basis for royalty, processing and transportation costs may be deducted from values or prices established for processed and transported gas." *Id.* at 242.

All of these jurisdictions have simply looked at the plain language of the leases, held that "market value at the well" language must be given meaning, and concluded that use of the netback method is an appropriate method of giving such language meaning.

E. <u>Proposition of Law No. 5:</u>

Neither the "Marketable Product" Rule nor the "*Tawney*" Rule Gives Meaning to Contractual "Market Value At the Well" Language.

Plaintiffs' proposed approaches to royalty calculation are ill-defined and fail to give meaning to the lease language. Over the course of this litigation, plaintiffs have advocated for two different rules, both of which ignore the "market value at the well" lease language at issue in this case. Plaintiffs simply seek any approach that grants them all of the potential upside of downstream sales without incurring any of the costs or risks of such sales. But plaintiffs' effort to secure a windfall fails for the basic reason that no rule they have advocated for is consistent with the language of the leases, and thus, with Ohio law.

1. The "*Tawney*" Rule Ignores the Lease Language and Has Been Rejected in All But One State

First, plaintiffs have advocated for a rule known as the "*Tawney*" rule. (*See* Compl. ¶¶ 48-50.) But this rule (which plaintiffs erroneously cast as a variant of the "marketable product" rule discussed below) has been adopted by only one state and disregards the language of the leases between the parties—and is thus incompatible with Ohio law.

Only one state has adopted the so-called *Tawney* rule: West Virginia. The rule gets its name from a West Virginia court decision providing that the lessee presumptively bears all post-production costs, even when the lease provides that the "royalty is to be calculated 'at the well,' [or] 'at the wellhead * * *.'" *See Estate of Tawney v. Columbia Natural Resources, L.L.C.*, 219 W.Va. 266, 268, 274, 633 S.E.2d 22 (2006).

This approach simply ignores the "market value at the well" language in such leases, and imposes non-legislative policy-making instead. Since *Tawney* was decided nine years ago, royalty owners have repeatedly tried to import the rule into other states—and they have failed every time. *See* Brian S. Wheeler, *Deducting Post-Production Costs When Calculating Royalty: What Does the Lease Provide?*, 8 Appalachian J.L. 1, 13 (2008 (discussing *Tawney* and noting that "West Virginia appears to be the only state following this approach"); *see also Appalachian Land Co. v. EQT Prod. Co.*, E.D.Ky. No. CV 7:08-139-KKC, 2012 WL 523749, at *3 (Feb. 16, 2012) (declining to follow *Tawney*); *Pollock v. Energy Corp. of Am.*, W.D.Pa. No. CV 10-1553, 2012 WL 6929174, at *6 (Oct. 24, 2012), *report and recommendation adopted*, 2013 WL 275327 (Jan. 24, 2013) (same).

These courts have refused to adopt the *Tawney* rule for good reason: it ignores the plain language of the lease. *See* 3-6 Williams & Meyers, Oil and Gas Law Section 645.2 (*Tawney* "leaves one scratching one's head as to whether the court was really looking at the bargain struck

between the parties"). There is nothing in Ohio jurisprudence to suggest that Ohio would adopt the *Tawney* rule. To the contrary, *Tawney* is incompatible with long-standing Ohio precedent that requires leases to be applied as written.

2. The "Marketable Product" Rule Ignores Contractual Language and Instead Applies an Extra-Contractual "Policy" Gloss on the Parties' Written Agreement

A distinct minority rule is known as the "marketable product" rule. Unlike the *Tawney* rule, the marketable product rule typically requires the lessee to bear only certain post-production costs in certain situations. But this rule, too, ignores the lease language and is thus incompatible with Ohio law. *See, e.g.*, Byron C. Keeling & Karolyn King Gillespie, *The First Marketable Product Doctrine: Just What Is the "Product"?*, 37 St. Mary's L.J. 1, 84-85 (2005) (noting that "the [marketable product] doctrine does not correctly apply the rules of contract construction" and "fails to give effect to the plain terms of a standard royalty clause").

