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COMMONWEALTH OF KENTUCKY
SUPREME COURT OF KENTUCKY
NO. 2013-SC-000497-DG

NOBE BAKER, INDIVIDUALLY AND AS ADMINISTRATOR OF THE ESTATE OF JOANN BAKER, ET AL — **APPELLANTS**

v.

ON REVIEW FROM COURT OF APPEALS
NO. 2012-CA-001016
HARLAN CIRCUIT COURT NO. 11-CI-00310

MAGNUM HUNTER PRODUCTION, INC. — **APPELLEE**

BRIEF OF APPELLANTS

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CERTIFICATE OF SERVICE

This is to certify that a true and correct copy of this Brief has been served by mailing same, postage prepaid, to Hon. James L. Bowling, Jr., Special Judge of the Harlan Circuit Court, Courthouse, Harlan, KY 40831; Anne A. Chestnut, R. Clay Larkin, 300 W. Vine St., Suite 1100, Lexington, KY 40507; Harry D. Callicotte, Senior Corporate Counsel – Land, Magnum Hunter Production, Inc., 120 Prosperous Place, Lexington, KY 40509, Counsel for the Defendant, on this the 11th day of August, 2014.

COUNSEL FOR APPELLANTS

INTRODUCTION

This appeal involves (i) the interpretation of two oil and gas leases and certain deductions taken by the gas company lessee in the payment of gas royalties due to Harlan County landowners, and (ii) whether gas that is not marketable at the point of production is sufficient to extend leases once past their primary term. The landowners appeal from a dismissal for failure to state a claim which was affirmed by the Court of Appeals.

STATEMENT CONCERNING ORAL ARGUMENT

The Appellants request oral argument because such parties believe that oral argument may be helpful to the Court in understanding the complexities of the Kentucky oil and gas law as applied to the issues of this case.

STATEMENT OF POINTS AND AUTHORITIES

STATEMENT OF THE CASE

Trial Court Action. The initial complaint was filed on May 12, 2011. (R. pp. 1-28.) The complaint with all amendments ("Complaint") was filed with leave of court on February 20, 2012. (R. pp. 104-113, Complaint.) Count I is for breach of contract based on the Defendant, in the calculation and payment of gas royalties due to the Bakers and Jacksons, deducting certain costs and expenses incurred in the gathering, compression, and treatment of the natural gas to enable it to be sold. (R. pp. 109-110, Complaint.) Count IV seeks a declaration of rights as to (i) the deductions, if any, that may be taken in the calculation and payment of gas royalties due to the Bakers and Jacksons, and (ii) whether production of gas that is not salable or marketable at the wellhead (place of production) is sufficient to perpetuate the Leases in their respective extended term. (R. pp. 111-112, Complaint.) Magnum Hunter Production, Inc. ("MHP") filed its motion to dismiss Counts I and IV, and the Trial Court granted such motion by Order dated March 29, 2012, a copy of which is attached hereto as Appendix A. (R. pp. 632-634.) An Amended Order which confirms that the Order is final and appealable and there is no just reason for delay was entered on May 8, 2012, a copy of which is attached hereto as Appendix B. (R. pp. 748-750.) The Bakers and Jacksons filed their amended notice of appeal on June 7, 2012. (R. pp. 754-756.)

Appellate Action. An appeal was perfected to the Court of Appeals. The Kentucky Oil and Gas Association, Inc. sought and was granted leave to file a brief as *amicus curiae*. (Leave to File *Amicus Curiae* filed on September 24, 2012 and Motion granted on October 24, 2012.) The matter was briefed by the parties and on June 28, 2013, the Court of Appeals rendered its Opinion Affirming, a copy of which is attached hereto as Appendix C ("Opinion"). The Bakers and Jacksons timely filed their motion for discretionary review, which was granted by this Court on June 11, 2014. The Bakers and Jacksons now file their Brief of Appellants.

The Parties. JoAnn and Nobe Baker, husband and wife (the "Bakers"), are the lessors in an oil and gas lease dated October 30, 2004, to Daugherty Petroleum, Inc., as lessee, covering 60 acres, more or less, in Harlan County, Kentucky. This lease is of record in Harlan County in Lease Book 44, Page 381, a copy of which is attached hereto as Appendix D ("Baker Lease"). (R. ¶ 8, Complaint.) JoAnn Baker died a resident of Harlan County on the 2nd day of May, 2012. On July 26, 2012, the parties filed a joint motion with this Court to substitute the Administrator, Nobe Baker, in place of JoAnn Baker, deceased, which was subsequently granted on August 31, 2012.

Lowell Jackson and wife Geneva Lee Jackson, Jerold Jackson and wife Virginia L. Jackson, Merle Jackson and wife Louellen Jackson, Harold Jackson and wife Sandra Jackson, Carolyn Ruth J. Knuckles and husband Charles Knuckles, Sue Carol J. Farley and husband Anthony Farley, Lillie Jackson, Michael Wickline and wife Janet Wickline, Cassie Wickline, and Kimberly Wickline, are the heirs of Chester Jackson, deceased ("Jacksons" or "Jackson Heirs"). The Jacksons are the lessors in an oil and gas lease dated May 7, 2004, to Daugherty Petroleum, Inc., as lessee, covering 130 acres, more or less, in Harlan County, Kentucky. This lease is of record in Harlan County in Lease Book 44, Page 6, a copy of which is attached hereto as Appendix E ("Jackson Lease"). (R. ¶ 9, Complaint.)

The defendant MHP is a successor by name change from NGAS Production Co. who is a successor by name change from Daugherty Petroleum, Inc. ("Daugherty"), the named lessee under the Baker Lease and the Jackson Lease ("Leases"). (R. ¶ 5, Complaint.)

The Leases. The essential terms of the Leases are identical for the purposes of this appeal unless otherwise noted. The certificate of preparation discloses that each Lease was prepared by the Vice President, Acquisitions & Legal Affairs for the lessee.

The gas royalty clause ("Gas Royalty") of the Leases provides in pertinent part as follows:

> [t]o pay Lessors one-eighth of the market price at the well for gas sold or gas so used from each well off the premises, . . .

