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

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

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I. INTRODUCTION

The single certified question accepted by this Court concerns how Ohio interprets oil and gas leases providing that royalties are to be based on the *value of gas* "at the well" when the gas is sold downstream for a higher price rather than "at the well." Chesapeake submits that the lease language must be given meaning, whereas plaintiffs suggest an approach that discards the lease language in lieu of a new public policy.[1]

Under the traditional approach—referred to as the "at the well" rule—courts give meaning to the "at the well" language in such leases by endorsing a calculation that nets out the costs of obtaining the higher downstream price in order to calculate a wellhead value, and allocates those costs (referred to as "post-production costs") to both the lessor and lessee. This provides the value of the gas "at the well." An alternative approach—referred to by plaintiffs as the "marketable product" rule—is not really a single, uniform rule, but rather is shorthand for a variety of approaches that are rooted in policy instead of the language of the contract.

Plaintiffs concede, as they must, the very principles of Ohio law that confirm that Ohio would give meaning to the language providing that royalties are to be paid based on the "market value" of gas "at the well." It is undisputed that Ohio applies oil and gas leases as written, and gives meaning to every word in the leases. Applying these traditional principles of Ohio law, the "at the well" language must be construed to value the gas as the parties agreed in the oil and gas leases—"at the well."

Unable to contest these principles of Ohio law, plaintiffs claim that the lease language should not be applied as written because—in plaintiffs' words—the market for gas at the well is a

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[1] "Chesapeake" refers to defendant-petitioner Chesapeake Appalachia, L.L.C. "Plaintiffs" refers to plaintiffs-respondents. The United States District Court for the Northern District of Ohio certified a single question to this Court (and denied certifying other questions raised by plaintiffs in their brief).

"fiction." That is false as a matter of fact—the record in this case unequivocally shows that there is a very real market for gas at the well and gas from the wells at issue in this case has been sold "at the well" to third parties. But even if it were true that the sales of the gas were downstream of the well, that is no justification for ignoring the contractual language of the parties' agreements—the parties' agreements would still provide that royalties are to be based on the value of gas at the well, and those agreements must be applied as written. Indeed, plaintiffs never offer any interpretation of the lease that gives meaning to the "at the well" language—instead, they ask this Court to re-write the parties' leases to base royalties on a different point of valuation. Well-established Ohio law does not permit that.

Beyond that, plaintiffs' response brief fails to address several points raised by Chesapeake, and is instead strewn with straw men, distractions, and a personal attack on one of the nation's foremost oil and gas professors. As discussed in greater detail below, plaintiffs' discussions of implied duties (that are inapplicable to the leases at issue), lease modification (which is contradicted by plaintiffs' own briefing), leases that do not have "at the well" language (which are not the subject of this certified question), and the nose-count of states supposedly following the "at the well" rule as opposed to the "marketable product" rule (which is rife with demonstrable errors), do little to hide the fact that, in the end, plaintiffs are simply urging the Court to adopt a rule that would rewrite the parties' agreements.

Applying black-letter Ohio law, this Court should hold that leases providing that royalties are to be paid based on the "market value" of gas "at the well" permit the calculation of a wellhead valuation when gas is sold downstream from the well.

II. ARGUMENT

A. It Is Undisputed That Oil and Gas Leases Must Be Applied as Written Under Ohio Law.

Plaintiffs concede, as they must, the three principles of Ohio law establishing that Ohio follows the "at the well" rule in interpreting oil and gas contracts.

First, as Chesapeake explained in its opening brief, Ohio construes oil and gas leases as written, and Ohio courts look to the plain and ordinary meaning of a contract. (*See* Chesapeake's Merit Br. ("Br.") at 7-8 (citing, *inter alia*, *Myers v. E. Ohio Gas. Co.*, 51 Ohio St.2d 121, 125, 364 N.E.2d 1369 (1977); *Harris v. Ohio Oil Co.*, 57 Ohio St. 118, 129, 48 N.E. 502 (1897); and *Westfield Ins. Co. v. Galatis*, 100 Ohio St.3d 216, 2003-Ohio-5849, 797 N.E.2d 1256, ¶ 11).) Plaintiffs agree. (*See* Respondents' Merit Br. ("Resp.") at 16 ("Chesapeake's first proposition of law is correct * * *.").)

Second, Ohio construes oil and gas leases so as to avoid rendering any term meaningless. (*See* Br. at 8-9 (citing cases).) Plaintiffs do not dispute this, either. (*See* Resp. at 18 ("Chesapeake's second proposition is also a correct statement of law.").)

Third, under Ohio law, leases providing that royalties are to be paid based on the "market value" of gas "at the well" mean exactly that. (*See* Br. at 9-13.) On this, too, plaintiffs agree. In plaintiffs' own words: "Chesapeake is correct that, when possible, an oil and gas lease providing for royalties on the market value at the well should be applied as written." (*See* Resp. at 18.) Moreover, plaintiffs do not dispute that the "at the well" language is unambiguous. (*See* Br. at 9-10.)

The conclusion that follows from these undisputed principles of Ohio law is that Ohio applies contracts as written. Applied here, when gas is sold at the well, then the leases provide that royalties are based on the "amount realized" for the sale of the gas. (*See* Br. at Ex. 1 ¶ 3.) And if gas is not sold "at the well," then royalties are based on the "market value" of gas "at the well." (*See id.*)

As plaintiffs acknowledge, there is a well-established way to give meaning to "at the well" language when gas is sold downstream from the well: the "netback method."[2] The netback method calculates the "at the well" price by starting with the downstream sales price of the gas less the post-production costs (like the costs of processing and gathering/transporting gas) incurred to obtain that price. *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 omitted)), quoting *Martin v. Glass*, 571 F.Supp. 1406, 1413-14 (N.D.Tex.1983); *Kilmer*, 605 Pa. at 415-16, 990 A.2d 1147 (the netback method is used "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]").