As a point of clarification, the "marketable product" rule is not actually a single, uniform rule. Kansas, Colorado, and Oklahoma, for example, are all often categorized as "marketable product" states, but the rules in those states differ significantly from one state to the next. For example, in Kansas, the lessee typically bears certain post-production costs in some instances, *see Sternberger v. Marathon Oil Co.*, 257 Kan. 315, 322, 894 P.2d 788 (1995), but not when gas is sold at the well, *see Fawcett v. Oil Producers, Inc. of Kan.*, Kan. No. 108,666, 2015 WL 4033549, at *11 (July 2, 2015). In Oklahoma, the producer ***may*** in fact use the netback method provided that certain conditions have been met. *Mittelstaedt v. Santa Fe Minerals, Inc.*, 1998 OK 7, 954 P.2d 1203, ¶ 2. And in Colorado, the lessee typically bears all costs until the gas is in the physical condition and location to enter an interstate pipeline. *See Rogers v. Westerman Farm Co.*, 29 P.3d 887, 906 (Colo.2001).

Thus, whereas the "at the well" rule is shorthand for saying that a lease will be applied as written, the "marketable product" rule is simply shorthand for an approach that applies some state-specific, policy-based, extra-contractual gloss to the lease language—rather than applying the terms of the parties' agreement.[5]

3. The Marketable Product Rule Leads to More Uncertainty

Because the "at the well" rule is based on contract language, not non-legislative policy considerations, the "at the well" rule provides clarity and guidance for the parties. This allows the parties to structure their relations in a mutually productive manner.

The "marketable product" rule, on the other hand, fosters uncertainty—and, inevitably, litigation. The "marketable product" rule provides no clear guidance to the parties as to how to calculate royalties. *See, e.g.*, *Bice v. Petro-Hunt, L.L.C.*, 2009 ND 124, 768 N.W.2d 496, ¶ 17; *Schroeder*, 223 Mich.App. at 185 fn. 5, 565 N.W.2d 887. As the North Dakota Supreme Court explained in *Bice*, "'even the states which follow the [first] marketable product rule have failed to articulate a clear standard for determining when a marketable product has been created.'" *Bice* at ¶ 17, quoting Wheeler, 8 Appalachian J.L. at 24; *see also Schroeder*, 223 Mich. App. at 185 fn. 5, 565 N.W.2d 887 (similar holding).

The Pennsylvania Supreme Court rejected the marketable product rule for a similar reason, explaining that the marketable product rule would result in different lessors receiving different

[5] Not only does the marketable product rule eschew the parties' agreement in favor of a state-by-state "policy" determination, the policy considerations underpinning the marketable product rule are themselves counterproductive. *See* John W. Broomes, *Waste Not, Want Not: The Marketable Product Rule Violates Public Policy Against Waste of Natural Gas Resources*, 63 U. Kan. L. Rev. 149, 182, 186 (2014) ("[T]he Marketable Product Rule is a regressive doctrine that benefits past generations of lessors by essentially rewriting more favorable lease terms on their behalf, while shifting the costs to lessees, future lessors, and the general public.").

royalties based on the happenstance of where the gas is sold, as opposed to how valuable the gas is when it emerges from the ground:

> [T]he natural gas can be sold at different degrees of processing for different prices and at different prices based upon the proximity of the market to high demand cities. If one company sells it at a point halfway to fully processed (or half-way to New York City), the landowner will get dramatically lower royalties than a neighbor whose gas is sold after it is fully processed. The use of the net-back method eliminates the chance that lessors would obtain 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, 605 Pa. at 430, 990 A.2d 1147 (2010).