The "habendum" or "term clause" of the Leases provides in pertinent part as follows:

> It is agreed that this lease shall remain in force and effect for a term of [one (1) year for Baker Lease and three (3) years for the Jackson Lease] from this date and as long thereafter as oil, gas, casing-head gas, casing-head gasoline or any of them is produced from said leased premises . . .

The initial stated term of each Lease ("Primary Term") has expired and currently only natural gas is being produced in the extended term ("Extended Term"). During the Primary Term of each of the Leases, one or more gas wells were completed pursuant to the terms of the Leases and the Defendant commenced payment of royalties on the natural gas produced. (R. ¶ 13, Complaint.) In the payment and calculation of such gas royalties, the Defendant deducted costs and expenses incurred in the gathering, compression, and treatment necessary for such gas to be sold and marketed. (R. ¶ 14, Complaint.)

Royalty Statement. Attached hereto as Appendix F is the Revenue Summary Statement for Lowell Jackson, which is dated 11/30/11 and covers production of natural gas ("G") and natural gas liquids ("NGL") for September of 2011 ("Royalty Statement"). (Brief of Appellants, Filed September 6, 2012, Appendix E.) The Royalty Statement shows gross value and net value of gas sold from each well. The net value is after a deduction of transportation ("Transport") attributable to the net interest of Lowell Jackson. An adjustment also is made for the British thermal unit ("BTU") quality of the natural gas. The BTU adjustment is not at issue in this lawsuit. It should be noted that the deduction of Transport includes gathering, compression, and treatment necessary to make the natural gas marketable although MHP does not undertake to set forth the specific amount of each such deduction.

The Royalty Statement indicates that for natural gas production from wells denoted as DPI ## 991, 367 and 1286 in September of 2011, MHP was paid a wellhead price of $4.15 per unit and MHP deducted $3.65 per unit for Transport, leaving a balance of $.50 per Mcf (volume of 1,000 cubic feet of natural gas). The landowners' royalty due the Jacksons is based upon 1/8th of the $.50 per Mcf. In the Trial Court, MHP referred to the deduction as "a small share of post-production costs." (R. p. 143, Defendant's Memorandum In Support Of Its Motion To Dismiss Counts I And IV.) "Small share" like beauty appears to reside in the eye of the beholder.

Natural Gas Production Process. *ConocoPhillips Co. v. Lyons,* 299 P.3d 844, 849-850 (N.M. 2012), sets forth, in non-technical language, the various steps involved in the natural gas production process:

> When gas is extracted from a well, it is in a form that is not commercially merchantable. In order to be sold on the commercial market, the gas must be processed. . . . These processes include: gathering, compressing, dehydrating,[1] and treating the gas.
>
> . . .
>
> ...[T]he gas stream is measured by a meter near the wellhead. The meter measures the volume of the gas and its heat content. . . . The gas is then transported from the meter to a processing plant or treatment facility via pipelines or gathering lines. In order for the gas to move through the gathering lines to the processing plants, the gas must be compressed at compression stations along the pipelines. When the gas reaches the processing or treatment facility the NGLs [natural gas liquids] are extracted...After the NGLs are extracted, the remaining gas, or residue gas, is pure methane gas, which is then sent through different pipelines to various parts of the country.

THE OPINION

Count I of the Complaint alleged that MHP breached the terms of the Leases by deducting costs it incurred in the gathering, treatment, and compression of the natural gas prior to the calculation and payment of royalties due the Bakers and Jacksons based upon "market value at the well." (R. pp. 109-110, Complaint.) Count IV sought a declaration that the Leases could not be extended in their secondary term by production of gas that is not salable at the wellhead. (R. pp. 111-112, Complaint.) The Opinion of the Court of Appeals relied upon *Poplar Creek Dev. Co. v. Chesapeake Appalachia, L.L.C.,* 636 F.3d 235 (6th Cir. 2011) ("*Poplar Creek*"), and its federal court prodigy, and held that such gathering, compression and treatment costs and expenses could be deducted in the payment of royalties due the Bakers and Jacksons. Since the Leases were producing gas that was salable after it was gathered, compressed, and treated (which occurred after the

[1] For the purposes of this litigation "dehydration" has been included as part of the treatment process.

gas left the wellhead), the Court of Appeals reasoned that gas was being produced in "paying quantities" at the wellhead.

STANDARD OF REVIEW

C.R. 12.02(f) provides for the filing of a motion to dismiss for the failure to state a claim upon which relief may be granted. MHP filed such a motion which was granted by the Trial Court. *Fox v. Grayson,* 317 S.W.3d 1, 7 (Ky. 2010), confirms the *de novo* standard of review:

> [T]he pleadings should be liberally construed in the light most favorable to the plaintiff, all allegations being taken as true. . . . [T]he question is purely a matter of law. . . . Since a motion to dismiss for failure to state a claim upon which relief may be granted is a pure question of law, a reviewing court owes no deference to a trial court's determination; instead, an appellate court reviews the issue de novo.
> (Internal citations omitted.)

The facts are not in dispute. The correct application of Kentucky law is.

ARGUMENT

I. THE COURT OF APPEALS ERRED IN AFFIRMING THE DISMISSAL OF COUNTS I AND IV OF THE COMPLAINT FOR FAILURE TO STATE A CLAIM.

Overview. MHP, insofar as the calculation and payment of gas royalties is concerned, advocates for what has been termed "at the well" rule, which allows the lessee to deduct proportionately certain costs *after* the gas is captured at the wellhead. The Bakers and Jacksons insist these deductions are inappropriate and assert that under Kentucky law and the provisions of the Leases the lessee should bear all costs incurred in obtaining a marketable product (the "marketable product" rule). Once a marketable product has been obtained, the parties are in agreement that all other reasonable costs to further enhance the value of the natural gas should be shared proportionately.

There are a number of jurisdictions that have considered the deduction of gathering, compression, and treatment in the calculation and payment of gas royalties and they appear to be about evenly divided.[2] While these out of jurisdiction cases make for interesting reading, most may be distinguished factually or by the common law of the particular jurisdiction, and offer little guidance for deciding the instant case.