Conversely, as discussed in Chesapeake's opening brief, these undisputed principles of Ohio law similarly confirm that Ohio does ***not*** apply the so-called "marketable product" rule—a loose amalgamation of rules that rewrite contracts and ignore contractual language in favor of policy judgments about how lessors and lessees should have structured their business affairs.

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[2] Plaintiffs acknowledge the netback approach but are inconsistent in their characterization of it. At times, plaintiffs suggest that *all* post-production costs are deducted from the lessor under the netback approach. (*See* Resp. at 7.) But as plaintiffs acknowledge elsewhere, only a minority, pro rata share of post-production costs are borne by the lessor. (*See id.*) The majority of the post-production costs—typically 7/8—is borne by the lessee (*i.e.*, Chesapeake). As the Kilmer court noted, the fact that lessees bear the vast majority of post-production costs belies any fear that such costs are unnecessary or inflated. *See Kilmer v. Elexco Land Servs., Inc.*, 605 Pa. 413, 430, 990 A.2d 1147 (2010).

B. <u>Plaintiffs' Claim That There Is No Market for Gas "At the Well" Is Both Irrelevant and False.</u>

Despite the fact that the leases relevant to the certified question provide that royalties are to be paid based on the value of gas "at the well," and despite plaintiffs' inability to dispute that Ohio law requires leases to be applied as written, plaintiffs nonetheless argue that the Court should not value the gas "at the well" because there supposedly is no longer any market for gas "at the well."

Even if there were no longer any market for gas "at the well" (which is false, as discussed below), that still would not justify ignoring the lease language. Indeed, the whole point of the netback method is to calculate an "at the well" value for gas in situations where gas is not sold at the wellhead. This calculation allows the parties to give meaning to "at the well" language in leases even if gas is sold downstream.

Not only is plaintiffs' repeated factual assertion that there is no longer any market for gas at the well irrelevant, but it is also utterly devoid of factual support. (*See* Resp. at 1, 5, 6, 8, 18, 19, 20.) Merely repeating over and over that the market for gas at the well is "fictional" or "hypothetical" simply does not make it so. Indeed, plaintiffs go so far as claiming (without any support) that "Chesapeake admits that there is now no feasible way for gas purchasers to buy gas 'at the well,'" and that "[t]he only sales that now occur 'at the well' are sales to a gas marketing affiliate." (*See id.* at 5 & 6 fn.2.)

But these factual assertions are all demonstrably false—as plaintiffs themselves know. During discovery in this case (a putative class action) before the federal court, plaintiffs asked Chesapeake how royalties are calculated for the various putative class members. Chesapeake explained that where gas is sold varies by well and the method of calculation thus varies by well. For numerous putative class members, however, gas is ***still*** sold at the well to unaffiliated third parties. (*See* Ex. A, Apr. 25, 2014 Letter from R. Naresh to R. Sanders at 2 ("Chesapeake sold gas from certain wells . . . at or near the wellhead to a third-party purchaser."); *see id.* at 4 (setting forth additional illustrative examples of wellhead sales to unaffiliated third parties).) It is simply false for plaintiffs to claim—as they repeatedly do—that there are no longer any sales at the wellhead.

As Chesapeake explained in its opening brief (which plaintiffs once again ignore), the fact that gas is sold at varying locations—at the wellhead and at various points downstream—only underscores why most states have emphatically endorsed the netback method to calculate a wellhead value for gas. (*See* Br. at 22-23.) As the Pennsylvania Supreme Court put it in *Kilmer*: "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." 605 Pa. at 430, 990 A.2d 1147. *See also Schroeder v. Terra Energy, Ltd.*, 223 Mich.App. 176, 185 fn.5, 565 N.W.2d 887 (1997) ("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.").

C. Plaintiffs' Approach Would Render the "At the Well" Language in the Leases a Nullity.

In plaintiffs' view, even though Ohio law requires contracts to be applied as written, this Court should 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." That simply is not what the relevant leases say. As Chesapeake pointed out in its opening brief (which plaintiffs simply ignore), the leases provide that royalties are to be paid based on what the gas is worth at the well—***no matter where the gas is sold***. (*See* Br. at 12-13.) The leases expressly provide that if gas is sold "at the wells the royalty shall be one-eighth of the amount realized from such sale." (*Id*. at Ex. 1 ¶ 3.) And 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 ignores 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 offer no interpretation of the leases that would give any meaning to the “at the well” language in the leases. Rather, despite conceding that Ohio does not permit a reading of a contract that renders language mere “surplusage,” *see Local Marketing Corp. v. Prudential Insurance Co. of America*, 159 Ohio App.3d 410, 2004-Ohio-7001, 824 N.E.2d 122, ¶ 8 (1st Dist.), that is precisely what plaintiffs’ reading does here: it renders the “at the well” language a nullity. That approach is irreconcilable with Ohio law and it should be rejected. *See Wohl v. Swinney*, 118 Ohio St.3d 277, 2008-Ohio-2334, 888 N.E.2d 1062, ¶ 22; *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).

D. <u>Response to Plaintiffs’ Propositions of Law:</u>

1. <u>Response to Plaintiffs’ First and Second Propositions of Law</u>

Plaintiffs’ Claim: Ohio Recognizes the “Implied Covenant to Market” in All Oil and Gas Leases.