These courts all recognize that the "at the well" rule, in contrast, provides clarity and uniformity. Where permitted by lease, all post-production costs incurred by the parties after production are proportionately shared. *Schroeder*, 223 Mich. App. at 185 fn.5 ("We also believe that [the netback method] has the virtue of establishing a uniform location for ascertaining the value of the gas, namely, its value at the wellhead.").

4. <u>The Existence of an Implied Duty to Market Does Not Mean Ohio Would Adopt the Marketable Product Rule</u>

Plaintiffs may argue, as they did before the federal court, that because Ohio recognizes an "implied duty to market," Ohio would adopt the marketable product rule. But whether or not a state recognizes an implied duty to market has no bearing on whether a state would adopt the marketable product rule.

The leases at issue here clearly provide that if gas is sold "at the well," then royalties are based on the "amount realized" for the sale of the gas, and if gas is not sold "at the well," then royalties are to be based on the "market value" of gas "at the well." In such circumstances, any "implied duty to market" does not override the actual lease language. It has long been the law in Ohio implied duties cannot override express terms in a contract. *See Kachelmacher v. Laird*, 92

Ohio St. 324, 332, 110 N.E. 933 (1915) ("The rights of the parties must be determined from their own contract. * * * An implied covenant can arise only when there is no expression on the subject."); *see also Hamilton Ins. Servs., Inc. v. Nationwide Ins. Companies*, 86 Ohio St.3d 270, 274, 714 N.E.2d 898 (1999); *Aultman Hosp. Assn. v. Community Mut. Ins. Co.*, 46 Ohio St.3d 51, 53-54, 544 N.E.2d 920 (1989) ("There can be no implied covenant in a contract in relation to any matter that is specifically covered by the written terms of the contract.")

Indeed, almost all states recognize an "implied duty to market" as a general matter, but that does not mean that almost all states are marketable product-rule states. To the contrary, most states are ***not*** marketable product-rule states. For example, Pennsylvania recognizes the "implied duty to market," *see Iams v. Carnegie Natural Gas Co.*, 194 Pa. 72, 74-75, 45 A. 54 (1899), but has nonetheless adopted the "at the well" rule, *see Kilmer*, 605 Pa. at 428-30, 990 A.2d 1147. Indeed, the plaintiffs in *Kilmer* made the same "implied duty to market" argument as plaintiffs here, *see* 605 Pa. at 420, but the *Kilmer* court adopted the plain language, "at the well" approach.

In fact, this exact issue was addressed in *Yzaguirre v. KCS Resources, Inc.*, 53 S.W.3d 368 (Tex.2001). There, "the parties entered into a lease requiring a market-value royalty." *Id.* at 374. The court found that "[b]ecause the lease provides an objective basis for calculating royalties that is independent of the price the lessee actually obtains, the lessor does not need the protection of an implied covenant," like the implied duty to market. *Id.* In other words, because the plain language of an "at the well" lease unambiguously determines the basis for calculating royalties, the implied duty to market does not come into play. *See id.*

IV. CONCLUSION

For the reasons set forth above, Chesapeake respectfully requests that the Court apply longstanding principles of Ohio law to hold that Ohio follows the "at the well" rule in interpreting oil and gas leases.

DATED: August 3, 2015

Respectfully submitted,

/s Daniel T. Donovan

Daniel T. Donovan (0067833)
daniel.donovan@kirkland.com
KIRKLAND & ELLIS LLP
655 Fifteenth Street, N.W.
Washington, D.C. 20005
Tel: (202) 879-5000
Fax: (202) 879-5200

John K. Keller (0019957)
jkkeller@vorys.com
VORYS SATER SEYMOUR AND PEASE LLP
52 East Gay Street
Columbus, OH 43215
Tel: (614) 464-6400
Fax: (614) 464-6350

Kevin C. Abbott (0091504)
kabbott@reedsmith.com
Nicolle R. Snyder Bagnell (0091442)
nbagnell@reedsmith.com
REED SMITH LLP
225 Fifth Avenue
Pittsburgh, Pennsylvania 15222
Tel: (412) 288-3804
Fax: (412) 288-3063

Attorneys for Chesapeake Appalachia, L.L.C.