The second issue is whether the quality of the gas produced at the wellhead is sufficient to maintain the Leases in full force and effect. This issue is germane only if the Court should determine that MHP may legally deduct gathering, compression, and treatment in the calculation and payment of gas royalties due under the Leases to the Bakers and Jacksons. MHP argues that all that is required is for the gas to be sold and royalty paid – an endorsement of the marketable product rule. The Bakers and Jacksons maintain that if the wellhead is the place of production (as insisted by MHP), under Kentucky law and the terms of the Leases, MHP has failed to produce gas in paying quantities necessary to extend the Leases. In other words, if the wellhead is the place of production, gas is not being produced (in paying quantities or otherwise) if it cannot be sold at the place of production.

<u>Construction of Oil and Gas Leases.</u> An oil and gas lease is subject to the same rules of construction as ordinary contracts. *Oliver v. Louisville Gas & Electric Co.*, 732 S.W.2d 509 (Ky. App. 1987). Under Kentucky law, contract interpretation generally is a

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[2] *See* Rachel M. Kirk, *Variations in the Marketable-Product Rule from State to State,* 60 Oklahoma L. Rev., 769, 773 (2007). The author notes that Michigan, Wyoming and Nevada have adopted a statutory version of the marketable product rule.

matter of law for the court to decide. *Morganfield Nat'l Bank v. Damien Elder & Sons*, 836 S.W.2d 893, 895 (Ky. 1992). Kentucky traditionally has recognized that the cardinal rule in contract interpretation is to ascertain the intention of the parties and give effect to such intention. The intention is to be gathered from the words that the parties employ in drafting their contract, and, "in arriving at the intention which the terms employed import and manifest, the entire contract should be looked to." *Siler v. White Star Coal Co.*, 226 S.W. 102, 104 (Ky. 1920). In *State Farm Mut. Auto. Ins. Co. v. Hobbs,* 268 S.W.2d 420, 422 (Ky. 1954), the court acknowledges it "must give consideration and effect to every provision…." *See, also, International Union of Operating Engineers v. J.A. Jones Const. Co.,* 240 S.W.2d 49, 55 (Ky. 1951) (A single phrase or clause in a contract "cannot be considered in isolation."). The construction must be "reasonable and agreeable to common understanding," and the words should be given their "fair and reasonable meaning," receiving the interpretation accorded by the "common usage of mankind," viewed in the circumstances of their use and context. *Franklin Fluorspar Co. v. Hosick,* 39 S.W.2d 665, 666 (Ky. 1931); *Florman v. MEBCO Ltd. Partnership,* 207 S.W.3d 593, 600 (Ky. App. 2006); and *Clements v. Morgan,* 211 S.W.2d 164, 167 (Ky. 1948).

If the lease is ambiguous, the entire lease is to be construed strongest against the lessee. *Kies v. Williams,* 228 S.W. 2d 40, 42 (Ky. 1921).

A. Kentucky Law Does Not Permit The Deduction Of Gathering, Compression, and Treatment Costs And Expenses In The Calculation And Payment Of Gas Royalty Based Upon The "Market Price Of Gas At The Well."

1. The Plain Meaning Of The Prepositional Phrase And Its Object Require Gas Royalty Be Paid On A Marketable Product.

"Market price at the well for gas" is the phrase the Trial Court and Court of Appeals was called upon to construe. It is remarkably similar to "market value of such gas at the well" which was the subject of *Poplar Creek,* an appeal from the Eastern District of Kentucky.[3] In *Poplar Creek,* the federal court held that Kentucky follows the "at the well" rule. *Poplar Creek* was followed by *In re KY USA Energy, Inc.,* 448 B.R. 191 (Bankr. W.D. Ky. 2011) and *Appalachian Land Co. v. EQT Production Co.,* 2012 WL 523749 (E.D. Ky.), which is currently under appeal to the Sixth Circuit (6th Cir. 12-5589).[4] The Sixth Circuit, the Federal District Court and the Bankruptcy Court are required to follow *Poplar Creek. Salmi v. Secretary of Health & Human Services,* 774 F.2d 685, 689 (6th Cir. 1985); *Combs v. International Ins. Co.,* 163 F.Supp.2d 686, 691 (E.D. Ky. 2001). This Court is not required to follow *Popular Creek* - especially where the federal court has not applied Kentucky law.

Acceptable English grammar dictates the phrase "at the well" modifies the object of such prepositional phrase, "market price" (or "market value") - it does not supplant, replace, remove, obfuscate or emasculate the phrase which it seeks to modify. *Hardt v. Town of Watertown,* 895 A.2d 846, 851 (Conn. App. Ct. 2006) ("Ordinary rules of English grammar dictate that the prepositional phrase . . . must modify a verb, noun or adjective."); *Popplewell's Alligator Dock No. 1, Inc. v. Revenue Cabinet,* 133 S.W.3d 456, 464 (Ky. 2004) (Under the rules of English grammar, the prepositional phrase

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[3] The slight variation in royalty phrasing between "market value at the well" in *Poplar Creek* and "market price at the well" in the instant case, is a distinction without a difference.

[4] The Sixth Circuit has certified a question of law to this Court whether, under Kentucky law, the lessee in the calculation and payment of gas royalties due the landowner based on "the market price of gas at the well" may deduct severance taxes. 2013-SC-000598-CL.

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modifies the preceding noun.); *Barnhart v. Thomas,* 540 U.S. 20, 26, 124 S. Ct. 376, 157 L. Ed.2d 333 (2003) ("A limiting clause or phrase . . . should ordinarily be read as a modifying only the noun or phrase that it immediately follows.").

Despite the simplicity of the clause, neither *Poplar Creek* nor its federal court progeny undertook to consider the entirety of "market value of such gas at the well:" instead these courts ignored "market value" and construed only the prepositional phrase: "at the well." In *Poplar Creek,* the subject or object of this prepositional phrase, "market value," was tossed aside like an old shoe. The term "market price" (or "market value") was not even discussed in *Poplar Creek.*

The Opinion of the Court of Appeals (p. 4) quotes from *Black's Law Dictionary* that "market value at the well" means "the value of oil and gas at the place where it is sold, minus the reasonable costs of transporting it and processing it to make it marketable."[5] The Opinion continues that Kentucky in *Cumberland Pipe Line Co. v. Commonwealth,* 15 S.W.2d 280, 284 (Ky. 1929), adopted the definition from *Black's* ("The value[6] at the place of production is the selling price less the cost of transportation to the place of sale."). These definitions are not the same. *Cumberland Pipe Line* got it right. The Opinion, just like *Poplar Creek*, fails to discuss or ascribe any meaning to "market price." To paraphrase Aldous Huxley: "market price" does not cease to exist because it was ignored.