Plaintiffs’ Claim: Contractual Duties Include Both the Performance of the Duty and Payment of All Costs Necessary for the Performance of the Duty.

Plaintiffs’ invocation of implied duties is a *non-sequitur* and an invitation for *dictum*. As Chesapeake has already explained, whether or not Ohio recognizes an implied covenant to market has no bearing on this case. (*See* Br. at 23-24.) The marketing of the gas is separate and distinct from the calculation of royalties. There is no dispute that Chesapeake in fact marketed the gas produced from the relevant wells. Moreover, royalty owners do not share in the marketing costs

Chesapeake incurs to sell the gas downstream at a higher price for the benefit of itself and royalty owners.

Generally speaking, there is no dispute that gas can be sold at two locations: at the well or downstream from the well. The leases at issue cover both situations. If gas is sold at the well, then the leases provide that royalties are based on the "amount realized" for the sale of the gas. (*See* Br. at Ex. 1 ¶ 3.) And if gas is not sold "at the well," then royalties are based on the "market value" of gas "at the well." (*See id.*) Because the leases expressly identify how royalties are to be paid at each possible location, they leave no room for an implied covenant to override the express lease language under Ohio law.

In these circumstances, any general "implied duty to market" does not override the actual lease language. This has long been the law in Ohio. *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. Cos.*, 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.").

Chesapeake explained all of this in its opening brief. (*See* Br. at 23-24.) Tellingly, plaintiffs simply ignore the point. Instead, plaintiffs assume an implied duty to market into the leases, and that this implied duty to market supports plaintiffs' view that Ohio would adopt the so-called "marketable product" rule rather than the "at the well" rule. (*See, e.g.,* Resp. at 4.)

But the existence of an implied duty to market does not lead to the conclusion that a marketable-product rule applies. 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 nonetheless rejected the "marketable product" 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 make here, *see* 605 Pa. at 420, but the *Kilmer* court rejected it.[3]

In fact, Chesapeake pointed out that the very argument that plaintiffs make here was expressly rejected in *Yzaguirre v. KCS Resources, Inc.*, 53 S.W.3d 368 (Tex.2001). (*See* Br. at 24.) Lacking any legitimate response to *Yzaguirre*, plaintiffs simply ignore it. After Chesapeake's opening brief, the Kentucky Supreme Court also rejected this very argument—noting that most jurisdictions recognize implied duties as a general matter but holding that such implied duties are inapplicable regarding leases basing royalty valuation on the value "at the well" because such language expressly provides how a royalty is to be calculated. *Baker v. Magnum Hunter Prod., Inc.*, No. 2013-SC-000497-DG, 2015 WL 4967131, at *5 (Ky. Aug. 20, 2015).

2. <u>Response to Plaintiffs' Third Proposition of Law</u>

Plaintiffs' Claim: More Jurisdictions Recognize the "Marketable Product" Rule Than the "At the Well" Rule.

The question in this case is how ***Ohio*** interprets oil and gas leases—not how other states interpret them. While both sides have cited out-of-state case law as persuasive authority, the key point is that it is now clear that the parties ***agree*** on the straightforward principle that Ohio applies oil and gas leases as written and gives meaning to every term in a contract. And it is now clear that

[3] Plaintiffs suggest an open question remains in Pennsylvania as to whether it follows the marketable-product rule or the at-the-well rule. This interpretation simply cannot be squared with *Kilmer* itself, in which landowners made the very arguments that plaintiffs make here, *see* 605 Pa. at 420, 990 A.2d 1147, and the Pennsylvania Supreme Court nonetheless affirmed the use of the netback method, *see id.* at 430.

neither party contends that the phrase "at the well" is ambiguous. Because these propositions are undisputed, the only result that follows is that Ohio follows the "at the well" rule, because it is the only rule that applies oil and gas leases as written and gives meaning to every term in a contract—including the term requiring that gas royalties be paid based on the "market value" of the gas "at the well."

Regardless, plaintiffs' tally of "at the well" states and "marketable product" states is rife with errors. Leaving aside that plaintiffs' tally vacillates (*compare* Resp. at 9, *with id.* at 22) and double-counts (*see id.* at 19 (counting Michigan in both categories)), it fundamentally misstates the law in numerous states.

a. <u>There Is No Single "Marketable Product" Rule.</u>

Most critically, while plaintiffs aver that the "marketable product" rule provides that "the obligation to pay post production costs rests solely with the gas producer" (*see* Resp. at 7), the reality is that there ***is no single*** marketable-product rule. While the "at the well" rule is simply shorthand for saying that a state applies leases as written, the "marketable product" rule is shorthand for saying that the state supplies a policy judgment in lieu of (or in addition to) the contractual language. The extra-contractual policy judgment, however, varies from state to state—there simply is no uniform "marketable product" rule. *See Bice v. Petro-Hunt, L.L.C.*, 2009 ND 124, 768 N.W.2d 496, ¶ 17 (rejecting marketable product rule and noting that "'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'" (brackets in original)), quoting Brian S. Wheeler, *Deducting Post-Production Costs When Calculating Royalty: What Does The Lease Provide?*, 8 Appalachian J.L. 1, 24 (2008).

b. Plaintiffs' Definition of the "Marketable Product" Rule Has Only Been Adopted in One State.

In purporting to define what the marketable-product rule is, plaintiffs have taken the definition from a single state—West Virginia, as adopted in *Estate of Tawney v. Columbia Natural Resources, L.L.C.*, 219 W.Va. 266, 633 S.E.2d 22 (2006). West Virginia is the only state in the country to find the term "at the well" to be ambiguous, *see id.* at 272-73 ("the 'wellhead'-type language at issue is ambiguous"), so it simply ignored that term in holding that the producer presumptively bears all post-production costs. *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 * * *."). But plaintiffs in this case do ***not*** contend that the "at the well" language is ambiguous.