CERTIFICATE OF SERVICE

I hereby certify that on August 3, 2015, a copy of the foregoing was sent by first class mail, postage prepaid, to the following:

James A. Lowe
Lowe Eklund & Wakefield Co., LPA
1660 West Second Street
610 Skylight Office Tower
Cleveland, OH 44113-1454
Tel: (216) 781-2600
Fax: (216) 781-2610

Robert C. Sanders
Law Office of Robert C. Sanders
12051 Old Marlboro Pike
Upper Marlboro, MD 20772
Tel: (301) 574-3400

/s Daniel T. Donovan
Counsel

EXHIBIT 1

GP54

711055

163100

form 89

OIL AND GAS LEASE

THIS AGREEMENT, made and entered into this 7 day of March, 1970, by and between Regis F. Lutz & Marion L. Lutz, his wife 2688 South Leavitt Rd. Warren, Ohio 44481, Lessor, and Murphy Oil Co Box 474 Worthington, Ohio, Lessee,

WITNESSETH:

1. That Lessor, in consideration of the sum of One Dollar, receipt of which is hereby acknowledged, and of the covenants and agreements hereinafter contained, grants, leases and lets exclusively unto Lessee for the purpose of exploring by geophysical and other methods, drilling and operating for and producing oil and all gas of whatsoever nature or kind, and of laying pipe lines and placing tanks, equipment and structures thereon to produce, save and take care of said substances, all that certain tract of land situated in Lords Town Township, Section 1, County, Trumbull bounded substantially as follows:

North by lands of Warren Twp. line & Sam Moss
East by lands of Charles Stitle & Sam Moss
South by lands of Russell Thomas & Standard Slag Co.
West by lands of Walter Church

being all the property owned by Lessor in said Section, containing 100 acres, more or less.

2. It is agreed that this lease shall remain in force for a primary term of ten (10) years from this date, and as long thereafter as oil or gas or either of them is produced from said land, or from lands with which said land is pooled therewith, by Lessee.

3. The royalties to be paid by Lessee are: (a) on oil, one-eighth of that produced and saved from said land, the same to be delivered at the wells or to the credit of Lessor into the pipe line to which the wells may be connected; Lessee may from time to time purchase any royalty oil in its possession, paying the market price therefor prevailing for the field where produced on the date of purchase; (b) on gas, including casinghead gas or other gaseous substance, produced from said land and sold or used off the premises or for the extraction of gasoline or other product therefrom, 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. If a well capable of producing gas from the above described land is shut in and no gas therefrom is sold or used, such shut-in well shall, under all of the provisions of this lease, be considered a well on such land producing gas in paying quantities and shall continue this lease in force at all times while such well is so shut in, whether during or after the primary term. If there be one or more of such shut-in gas wells and if there is no current production or operation on said land, Lessee shall pay or tender as royalty One Dollar ($1.00) per year per net royalty acre retained hereunder, such payment or tender to be made on or before the anniversary date of this lease next ensuing or within 90 days after such date and thereafter on or before the anniversary date of this lease during the period such well is shut in, to the royalty owners or to the royalty owners' credit in the depository bank herein designated.

4. Lessor shall have gas free of cost from any gas well on the above described premises for domestic use in one dwelling house on said land, Lessor to make his own connection with the well at his sole risk and expense. Lessee shall have free use of sufficient oil, gas and water produced on said land, except water from Lessor's wells, for all operations hereunder.