At this point in time, neither the federal nor state courts, as evidenced by *Poplar Creek,* its progeny, the Order of the Trial Court and the Opinion, have cast an open eye

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[5] The definition from *Black's* is contradicted in the same edition where the definition of "royalty interest" accurately points out "the authorities are split over what costs are costs of production." *Black's Law Dictionary,* 1446 (9th ed. 2009).

[6] "Value" refers to "market value" in *Cumberland Pipe Line* where the court was construing a tax imposed upon the "market value" of all crude oil.

toward the object of the prepositional phrase and have resolutely declined to discuss or attribute any meaning whatsoever to "market value" or "market price." This continued omission adds a new twist to the old adage: "*justice is blind.*" Obviously, this Court is not required to grant special consideration to the landowners; however, the Bakers and Jacksons continue to seek a judicial analysis of the entire phrase "market price at the well" which has not been undertaken by either the Court of Appeals or the Trial Court.

"At the well" cannot be considered standing alone because "[a]ny contract or agreement must be considered as a whole, giving effect to all parts and every word in it if possible." *City of Louisa v. Newland,* 705 S.W.2d 916, 919 (Ky. 1986). The judicial discard of (i) the rules of English grammar, and (ii) the object of the prepositional phrase, should cease once and for all.

A century ago, a Kentucky case offered the classic definition of "'fair market price' - "the usual standard for measuring the value of an article. It is worth what it may be reasonably sold for." *Burke Hollow Coal Co. v. Lawson,* 151 S.W. 657 (Ky. 1912). It is synonymous with "fair market value" which is that price upon which a willing and informed buyer and seller would agree. *Commonwealth v. R.J. Corman Railroad Co./Memphis Line,* 116 S.W.3d 488, 495 (Ky. 2003).

Poplar Creek at footnote 2 quotes from *Merritt v. Southwestern Electric Power Co.,* 499 So. 2d 210 (La. Ct. App 1986), that "gas was useless and had no market value at the wellhead until it could be moved into the gathering line by compression." Of necessity, "market value" and "market price" involve a willing and informed buyer and seller. With a product that is not marketable, or as phrased by *Merritt,* "useless," the gas at the wellhead cannot have a willing and informed buyer and seller because it must be gathered, compressed and treated before it is marketable. See, also *ConocoPhillips Co. v. Lyons, supra,* 299 P.3d at 849-850. Ignoring "market price" creates a fictitious value or price for a wellhead substance that is neither marketable nor salable. "At-the-well" cannot change the otherwise plain meaning of "market price." The plain meaning of "at-the-well" when read with "market price" can mean nothing more than a statement of the location of the sale in order that a royalty is not paid on value added by transporting the gas to a distant sales location. This interpretation is consistent with *Cumberland Pipe Line Co. v. Commonwealth,* 15 S.W.2d 280, 284 (Ky. 1929), as quoted in *Poplar Creek, supra,* 636 F.3d at 244:

> *There is seldom, if ever, a market at the place of production. The product must be carried to the markets. The value at the place of production is the selling price less the cost of transportation to the place of sale.* (Italics in original)

If "market price" is accorded the definition recognized by the Kentucky courts, "market price at the well" simply means that royalty is owed on a marketable product. Any perverse meaning ignores "market price," attempts to change the provisions of the Leases between the parties contrary to Kentucky law. *City of Louisa v. Newland,* 705 S.W.2d 916 (Ky. 1986); *Sparks v. Albin,* 241 S.W. 321, 323 (Ky. 1922); *International Union of Operating Engineers v. J.A. Jones Const. Co., supra*; and *O.P. Link Handle Co. v. Wright,* 429 S.W.2d 842, 847 (Ky. 1968).

"Market price" necessarily entails a willing buyer and a willing seller. In the case at bar, there is no market for the gas at the wellhead – the place of production according to MHP. Without gathering, compression, and treatment there can be no marketable product. Without gathering, compression, and treatment there can be no willing buyer and willing seller. Without gathering, compression, and treatment there can be no market price. Without gathering, compression and treatment, "market price" is only a FICTION.

Fairly read, "market price at the well" requires the lessee to (i) provide a marketable product which includes gathering, compression, and treatment, and (ii) pay the gas royalty on such marketable product less the pro rata portion of the reasonable cost to transport such marketable product to the place of sale. Under this interpretation, the object, "market price," is properly modified by the prepositional phrase, "at the well." Anything less, judicially sanctions the swallowing of the whale by Jonah.

2. *Poplar Creek* And Its Progeny Are Not Based On Kentucky Law And Should Not Be Followed.

The *Poplar Creek* three judge panel did not involve anyone from Kentucky. The judicial biography provided by the Sixth Circuit website indicates that the presiding panel judge and author of the Opinion was from Michigan[7] and the other two were from Tennessee. As recently confirmed, we are not "bound by the federal court's prediction . . . [or] interpretation of state law." *Aull v. Houston,* 345 S.W.3d 232, 236 (Ky. App. 2010). The reason why is succinctly set forth in *Lehman Bros. v. Schein,* 416 U.S. 386, 391, 94 S. Ct. 1741, 40 L. Ed.2d 215 (1974), when federal courts are called upon to apply state law, "they act . . . as 'outsiders' lacking the common exposure to local law which comes from sitting in the jurisdiction." *Poplar Creek* fails to correctly apply Kentucky law and should be discarded.

[7] Judge Griffin, the *Poplar Creek* author, sat on the Michigan Court of Appeals when *Schroeder v. Terra Energy, Ltd.,* 565 N.W.2d 887 (Mich. Ct. App. 1997) was decided. *Schroeder* is cited with approval in *Poplar Creek.* The lease being construed in *Schroeder* involved a gas royalty based upon "proceeds," as opposed to "market value" or "market price."