Moreover, West Virginia is the ***only*** state that has adopted the definition of "marketable product rule" that plaintiffs urge Ohio to adopt here. *See* Wheeler, *Deducting Post-Production Costs When Calculating Royalty* at 13 (discussing *Tawney* and noting that "West Virginia appears to be the only state following this approach").

In fact, while plaintiffs claim that the same approach is taken in other states, like Kansas, the leading Kansas cases quickly show that this claim is simply incorrect. (*See* Resp. at 20-21.) Kansas courts, unlike West Virginia courts, have held that "at the well" language is ***not*** ambiguous. *See Sternberger v. Marathon Oil Co.*, 257 Kan. 315, 322, 894 P.2d 788 (1995) ("[T]he lease's silence on the issue of post-production deductions does not make the lease ambiguous * * * [because] [t]he lease clearly specifies that royalties are to be paid based on 'market price at the well.'"). And Kansas courts, unlike West Virginia courts, have held that at-the-well language ***permits*** post-production cost deductions in many circumstances. *See Fawcett v. Oil Producers, Inc. of Kansas*, 352 P.3d 1032, 1041 (Kan.2015) ("[W]hen royalties are to be paid on the value of gas at the well, but no market exists there, the royalty owner must bear a proportional share of the reasonable expenses of transporting the gas to market."). Indeed, the Kansas Supreme Court held that cases holding that the producer bears the sole obligation to pay post-production costs are "at odds with our Kansas caselaw interpreting [at-the-well] provisions, as well as our caselaw giving effect to the 'at the well' language." *Id.* at 1042. Chesapeake cited this Kansas case law in its opening brief (*see* Br. at 21), but plaintiffs once again simply ignore it.[4]

c. Plaintiffs Mischaracterize the Law of Numerous Other States in Attempting to Inflate Their Tally of Marketable-Product States.

Plaintiffs fundamentally mischaracterize the law of other states as well in an effort to inflate the tally of marketable-product states. For example, plaintiffs argue that Oklahoma law supports their proposed approach that "the obligation to pay post production costs rests solely with the gas producer." (*See* Resp. at 7, 13.) But that is not the law of Oklahoma. While plaintiffs cite cases from 1992 and 1994 in Oklahoma, the Oklahoma Supreme Court later held that where gas is marketable at the wellhead, the netback method ***is*** appropriate for at-the-well leases such that post-production costs may be deducted to determine a wellhead valuation. *See Mittelstaedt v. Santa Fe Minerals, Inc.*, 1998 OK 7, 954 P.2d 1203, ¶ 2. Plaintiffs certainly have offered no factual basis to suggest that the gas from their wells is not marketable at the wellhead such that the Oklahoma-type approach would bar post-production costs in this case. To the contrary, the record

[4] Nor is the Colorado approach to the marketable product rule the same as the approach taken in *Tawney*. Whereas in West Virginia the producer presumptively bears all post-production costs, in Colorado, the lessee typically bears costs only until the gas is marketable. *See Rogers v. Westerman Farm Co.*, 29 P.3d 887, 906 (Colo.2001). Colorado's definition of what makes gas "marketable," however, differs from the definition of "marketable" in other states. The inability of the various states following versions of the "marketable product rule" to agree on what "marketable" means highlights the problems with courts re-writing leases on policy grounds rather than enforcing the parties' agreements as written.

shows that the gas from some class members ***was*** marketable at the wellhead and in fact sold to unaffiliated third parties there. (*See* Ex. A.)

Similarly, plaintiffs count New Mexico in their tally of "marketable product" states based solely on a federal district court opinion speculating that New Mexico might be a "marketable product" state rather than an "at the well" state. (*See* Resp. at 10, 13.) The federal district court opinion plaintiffs cite, *Anderson Living Trust v. WPX Energy Production, LLC,* 306 F.R.D. 312, 426 (D.N.M.2015), candidly refuses to follow its binding Tenth Circuit precedent holding that New Mexico is actually an "at the well" state. *See Elliott Industries Ltd. Partnership v. BP Am. Prod. Co.*, 407 F.3d 1091, 1113-14 (10th Cir.2005) ("This duty imagined by [plaintiff] is inconsistent with New Mexico law because the express terms of the royalty obligations direct the royalty to be paid on the value of the gas 'at the well.'"). Indeed, the Tenth Circuit had expressly rejected the very argument that plaintiffs make here that the existence of implied duties translates into the applicability of the marketable-product rule. *See id*.[5]

Moreover, the New Mexico Supreme Court has noted that lease language providing for payment of royalties "at the well" "typically entitles the lessee to deduct all post-production expenses," and explained that "New Mexico courts have also endorsed this approach to interpreting a royalty obligation when the language provides that such payments are to be payable

[5] Similarly, plaintiffs' sole support for claiming that Virginia is a marketable product state is an unpublished federal district court opinion speculating the result that a Virginia court might reach. Indeed, if federal district courts anticipating how a state might rule are counted, then Utah should be factored in as well, and Utah federal courts have squarely held that Utah gives meaning to the "at the well" language in leases. *See Emery Resource Holdings, LLC v. Coastal Plains Energy, Inc.*, 915 F.Supp.2d 1231, 1237-38 (D.Utah 2012) ("The language of this provision again provides that the royalty to be paid is the 'market value at the well' for 'gas sold at the wells.' On its face, this language demonstrates that there is only one reasonable interpretation: the parties intended the royalty value to be based on the wellhead value or proceeds on the gas as produced from the well.").

on net proceeds *at the well*." (Emphasis sic.) *ConocoPhillips Co. v. Lyons*, 2013-NMSC-009, 299 P.3d 844, ¶ 18-19 (2012).[6]

d. Plaintiffs' Discussion of Other States' Statutes Has No Bearing on Ohio Contract Law.