5. If operations for drilling are not commenced on said land or on acreage pooled therewith as provided herein on or before ~~one~~ SIX (6) MONTHS ~~(1) year~~ from date hereof, this lease shall then terminate as to both parties unless on or before such date Lessee shall pay or tender the sum of One hundred ——— and no/100 ——— Dollars ($100.00), herein called rental, which shall cover the privilege of deferring commencement of drilling operations for a period of twelve (12) months. In like manner and upon like payments or tenders annually, the commencement of drilling operations may be further deferred for successive periods of twelve (12) months each during the primary term. Payments or tenders of such rentals shall be to Lessor at address listed above or to his credit in the Second National Bank at Warren, Ohio or its successors, which bank and its successors are Lessor's agent and shall continue as the depository for all rentals regardless of changes in ownership. Such payment or tender of rental may be made by Lessee's check mailed or delivered to the party entitled thereto or to said bank on or before the date of payment. Lessee may at any time release a portion of the leased premises and thereafter be relieved of all obligations as to the acreage surrendered, and subsequent rentals shall be reduced in the proportion that the acreage covered hereby is reduced by releases.

6. Lessee is authorized to pool or combine the land covered by this lease, or any portion thereof, or formations thereunder, as to oil and/or gas, with any other land, lease or leases when in Lessee's judgment it is advisable to do so in order to properly develop or operate said premises, such pooling to be into a well unit or units not exceeding approximately 40 acres for oil and not exceeding approximately 640 acres for gas. Lessee shall execute and record an instrument or instruments identifying and describing the pooled acreage. Production, drilling or reworking operations anywhere on a unit which includes all or a part of this lease shall be treated as if it were production, drilling or reworking operations under this lease. In lieu of the royalties elsewhere herein specified, Lessor shall receive from a unit so formed only such portion of the royalty stipulated herein as the amount of his acreage placed in the unit or his royalty interest therein bears to the total acreage so pooled in the particular unit involved.

7. If prior to discovery of oil or gas on said land Lessee should drill a dry hole or holes thereon, or if after discovery of oil or gas the production thereof should cease from any cause, this Lease shall not terminate if Lessee commences additional drilling or reworking operations within 60 days thereafter or (if it be within the primary term) commences or resumes the payment or tender of rentals on or before the rental paying date next ensuing after the expiration of three months from date of completion of dry hole or cessation of production. If during the last year of the primary term and prior to the discovery of oil or gas on said land Lessee should drill a dry hole thereon, no rental payment or operations are necessary in order to keep the lease in force during the remainder of the primary term. If at the expiration of the primary term of this lease, oil or gas is not being produced on or from said land but Lessee is then engaged in drilling or re-working operations thereon, then this lease shall continue in force so long thereafter as drilling or re-working operations are being continuously prosecuted on said land; and drilling or re-working operations shall be considered to be continuously prosecuted if not more than 60 days shall elapse between the completion or abandonment of one well and the beginning of operations for the drilling or re-working of another well. If oil or gas shall be discovered and produced from any such well or wells drilled, being drilled or re-worked, at or after the expiration of the primary term of this lease, this lease shall continue in force so long thereafter as oil or gas is produced from the leased premises.

8. Lessee shall have the right at any time during or after the expiration of this lease to remove all property and fixtures placed by Lessee on said land, including the right to draw and remove all casing. When required by Lessor, Lessee will bury all pipe lines below ordinary plow depth, and no well shall be drilled within two hundred (200) feet of any residence or barn now on said land without Lessor's consent. Lessee shall pay for damages caused by his operation to growing crops on said lands.

9. The rights of either party hereunder may be assigned in whole or in part, and the provisions hereof shall extend to their heirs, successors and assigns; but no change or division in ownership of the land, rentals or royalties, however accomplished, shall operate to enlarge the obligations or diminish the rights of Lessee; and no change or division in such ownership shall be binding on Lessee until thirty (30) days after Lessee shall have been furnished by registered U. S. mail at Lessee's principal place of business with originals or certified copies of recorded muniments of title deraigning title from Lessor. In the event of assignment hereof in whole or in part, liability for breach of any obligation hereunder shall rest exclusively upon the owner of this lease or of a portion thereof who commits such breach. In the event of assignment of this lease as to a segregated portion of said land, the rentals payable hereunder shall be apportionable as between the several leasehold owners ratably according to the surface area of each, and default in rental payment by one shall not affect the rights of other leasehold owners hereunder.