The dispositive issue in *Poplar Creek* was identified as the "meaning of 'wholesale market value of such gas at the well.'" *Id.* at 240. *Poplar Creek* held that Kentucky follows the "at-the-well" rule which allows the deduction of post-production costs prior to calculating the royalties due the landowner. "At-the-well" was said to refer to gas in its natural state, before it has been processed or transported from the well. *Id.* at 244.

After correctly identifying the dispositive issue, *Poplar Creek* thereafter fails to follow established Kentucky law in three essential areas: (a) it applies the law of Mississippi, as set forth in *Piney Woods Country Life School v. Shell Oil Co.,* 726 F.2d 225 (5th Cir. 1984), to the meaning of the prepositional phrase "at the well" and accords no meaning to the subject of the prepositional phrase, "market value," (b) it misconstrues *Lafitte v. United Fuel Gas Co.,* 177 F. Supp. 52 (E.D. Ky. 1959), as affirmed in 284 F.2d 845 (6th Cir. 1960), and the Kentucky gas cases; and (c) it misreads *Cumberland Pipe Line Co. v. Commonwealth, supra,* and what is included in an approved deduction of transportation costs and expenses.

a. Piney Woods.

Despite the recitation that it is required to apply Kentucky law, the dispositive issue in *Poplar Creek* was resolved by reliance upon *Piney Woods, supra,* a federal case APPLYING MISSISSIPPI LAW. *Poplar Creek* cites *Piney Woods* for the definition of "at the well." 726 F.2d. at 242. No Kentucky cases are cited for this proposition and the *Poplar Creek* opinion neither cites nor discusses any meaning attached to the subject of this prepositional phrase – "market value."

In an effort to craft a "one rule fits all," the emphasis in *Piney Woods* was on "at the well" because three of the involved leases provided for a gas royalty measured by "the amount realized by lessee" at the well. *Poplar Creek* ignores the subject of the prepositional phrase – "market value," in contravention of the established rule of construction that meaning shall be accorded all words of a contract. *City of Louisa v. Newland,* 705 S.W.2d 916, 919 (Ky. 1986) (Contracts "must be construed as a whole, giving effect to all parts and every word in it if possible.").

The work-back method adopted by *Piney* Woods and proposed by MHP emasculates the plain meaning of "market price." This method creates an illusory wellhead price for royalty purposes by working back from a point where gas has an established market price. In addition to transportation, the work-back method deducts gathering, compression, and treatment from the gas sales price. As Kentucky cattle, hog, and grain farmers well know, costs of production have very little to do with price. It is for good reason that the work-back method is the least favorite method of determining market value at the well even where permitted by applicable state law. *Piney Woods, supra,* 726 F.2d at 239 ("the actual sale price less costs . . . is the least desirable method of determining market price.").[8]

b. *Lafitte, Warfield, Reed,* and *Rains.*

Poplar Creek concludes that based upon the previous decision of this Court in *Lafitte* and the review of Kentucky law, "we hold that Kentucky follows the 'at-the-well'

[8] The work-back method of establishing market price has not been sanctioned by the Kentucky courts. While *Cumberland Pipe Line* may facially appear to support the work-back method, the transportation deduction so taken was **mandated by the statute** and it was AFTER a marketable product had been obtained.

rule." In *Lafitte, supra, Warfield Natural Gas Co. v. Allen,* 88 S.W.2d 989 (Ky. 1935), *Reed v. Hackworth*, 287 S.W.2d 912 (Ky. 1956) and *Rains v. Kentucky Oil Co.*, 255 S.W. 121 (Ky. 1923), the respective lessors were each paid a royalty based on a marketable product at or in the vicinity of the well for sales (i) at the wellside, AND also (ii) at distant non-well locations.[9] **The Court in *Poplar Creek* utilizes *Lafitte* and the other Kentucky gas cases to deny Poplar Creek the same relief that was accorded the lessors in each of such gas cases – a royalty based on a marketable product at wellside.**

The *Poplar Creek* reliance on *Lafitte* is misplaced inasmuch as the holding of such case specified that the gas royalty was not to be less than the fair wholesale market value in the vicinity of the well. *Poplar Creek* involved the calculation and payment of gas royalty on a product that had no "market value at the well." 636 F.3d at 239. *Lafitte* involved the sale of gas at the vicinity of the wellside AND also at some distance removed. The *Lafitte* lease did not specify the place of the market and, under *Warfield* and *Rains* the *Lafitte* trial court held that the market value of the gas was to be fixed at or in the vicinity of the wellside. In *Lafitte,* the gas was in marketable condition when it was sold at the wellside vicinity AND also at distant locations. **There is no doubt that *Lafitte, Warfield, Reed,* and *Rains* hold that when a marketable gas product is sold at the wellside and also at a distant location, the royalty must be based on the sale of the marketable product at or in the vicinity of the wellside.** A close reading of these four cases discloses that gathering, compression, and treatment were not discussed.

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[9] The gas royalties paid the lessor in *Reed* for gas sold at wells distant from the wellside were equal to the market value of such gas at the distant located wells less <u>only</u> the cost of transportation.

In the instant case the gas is not in marketable condition at the wellside. In fact, *Merritt, Poplar Creek* and *ConocoPhillips* all confirm that such gas is "useless" at the wellside.