Lastly, plaintiffs attempt to bolster their count of marketable-product states by including statutes governing the calculation of royalties—for Michigan, Nevada, Wyoming, and the federal government. Without counting these states, plaintiffs freely admit that the marketable-product rule is the minority rule. (*Compare* Resp. at 9, *with id.* at 19.) But there is no dispute here about Ohio statutory law—the question here is how to interpret ***contracts*** under Ohio common law, not how to interpret other states' statutes. Indeed, as the courts of those states have noted, these "statutory scheme[s]" are "unique," and "[i]t is not particularly helpful to engraft upon that express statutory scheme the common law construction approach * * * as it may have evolved in other states * * *." *See, e.g.*, *Wold v. Hunt Oil Co.*, 52 F.Supp.2d 1330, 1336 (D.Wyo.1999).[7]

Plaintiffs' discussion of Michigan warrants one final note because plaintiffs count Michigan as *both* an "at the well" state and a "marketable product" state. But as plaintiffs admit, under common law contractual interpretation, Michigan is an "at the well" state—*i.e.*, it applies the contracts as written. In *Schroeder v. Terra Energy, Ltd.*, 223 Mich.App. 176, 188-89, 565 N.W.2d 887 (1997), the Michigan court of appeals expressly adopted the "at the well" rule, finding that "to determine the royalty valuation, postproduction costs must be subtracted from the sales

[6] Plaintiffs do not dispute that Texas follows the "at the well" rule, but nonetheless cite two inapposite cases from Texas. (*See* Resp. at 10.) These cases have nothing to do with any issue in this case.

[7] In addition, it is simply incorrect to claim, as plaintiffs do, that there is a "trend" towards the marketable product rule. (*See* Resp. at 9.) That has it exactly backwards. No state supreme court has adopted the marketable product rule in over 14 years, since Colorado in 2001. All of the state supreme courts to assess which rule to adopt since that time have adopted the "at the well" rule, with the exception of West Virginia, which created and adopted the *Tawney* rule (which is not a marketable product rule at all, as discussed above) in 2006.

price of the gas where it is subsequently marketed." *See id.* (the "at the well" rule "accord[s] reasonable meaning to the plain language of the contract"). While Michigan subsequently enacted a statute governing royalty calculation, *see* Mich.Comp.Laws Ann. 324.61503b(1), the statute does not override the way "at the well" contracts are interpreted. Indeed, the statute applies only to leases entered into after March 2000—it says nothing about how pre-2000 leases, such as plaintiffs' leases at issue here, are to be interpreted.[8]

e. <u>Plaintiffs Would Not Prevail Even Under the Marketable Product Rule.</u>

Finally, even if some version of the marketable product rule *were* the law of Ohio (which it emphatically is not), plaintiffs' claims would still fail because they have offered no evidence to suggest that the gas produced from plaintiffs' wells is ***not*** marketable. Under the cases cited by plaintiffs, to prevail under the marketable product rule, plaintiffs would have to show that the gas was not marketable—the marketable product rule ***allows*** the deduction of post-production costs once gas is marketable. *See, e.g., Rogers*, 29 P.3d at 906; *see also Sternberger*, 257 Kan. at 322, 894 P.2d 788; *Mittelstaedt*, 1998 OK 7, 954 P.2d 1203, at ¶ 2. Here, the record establishes that much of the gas is marketable at the wellhead, so post-production costs may be deducted even under the marketable product rule. *See Rogers*, 29 P.3d at 906 (gas is "marketable" "when it is in the physical condition such that it is acceptable to be bought and sold in a commercial marketplace, and in the location of a commercial marketplace, such that it is commercially saleable in the oil and gas marketplace"). Chesapeake in fact ***sold*** a portion of its gas at the wellhead in Ohio. (*See* Ex. A.) Thus, even if the marketable product rule applies, plaintiffs' claims would still fail.

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8 Similarly, the federal regulation plaintiffs cite is inapposite—the regulation merely says that in leases with the federal government, producers are required to agree to place the gas into marketable form at no cost to the government. *See* 30 C.F.R. 1206.153(i). In other words, this regulation codifies that the federal government would not enter into an "at the well" lease; it has no bearing on what "at the well" means when it is in the lease.

3. Response to Plaintiffs' Fourth and Fifth Propositions of Law

Plaintiffs' Claim: A Party May Waive the Terms of a Written Contract by Words or Conduct.

Plaintiffs' Claim: Parties May Implicitly Modify an Agreement by Their Actions and a Continued, Different Course of Performance Between Parties Manifests a Modification of the Original Agreement.

Plaintiffs' fourth and fifth propositions of law are similarly irrelevant and merely a distraction. Whether or not a party may waive or modify the terms of a contract simply has no bearing on the issues presented to this Court.

The certified question presented to this Court is whether "Ohio follow[s] the 'at the well' rule (which permits the deduction of post-production costs) or [whether] it follow[s] some version of the 'marketable product' rule (which limits the deduction of post-production costs under certain circumstances)." Whether or not a party may waive or modify the terms of a contract simply has no bearing on the question certified to this Court here.