10. Lessor hereby warrants and agrees to defend the title to said land and agrees that Lessee at its option may discharge any tax, mortgage or other lien upon said land, either in whole or in part, and in event Lessee does so, it shall be subrogated to such lien with the right to enforce same and apply rentals and royalties accruing hereunder toward satisfying same. Without impairment of Lessee's rights under the warranty in event of failure of title, it is agreed that if Lessor owns an interest in said land less than the entire fee simple estate, then the royalties and rentals to be paid Lessor shall be reduced proportionately.

11. Should Lessee be prevented from complying with any express or implied covenant of this lease, from conducting drilling or re-working operations thereon or from producing oil or gas therefrom by operation of force majeure, any Federal or State law or any order, rule or regulation of governmental authority, then while so prevented, Lessee's obligation to comply with such covenant shall be suspended, and Lessee shall not be liable in damages for failure to comply therewith; and this lease shall be extended while and so long as Lessee is prevented by any such cause from conducting drilling or re-working operations on or from producing oil or gas from the leased premises; and the time while Lessee is so prevented shall not be counted against Lessee, anything in this lease to the contrary notwithstanding.

[OVER]

CHK00000073

IN WITNESS WHEREOF, the parties have hereunto set their hands and seals as of the date first above written.

Signed and delivered in the presence of

x Regis F. Lutz [SEAL]

[SEAL]

Judith Bolinger

George Pahoundis

Witnesses

x Marion L. Lutz [SEAL]

[SEAL]

Lessors

STATE OF Ohio
COUNTY OF Trumbull } SS.

(Individual—)

Before me, a Notary Public in and for said county and state, personally appeared the above named Regis F. Lutz who acknowledged to me that he did execute the foregoing instrument and that the same is his free act and deed for the uses and purposes therein set forth.

In Testimony Whereof, I have hereunto set my hand and affixed my official seal at Johnston, Ohio this 14 day of March, 19 70.

My Commission Expires:
Nov 5, 1973

Judith Bolinger
NOTARY PUBLIC

STATE OF Ohio
COUNTY OF Trumbull } SS.

(Individual—)

Before me, a Notary Public in and for said county and state, personally appeared the above named Marion Lutz who acknowledged to me that she did execute the foregoing instrument and that the same is her free act and deed for the uses and purposes therein set forth.

In Testimony Whereof, I have hereunto set my hand and affixed my official seal at Johnston, Ohio this 14 day of March, 19 70.

My Commission Expires:
Nov 5, 1973

Judith Bolinger
NOTARY PUBLIC

711055 INDEXED

163100

COMPARED

OIL AND GAS LEASE

From

To

Date, 19

LOCATED

RECEIVED FOR RECORD
APR 1 1970
AT 7:41.9 O'CLOCK A.M.

RECORDED
VOL 83 PAGE 173
MARGARET MANASSAH 19
Recorder of Trumbull County, Ohio

Rec'd for Record

Recorded 300 19

Book Page

Records of County, Ohio

County Recorder.

STATE OF
COUNTY OF } SS.

(Corporation—)

Before me, a Notary Public in and for said county and state, personally appeared and the President and Secretary, respectively, of the above named corporation, who acknowledged to me that they did execute the foregoing instrument for and on behalf of said corporation, pursuant to authority so to do duly conferred on them by the Board of Directors of said corporation, and that the same is the free act and deed of said corporation and of themselves as such officers, for the uses and purposes therein set forth.

In Testimony Whereof, I have hereunto set my hand and affixed my official seal at this day of , 19

My Commission Expires:

NOTARY PUBLIC

This instrument was prepared by: Murphy Oil Co.