In response to the argument that *Lafitte* and the three Kentucky state court gas cases involved sales of gas at or in the vicinity of the wellside, *Poplar Creek* states that "nothing in *Lafitte* indicates that its holding was limited to cases involving sales at the wellside" and insists that *Lafitte* "focused on where the gas was produced, not sold . . . ." 636 F.3d at 243. This response by *Poplar Creek* only begs the question – without sales at or in the vicinity of the wellside, the *Lafitte* court has nothing on which to base the landowner's royalty. In *Lafitte,* the gas was produced AND sold in the vicinity of the wellside. Without such sale of gas at or in the vicinity of the wellside, the court must decide how the royalty is to be calculated, and that is precisely the issue presented in *Poplar Creek* and the instant case.

c. *Cumberland Pipe Line.*

Finally, *Poplar Creek* states that the transportation deduction approved in *Cumberland Pipe Line* includes gathering, compression and treatment. 636 F.3d at 244. *Poplar Creek* states that gathering and compression are clearly necessary to transport gas and such activity increases the value of the gas at its final destination. *Id.*

The gas produced from the Leases is subject to federal jurisdiction which starts at the wellhead. *Public Service Commission of Kentucky v. F.E.R.C.,* 610 F.2d 439, 444 (6th Cir. 1979). Each of the Leases, at paragraph 19, provides that it "shall be subject to all federal and state laws, all . . . rules or regulations of state and federal authorities . . . ."

In accordance with the federal jurisdiction of the gas production, the definitions of "gathering"[10] and "compression"[11] set forth in *Poplar Creek* are taken from 30 Code of Federal Regulations Sec. 1206.151 (2010). *Poplar Creek* at notes 1 and 2. *Poplar Creek,* at note 3, references 99 A.L.R. 5th 415 for the description of "treatment costs."[12]

Once a marketable product has been achieved, the parties are in agreement that other reasonable costs to enhance the value of the gas, including transportation costs, should be shared proportionally. *Poplar Creek* offers no definition for "transportation costs," yet makes the following comment: "We fail to see, however, how gathering, compression, and treatment expenses are materially distinguishable from 'transportation costs.'" *Poplar Creek* at 244. The visual observation of the *Poplar Creek* Court is not supported by decided case law.

The Eighth Circuit in *Northern Natural Gas Co. v. F.E.R.C.,* 929 F.2d 1261 (8th Cir. 1991), *cert. denied,* 502 U.S. 856 (1991), reviewed a Federal Energy Regulatory Commission decision relating to the rates charged for moving natural gas through a company's own gathering facilities. In reaching its decision, the federal court points out the difference between "gathering" and "transportation:"

> The term "gathering" refers to the process of collecting gas at the point of production (the wellhead) and moving it to a collection point for further movement through a pipeline's principal transmission system.
> . . .
> "Transportation" involves the movement of gas through a pipeline's principal transmission system.

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[10] "Gathering" is defined as "the movement of lease production to a central accumulation point and/or treatment point . . . ."

[11] "Compression" is defined as "the process of raising the pressure of gas."

[12] "Treatment costs" were described as arising from "the need, in some cases . . . to treat the gas to remove harmful substances or to enhance its value."

Id., 929 F.2d at 1265.

The definitions of "gathering" and "compression" set forth in footnotes 1 and 2 of *Poplar Creek* confirm that neither is a part of "the movement of gas through a pipeline's principal transmission system," rather they are two of the necessary preliminary steps required for the gas to be introduced to the pipeline to market. Contrary to *Poplar Creek,* transportation does not include either gathering or compression.

Poplar Creek at note 3 states that gas is treated before it is sold to remove impurities or otherwise enhance its value. To the extent that treatment undertaken by MHP increases the value of an already marketable product, there is no disagreement that reasonable costs of enhancement may be properly deducted. However, if the treatment is necessary to produce a marketable product, such expense must be borne entirely by the lessee. No matter how it is viewed, treatment is not a part of the transportation process.

There is no rational basis for the *Poplar Creek* statement that *Cumberland Pipe Line* "strongly suggests" that Kentucky courts would deduct gathering, compression and treatment to determine market value at the well. *Cumberland Pipe Line* DID INVOLVE gathering (from the wellhead to the tank battery to the pipeline) and the lessee DID PROVIDE a marketable product when the oil entered the principal pipe line. Under *Cumberland Pipe Line* ONLY reasonable transportation (via the principal pipe line) of the marketable product may be deducted in the calculation and payment of the gas royalties due Poplar Creek. It is stated very simply:

> There is seldom, if ever, a market at the place of production. The product must be carried to the markets. The value at the place of

> production is the selling price less the cost of transportation to the place of sale.
>
> . . .
>
> The market value of a commodity is its selling price in the usual and ordinary course of business, but, if there be no market at a particular place at which it is desired to fix the market value, then the market value is taken at the nearest point available, with adjustments to care for the cost of transportation to that market.

Cumberland Pipe Line, 15 S.W.2d at 284. Indeed, *Cumberland Pipe Line* did get it right.

3. The Implied Covenants In The Leases Mandate That Gas Royalties Be Paid On A Marketable Product.

a. "Reason and Justice" Implication.

As this litigation amply illustrates, the Leases do not expressly set forth the duties and obligations intended to be assumed by the parties with respect to providing a marketable gas product. The "Witnesseth" paragraph recites the purposes of the Leases: "operating for and producing oil, gas . . . ." All of the operating rights in the Leases are granted the Lessee.

For a number of years Kentucky has judicially recognized that

> [I]n the absence of specification of duties and obligations intended to be assumed, the law will imply an agreement to do and perform those things that according to **reason and justice** the parties should do in order to carry out the purpose for which the contract was made. (Emphasis added.)

Warfield Natural Gas Co., v. Allen, 59 S.W.2d 534, 536 (Ky. 1933); *See also*, *Humphreys v. Central Kentucky Nat. Gas Co.*, 229 S.W. 117, 119 (Ky. 1920).

In *Holly Creek Production Corp. v. Rose,* 2009-CA-001971 (Ky. App. 2011) (copy attached in Appendix, G), the court was faced with a question as to the party responsible for the costs necessary to bury a pipeline. The *Holly Creek* opinion notes that the lease granted the lessor (Rose) the right to require the pipeline be buried without specifying the party responsible for the associated costs. The appellate court held for the lessor and emphasized, "Holly Creek's obligation to bear this cost is implicit in the authority it granted Rose to require the pipeline be buried." The court explained its holding with the adoption of the "reason and justice" quote set forth above.