In fact, these propositions of law are doubly irrelevant because they again assume facts that are neither correct nor in the record. Plaintiffs claim that Chesapeake changed its course of performance in the early 1990s. Plaintiffs argue that before the early 1990s, Chesapeake did not deduct a *pro rata* share of post-production costs, but beginning in the early 1990s, Chesapeake started deducting a *pro rata* share of such costs. (*See* Resp. at 22-25.)

But plaintiffs leave out an important and undisputed fact: the early 1990s was precisely when industry regulations were changing. As plaintiffs themselves explain elsewhere in their brief, in the early 1990s, federal deregulation of the gas pipeline industry permitted production companies (like Chesapeake) to sell gas downstream for the first time. (*See* Resp. at 5-6.) Before the 1990s, there simply ***were*** no post-production costs, and hence there were no post-production cost deductions.

Chesapeake never changed its course of performance. Chesapeake paid royalties based on the "market value" of gas "at the well" the entire time. Before deregulation in the 1990s, the market value of gas at the wellhead was calculated based on the wellhead sales price. And after deregulation, the market value of gas at the wellhead was calculated pursuant to the netback method. Thus, the unpublished opinion cited by plaintiffs, *Schmidt v. Texas Meridian Resources, Ltd.*, 4th Dist. Washington No. 94CA12, 1994 WL 728059, *5-6 (Dec. 30, 1994), is inapposite. (*See* Resp. at 22-25.) In that case, unlike here, there ***was*** a change in the lessee's course of performance.

4. Response to Plaintiffs' Sixth Proposition of Law

Plaintiffs' Claim: The Arguments of the Amici Are Incorrect on the Law.

Plaintiffs' sixth proposition of law is not a proposition of law, and Professor Kramer—who plaintiffs acknowledge is one of the editors of one of the leading oil and gas treatises—will reply separately to plaintiffs' *ad hominum* attack on his character and credibility.[9] Notably, plaintiffs fail to acknowledge that the Pennsylvania Supreme Court repeatedly cited Professor Kramer's amicus brief and academic treatise in holding in *Kilmer* that Pennsylvania does not follow the marketable product rule, and in endorsing the use of the net-back method to calculate the wellhead value of gas. *See Kilmer*, 605 Pa. at 415 fn.3, 420 fn.8, 429, 990 A.2d 1147.

[9] Indeed, before choosing to attack Professor Kramer in their brief before this Court, plaintiffs have repeatedly invoked Professor Kramer's treatise in other contexts. *See, e.g.*, *Lutz v. Chesapeake Appalachia, L.L.C.*, Case Nos. 10-4538, Br. of Appellants, at 18 fn.7 (6th Cir. Jan. 21, 2011), ECF No. 006110850873 (citing *Williams & Meyers* treatise in discussing "settled law").

5. Response to Plaintiffs' Seventh Proposition of Law

Plaintiffs' Claim: Chesapeake Presents No Argument as to the Other Royalty Clauses.

Plaintiffs' final proposition is not a proposition of law, either. Rather, it is a misguided claim that Chesapeake has somehow waived arguments regarding lease language that is not at issue before this Court.

To be clear, the question this Court has accepted is whether "Ohio follow[s] the 'at the well' rule * * * or [whether] it follow[s] some version of the 'marketable product' rule * * *." This Court was not asked to interpret, and did not agree to interpret, *other* kinds of lease language, like the payment of royalties pursuant to a "field market price." Indeed, while plaintiffs requested that the federal district court certify additional questions to this Court for review regarding other lease forms, the federal district court rejected that request and certified solely the question regarding how "at the well" language is to be interpreted. As the federal district court explained in certifying the question for appeal, the issue is similar to the issue that was decided by the Sixth Circuit in *Poplar Creek Development Co. v. Chesapeake Appalachia, L.L.C.*, 636 F.3d 235 (6th Cir.2011). (*See* Apr. 6, 2015 Order Certifying Question to Ohio Sup. Ct. at 2 (explaining that *Poplar Creek* "is helpful in framing the question this Court certifies").) The issue in *Poplar Creek* was the meaning of "at the well" language in the relevant oil and gas leases—not the meaning of *other* lease language, like "field market price."

An interpretation of "at the well" language would not resolve the interpretation of leases that do not have "at the well" language in them. As *amici* Sam Johnson, et al., explain, this Court has long held that "'the law applicable to one form of lease may not be, and generally is not, applicable to another and different form.'" *See* Br. of Amici Curiae Sam Johnson, *et al.* at 2, quoting *Harris v. Ohio Oil Co.*, 57 Ohio St. 118, 129, 48 N.E. 502 (1897).

III. 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: October 13, 2015

Respectfully submitted,

/s Daniel T. Donovan

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CERTIFICATE OF SERVICE

I hereby certify that on October 13, 2015, a copy of the foregoing was sent by first class mail, postage prepaid, to the following:

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EXHIBIT A

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April 25, 2014

Via Email and U.S. Mail

Robert C. Sanders
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Re: *Lutz v. Chesapeake*

Dear Rob,

You have asked us to provide further detail regarding six of Chesapeake's responses and objections to Plaintiffs' interrogatories—specifically, Interrogatories Nos. 3-4, 6, and 8-10. As previously stated, although Chesapeake believed its responses were appropriate and sufficient, Chesapeake is willing to supplement its responses and objections pursuant to your request. This letter provides Chesapeake's supplemental responses and objections.

Interrogatories Nos. 3 & 4	
INTERROGATORY NO. 3: State whether the royalties paid under the leases were calculated using the same methodology and, if so, describe the methodology. INTERROGATORY NO. 4: If the royalties paid under the leases were calculated using different methodologies, describe each methodology and explain why each different methodology was used.	ORIGINAL RESPONSE: Chesapeake objects that this interrogatory is vague and ambiguous, especially to the extent it incorporates undefined terms. Specifically, a primary term in this interrogatory, *i.e.*, "methodology," is undefined and capable of multiple interpretations. Chesapeake further objects that this interrogatory is overly broad, unduly burdensome, and not reasonably calculated to lead to the discovery of admissible evidence. To the extent Plaintiffs revise and clarify this interrogatory, Chesapeake is willing to revisit its response.