The Leases grant the Lessee the exclusive right to drill, explore for and produce oil and gas. These rights necessarily include gathering, compression and treatment necessary to provide a marketable product. The purpose of an oil and gas lease is production and payment of royalties. *Carroll Gas & Oil Co. v. Skaggs,* 21 S.W.2d 445, 447 (Ky. 1929). Without the production of a marketable product, the purpose of the Leases will be frustrated. *Holly Creek* confirms that MHP is solely obligated to provide a marketable product and should be followed. "Reason and justice" demand no less.

b. Implied Obligation to Market.

As noted above, the fundamental purpose of an oil and gas lease is to make the mineral estate profitable for both parties. *Carroll Gas & Oil, supra; Garman v. Conoco, Inc.,* 886 P.2d 652 (Colo. 1994). Where the lease does not contain express provisions creating duties in the lessee to accomplish such a purpose, the law will imply them. *Warfield Natural Gas Co. v. Allen,* 59 S.W.2d 534, 536 (Ky. 1933). If there is discovery in paying quantities, this covenant obligates the lessee to "proceed with the operations and development so as to obtain full production in order that the lessor may receive his royalty." *Id. Poplar Creek* correctly points out that the jurisdictions which recognize this implied covenant to market are in agreement that such covenant imposes upon the lessee the duty to make the gas marketable. 636 F.3d at 240. Kentucky has followed this view for more than 90 years. In *Hails v. Johnson,* 263 S.W. 679, 680 (Ky. 1924), our senior court confirms that:

> …if oil or gas is found in paying quantities then the lessees are bound to diligently work and operate the lease so as to bring the product to a present market and so as to promptly yield to lessor his royalties.

The reason for this implication is clearly stated in *Warfield Natural Gas Co. v. Allen,* 88 S.W.2d 989, 991 (Ky. 1935):

> Defendant [lessee] had the exclusive right to produce the gas and to market the gas. **It was as much its duty to find the market as to find the gas. Nothing is said about its expenses in doing either. It must be presumed that the payment by the defendant [lessee] of its expenses in doing both is the consideration it is to pay for its seven-eighths of the proceeds, for it pays no other and it certainly gets the lion's share.** (Emphasis supplied.)

The *Warfield* language does not equivocate about the responsibility for costs and expenses required to place the gas in condition to be marketed. These costs and expenses were undertaken by the lessee in *Warfield,* and again by the lessee in *Lafitte, Reed,* and *Rains.* Otherwise, the gas could not have been sold.

In each of these four cases, the lessee was responsible for and provided a marketable product at or in the vicinity of the well. The Bakers and Jacksons seek the very same relief accorded the landowner in each of the four cases – a gas royalty based upon the sale of a marketable product at the wellside. Under *Warfield,* there is no question that the expenses in providing a market for the gas must be borne solely by the lessee – after all, the lessee gets the "lion's share" of the proceeds.

4. If The Gas Royalty Clause Is Ambiguous, It Should Be Construed Most Strongly Against The Lessee, MHP, Who Prepared The Leases.

In Kentucky, a document is ambiguous when its language is "reasonably susceptible of different constructions." *Blevins v. Riedling,* 158 S.W.2d 646, 648 (Ky. 1942). While the Bakers and Jacksons maintain that "market price at the well" contained in the Leases is free from doubt,[13] some states have decided that similar language is ambiguous. See, e.g., *Estate of Tawney v. Columbia Natural Resources, L.L.C.,* 633 S.E.2d 22, 28 (W.Va. 2006) (The court considered various royalty provisions including ones that were based upon "market value" and concluded that "we believe that the 'wellhead' language at issue is ambiguous."). For more than 90 years Kentucky has recognized that in cases of ambiguity, oil and gas leases are construed in favor of the lessor and against the lessee. *Kies v. Williams,* 228 S.W. 40, 41-42 (Ky. 1921) ("the entire lease and all its terms . . . are construed strongest against the grantee [lessee]."). This rule appears to be followed by virtually all of the oil and gas producing jurisdictions. *Rogers v. Westerman Farm Co.,* 29 P.3d 887, 901 (Colo. 2001) ("we are mindful of the generally accepted rule that oil and gas leases are strictly construed against the lessee in favor of the lessor."). The reason for this rule is well stated in *Gilmore v. Superior Oil Company,* 388 P.2d 602, 603 (Kan. 1964):

> Construction of oil and gas leases containing ambiguities is in favor of the lessor and against the lessee for the reason that the lessee usually provides the lease form or dictates the terms thereof and if such lessee is desirous of

[13] *Poplar Creek* points out that the *Lafitte* trial court held the lease language was not "clearly ambiguous." 600 F.3d at 235. It was not "clearly ambiguous" for good reason. The *Lafitte* lease provides that the lessee will not sell the gas for "less than the fair wholesale market value in the vicinity" of the wellside – AND gas was sold in the vicinity of the wellside. The issue in the instant case is decidedly different. The Leases provide for a gas royalty based on "market price at the well" and there are no sales at or in the vicinity of the wellside.

> more complete coverage, the lessee has the opportunity to protect itself by the manner in which it draws the lease.

Both of the Leases were prepared by the Vice President, Acquisitions & Legal Affairs for the MHP predecessor by name change. As a corollary to the above, "no rule is better established than . . . when a contract is susceptible of two meanings, it will be construed strongest against the party who drafted and prepared it." *Glenmary Land Co. v. Stewart,* 290 S.W. 503 (Ky. 1927).

Should there be any doubt as to the meaning of "market price at the well," such doubt should be resolved in favor of the Bakers and Jacksons. The very fact that various state courts have reached opposite conclusions on the meaning of "market price at the well" would tend to confirm, at the very least, that such language is "reasonably susceptible of different constructions."

B. If MHP Is Not Required To Provide A Marketable Product, The Quality Of Gas Produced At The Wellhead Is Not Sufficient To Maintain The Leases In Full Force And Effect.

Oftentimes, when a party takes a provision out of context and promotes a strained interpretation, it contravenes other clauses in the lease. *Greer v. Salmon,* 479 P.2d 294, 296 (N.M. 1970). Such is the situation with MHP and its initial insistence that gas royalties are not payable on a marketable product. This MHP position has jeopardized the continued existence of the Leases.

If production is complete only when a marketable product is obtained (as the Bakers and Jacksons maintain), the expiration of the Leases is not called into question. Under this approach, MHP is responsible for all costs necessary to obtain a marketable product. More importantly, this approach allows the Gas Royalty, the Primary and

Extended Term and the other express and implied provisions of the Leases to be construed together to achieve the purpose of the Leases – production and payment of royalties.

Each of the Leases provides for a specified Primary Term and an Extended Term for "as long thereafter as oil, gas, casing-head gas, casing-head gasoline or any of them is produced from said leased premises . . . ." The main purpose of the Extended Term is to prescribe the conditions of fact which must exist in order to perpetuate the Leases beyond their respective Primary Terms. *Smallwood v. Central Ky. Natural Gas Co.*, 308 S.W.2d 439, 442-443 (Ky. 1957), rev'd on other grounds, *Texas American Energy Corp. v. Citizens Fidelity Bank & Trust Co.*, 736 S.W.2d 25 (Ky. 1987). Since the lessee is the active agency through which these fact conditions must be caused to exist, "it must be determined from the 'thereafter' clause what acts are required of him [the lessee] . . . in the event it [the lease] is so continued, to keep it alive thereafter." *Smallwood, supra* at 442-443.

There seems to be general acceptance that production must be in "paying quantities" in order to perpetuate the Leases in their Extended Term. However, the first question is where is the place of production - where will paying quantities be determined?

Based on *Poplar Creek*, the Trial Court and the Court of Appeals have taken the position that gathering, treatment and compression are post-production costs. It necessarily follows that the place of production is at the wellhead. *Poplar Creek*, 636 F.3d at 239.

Notwithstanding the Leases do not use the term, courts of the Commonwealth uniformly hold that oil or gas must be in "paying quantities."[14] Sound logic dictates that you cannot have "paying quantities" if the object cannot be sold. Courts long have recognized that "paying quantities" involves "quality," "extent" and "value." *Southern Pacific Co. v. United States,* 249 F. 785, 804-805 (9th Cir. 1918), rev'd on other grounds, 251 U.S. 1, 40 S. Ct. 47, 64 L. Ed. 97 (1919). See, also, *Wood v. Axis Energy Corp.,* 899 So.2d 138, 142 (La. App. 2005), which quotes from *Clifton v. Koontz,* 325 S.W.2d 684, 691 (Tex. 1959): "The term 'paying quantities' involves not only the amount of production, but also the ability to market the product . . .." There is no question that the gas produced at the wells by MHP is sufficient to satisfy any question as to quantity. However, the gas produced at the wellheads on the Leases is not marketable. *Merritt, supra; ConocoPhillips, supra.*

Despite the fact "paying quantities" involves both quantum and quality, the analysis by the Trial Court and the Court of Appeals fails to progress past quantum. The junior appellate court notes incorrectly: "Here, a sufficient amount of gas is being produced at the wellhead to pay Appellants a royalty." Opinion, p.6. The lower courts overlooked the fact that the "gas was useless and had no market value at the wellhead" – which is the point of production. *Poplar Creek,* 636 F.3d at 239, note 2, quoting from *Merritt v. Southwestern Electric Power Co.,* 499 So.2d 210, 213 (La. App. 1986); *ConocoPhillips,* 299 P.3d at 849 ("When gas is extracted from a well, it is in a form that

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[14] The term "paying quantities" has been the subject of varying definitions. See, e.g., *United States v. 2847.58 Acres of Land,* 529 F.2d 682 (6th Cir. 1976). The quantum of production required for "paying quantities" is not germane to this appeal inasmuch none of the gas produced from the Leases is salable at the place of production – the wellhead.

is not commercially merchantable."). If the gas produced at the wellhead has no market value, there is no basis on which to pay the Bakers and Jacksons a production royalty.

More importantly for purposes of this review, there is no basis on which the Leases can be perpetuated in their Extended Term by production of gas which has no market value at the wellhead. Despite the magnitude of the production, if the gas has no market value at the wellhead there is a failure to satisfy the quality required for "paying production." *Southern Pacific Co. v. United States, supra; Wood v. Axis Energy Corp., supra.*.

MHP in the lower courts has insisted that the "paying quantities" requirement is satisfied if the gas ultimately is sold after it leaves the wellhead. This argument was accepted *carte blanche* by the Trial Court and the Court of Appeals ('a sufficient amount of gas is being produced at the wellhead to pay Appellants a royalty"). Opinion, p. 6. The gas produced at the wellhead is "useless" and not "commercially merchantable," and offers no basis on which a royalty can be paid due to the lack of market price at the wellhead. In order to have any market value, the gas once it is produced at the wellhead must be gathered, compressed and treated (and transported to the market).

The Opinion ignores the provisions of the Leases and violates long standing precedent of this Court. *Bennett v. Dudley,* 391 S.W.2d 375, 376-377 (Ky. 1965) ("The court cannot make a new contract for the parties or revise their contract under profession of construing it."); *Plaza Condominium Association, Inc. v. Wellington Corp.,* 920 S.W.2d 51, 54 (Ky. 1996) ("it is not the function of the judiciary to change the obligations of a contract which the parties have seen fit to make.").

Kentucky law requires production in paying quantities and the place of production is the wellhead. Production of natural gas which is not merchantable at the wellhead is not sufficient to perpetuate the Leases once in their Extended Terms. As noted in the preceding section, an oil and gas lease is construed most strongly against the lessee, which "is particularly reasonable and appropriate where the question is whether a lease is or is not in existence." *Greer v. Salmon,* 479 P.2d 294, 299 (N.M. 1970).

CONCLUSION

For the reasons set forth above, MHP is not permitted to deduct gathering, compression and treatment expenses in the calculation and payment of gas royalties to the Bakers and Jacksons based on the "market price at the well." *Poplar Creek* did not correctly apply Kentucky law and should not be followed. The dismissal of Count I for failure to state a claim should be REVERSED. With the reversal of Count I, the ruling on Count IV is rendered MOOT. Alternatively, should the Court affirm the dismissal of Count I, the production of gas that is not marketable at the wellhead is not sufficient to perpetuate the Leases in their Extended Term, and the dismissal of Count IV for failure to state a claim should be REVERSED.

Respectfully submitted,

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APPENDIX

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