Interrogatories Nos. 3 & 4 Supplemental Response
Chesapeake maintains that these interrogatories are vague and ambiguous, particularly with respect to the undefined term "methodology," which for the sake of these interrogatories, Chesapeake will interpret to mean the reason(s) post-production deductions for wells in the putative class were (or were not) taken. Chesapeake further maintains that, as drafted, these interrogatories are overly burdensome. Plaintiffs purport to require Chesapeake to identify, on a well-by-well basis, what methodology it applied for 113 different wells in the putative class. Thus, as drafted, this is an interrogatory that improperly contains 113 subparts. Chesapeake has no obligation to identify its methodolog(ies) for each of the 113 wells. In the interest of avoiding a discovery dispute, however, Chesapeake responds as follows subject to its objections. Chesapeake did not employ a common methodology for calculating royalties for all 113 wells. Although providing a description of each methodology for each of the 113 wells and 141 leases is overly broad and unduly burdensome, Chesapeake provides illustrative examples of differing methodologies it used to calculate royalties. *First*, Chesapeake sold gas from certain wells (like Well Nos. 721751 and 724669) at or near the wellhead to a third-party purchaser. For such wells, royalties were based off of the third-party purchase price, according to the royalty share (*e.g.*, one-eighth) in each lease. Moreover, because gas was sold at or near the wellhead, gathering costs were not incurred by Chesapeake and no such charges were charged to the royalty owner. *Second*, gas from certain wells (like Well Nos. 711335 and 720237) were connected to the "GatherCo" gathering system. The gas from these wells was sold by Chesapeake to GatherCo at or near the wellhead, and then was sold back to Chesapeake (or its affiliates) at the terminus of the gathering system at a higher price. Although Chesapeake (or its affiliates) incurred a gathering cost for GatherCo's services in the form of a price differential, and although Chesapeake was permitted to charge a pro rata share of this increased cost to numerous royalty owners, this cost was not passed on to royalty owners. After the gas was sold back to Chesapeake (or its affiliates), Chesapeake sold the gas to third-party purchasers. A weighted-average sales price was calculated based on those third-party sales, and the weighted-average sales price was used to calculate royalties. The share of royalty (*e.g.*, one-eighth) was paid according to the terms of each lease. *Third*, gas from certain other wells (like Well Nos. 722916 and 722979) were connected to the "OH Sheets" gathering system. Chesapeake did not to sell the gas from these wells at or near the wellhead. Rather, Chesapeake maintained title to the gas from these wells as it passed through the gathering system. A portion of a gathering charge was passed on to some but not all royalty owners. For example, a pro rata share of gathering charges was passed on to royalty owners

regarding Well No. 722916, but it was not passed on regarding Well No. 722979. Chesapeake or its affiliates eventually sold the gas at various points downstream to third-party purchasers. A weighted-average sales price was calculated based on those third-party sales, and the weighted-average sales price is what was used to calculate royalties. The share of royalty (*e.g.*, one-eighth) was paid according to the terms of each lease.

Interrogatory No. 6	
INTERROGATORY NO. 6: With respect to the royalties paid under each lease, state separately by well and by month: (i) the price of gas used in the royalty calculation; (ii) how the lessee determined the price; (iii) the buyer of the gas; (iv) the price paid to the lessee by the buyer of the gas; and (v) whether the buyer of the gas was a related company or the agent of a related company.	RESPONSE: Chesapeake objects to this Interrogatory to the extent it seeks information outside Chesapeake custody and control. Chesapeake further objects to this Interrogatory to the extent it purports to require Chesapeake to compile or summarize documents where the burden of doing so is substantially the same for Chesapeake as it is for Plaintiffs. See Fed.R.Civ.P. 33(d). Furthermore, to the extent this Interrogatory purports to require Chesapeake to identify how the lessee determined the price used to calculate royalties for each Lease for each month, Chesapeake objects to this Interrogatory as overly broad and unduly burdensome. The price was not common for all wells over the Time Period. Subject to and without waiving its General and specific objections, and in accordance with Rule 33(d), Chesapeake will produce underlying data from which this information can be generated to the extent that such information is within Chesapeake's custody and control.

Interrogatory No. 6 Supplemental Response
To begin, Chesapeake has already produced documents and data sufficient to show the information responsive to subpart (i) of this interrogatory, *see* CHK00000001-8, and thus Chesapeake need not provide additional information to responsive to subpart (i), *see* Fed. R. Civ. P. Rule 33(d). Chesapeake maintains that the remaining four subparts of this interrogatory are overly broad and unduly burdensome. Plaintiffs purport to require Chesapeake to identify, on a lease-by-lease and well-by-well basis, what methodology it applied for 113 different wells in the putative class to calculate the price used in the royalty calculation, who the buyer was, the month-by-month price paid by the buyer of the gas, and whether the buyer was a related company. Thus, as drafted, this is an interrogatory that improperly contains hundreds of subparts. However, in the interest of avoiding a discovery dispute, Chesapeake supplements its response as follows, subject to its objections. Chesapeake did not employ a common methodology for calculating royalty prices for all 113 wells, nor was the buyer the same for all 113 wells. Although providing a description of each methodology and buyer for each of the 113 wells and 141 leases for each month during the putative class period is overly broad and unduly burdensome, Chesapeake is willing to provide illustrative examples of its methodologies and who the gas purchasers were. Chesapeake sold gas at or near the wellhead pursuant to third-party contracts for certain wells. For instance, for Well No. 722099 in January 2009, gas was sold at or near the wellhead to NCL Natural Resources, LLC, which is not a company related to Chesapeake. The sale price to NCL was based on a contract with NCL. The sale price to NCL is the same as the price used to calculate royalties. Similarly, for Well No. 721754 in January 2009, gas was sold at or near the wellhead to JDS Energy Systems, Inc., which is not a company related to Chesapeake. The sale price to JDS is based on a contract with JDS. The sale price to JDS is the price used to calculate royalties, although certain fees and assessments charged to Chesapeake by JDS are not passed on to royalty owners. Chesapeake sold gas downstream for certain other wells. The method for calculating the royalty price and the buyer of the gas varied by well and by time period. For example, for Well Nos. 711425 and 724566, before July 2010, gas was marketed directly to unrelated third parties at the TCO Appalachia Pool hub, and a weighted-average sales price was calculated based on those third-party sales. The weighted-average sales price was used to calculate royalties. For Well Nos. 711425and 724566 after July 2010, gas was sold at the terminus of the gathering system to a related company, Chesapeake Energy Marketing, Inc. (“CEMI”). CEMI then marketed the gas to unrelated third parties at the TCO Appalachia Pool hub, and a weighted-average sales price was calculated based on those third-party sales. The weighted-average sales price was used to

calculate royalties.

Interrogatory No. 8	
INTERROGATORY NO. 8: With respect to the gas royalties paid under each lease, state separately by well and by month: (i) each category of post production cost that was deducted from the royalty; (ii) the dollar amount deducted for each type of post production service; (iii) how the lessee calculated the dollar amount deducted for each type of post production service; and (iv) the entity that provided the post production service.	RESPONSE: Chesapeake objects to this Interrogatory to the extent it seeks information outside Chesapeake custody and control. Chesapeake further objects to this Interrogatory to the extent it purports to require Chesapeake to compile or summarize documents where the burden of doing so is substantially the same for Chesapeake as it is for Plaintiffs. See Fed.R.Civ.P. 33(d). Furthermore, to the extent this Interrogatory purports to require Chesapeake to identify how the lessee determined the dollar amount deducted for each type of post production service for each Lease each month, Chesapeake objects to this Interrogatory as overly broad and unduly burdensome. How an amount deducted, if any, was calculated was not common for all wells over the Time Period. Subject to and without waiving its General and specific objections, and in accordance with Rule 33(d), Chesapeake will produce underlying data from which this information can be generated to the extent that such information is within Chesapeake's custody and control.

Interrogatory No. 8 Supplemental Response
Chesapeake has provided the relevant, non-privileged information that is responsive to this Interrogatory. The documents produced by Chesapeake at CHK00000001-8 contain, on a well-by-well basis, each category of post-production costs that was deducted from the royalty, the dollar amount deducted for each type of post-production service, and the entity that provided the post-production service. Chesapeake maintains that "how [Chesapeake] calculated the dollar amount deducted for each type of post-production service" calls for information that is irrelevant to class certification. Plaintiffs have not identified any plausible explanation for why this question "is necessary for creating subclasses" or what kinds of subclasses could be created by the answer to this question. Indeed, the data show that post-production costs were only deducted from a small number of putative class members. Moreover, "how [Chesapeake] calculated the dollar amount deducted for each type of post-production service" is overly broad and unduly burdensome. The calculation of the dollar amount deducted varies by well, and even with respect to a single well, the calculation of the dollar amount deducted varies over time.

Interrogatories No. 9-10	
INTERROGATORY NO. 9: State whether the lessee's method of calculating the royalties under the leases was the same as the lessee's method of calculating the royalties of its lessors in West Virginia between February 5, 1992 and the present. INTERROGATORY NO. 10: If the lessee's method of calculating the royalties under the leases was not the same as the lessee's method of calculating gas royalties under its leases in West Virginia between February 5, 1992 and the present, explain in detail: (i) each way that the methodology used in Ohio was different; and (ii) the time period(s) in which each different methodology was used.	RESPONSE: Chesapeake objects that this Interrogatory seeks information irrelevant to the legal claims and defenses in this case. The method of calculating royalties by Chesapeake or its predecessor in a different state pursuant to a different state's law over a more than twenty year period is irrelevant to the issues presented in this case. Chesapeake further objects that this Interrogatory is vague, ambiguous, and not reasonably calculated to lead to the discovery of admissible evidence.

Interrogatory Nos. 9-10 Supplemental Response
Chesapeake maintains that information related to how Chesapeake or its predecessors calculated royalties from different wells, from different gathering systems, pursuant to different leases, under a different state's law is irrelevant and not reasonably calculated to lead to the discovery of admissible evidence. Moreover, as explained above, Chesapeake's methodology for calculating royalties depends on a host of different factors that are unique to the geography of the wells, such as where the wells are located, what gathering system they are connected to, the governing lease language, and the arrangements that Chesapeake or its predecessors have or had for sales at or near the wellhead.

As set forth in this letter, Chesapeake has made a good faith effort to supplement its responses to the interrogatories at issue to the extent that Plaintiffs seek relevant, non-privileged information in a manner that is not overbroad and unduly burdensome. To the extent there are additional points you would like to address, Chesapeake remains willing to meet and confer with you further.

Sincerely,

/s/ Ragan Naresh

Ragan Naresh

Enclosures

cc: Daniel T. Donovan
Kevin C. Abbott