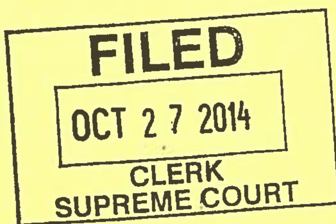

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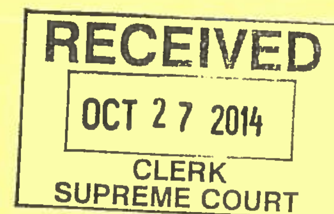

NOBE BAKER, INDIVIDUALLY AND AS ADMINISTRATOR OF THE ESTATE OF JOANN BAKER, ET AL — **APPELLANTS**

v.

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

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CERTIFICATE OF SERVICE

This is to certify that a true and correct copy of this Reply 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; Karen J. Greenwell and G. Brian Wells, Wyatt, Tarrant & Combs, 250 West Main Street, Suite 1600, Lexington, Kentucky 40507, Counsel for Kentucky Oil and Gas Association, Inc.; James L. Hamilton, Hamilton & Stevens, PLLC, P.O. Box 1286, Pikeville, Kentucky 41502 and J. Curtis Edmondson, Law Offices of J. Curtis Edmondson, 3699 NW John Olsen Place, Hillsboro, Oregon 97124, Counsel for National Association of Royalty Owners on this the 24th day of October, 2014. I further certify that ten (10) copies of this Reply Brief have been sent via FedEx to Susan Stokley, Clerk, Supreme Court of Kentucky, Capitol Building, 700 Capitol Ave., Room 209, Frankfort, KY 40601.

COUNSEL FOR APPELLANTS

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Posture of the Case

Discretionary review was sought and granted by this Court. The Bakers and Jacksons filed their initial brief ("Brief"). Kentucky Oil and Gas Association ("KOGA") and National Association of Royalty Owners ("NARO") each sought, obtained leave and filed a brief as an amici curiae. MHP has filed its response ("Response"), and the Bakers and Jacksons now file their reply to the KOGA brief and the MHP Response ("Reply").

I. Kentucky Courts Uniformly Hold Gas Royalties Are Payable on a Marketable Product

MHP and KOGA expend much of their written words on the ills that would befall the landowner if royalties are required to be paid on a marketable product. Yet, neither cites a case decided by the Kentucky courts where the landowner royalties were paid on anything other than a marketable product at or in vicinity of the wellside.

MHP and KOGA also utilize pages of rhetoric in discussion of the work back method to arrive at market price at the well. However, MHP and KOGA are unable to cite a single case decided by Kentucky courts where the work back method was used to reach market price at the well for gas. Neither MHP nor KOGA cites a case where the Kentucky courts even discuss the work back method in a non-statutory setting.[1]

Notwithstanding this dearth of authority, MHP (p. 5) states that Kentucky law "has always been that the calculation of "market price at the well" works **backwards** from (1) the sales price received wherever the market for gas exists, (2) and **subtracts** what it costs

1 In *Cumberland Pipe Line Co v. Commonwealth*, 15 S.W.2d 285 (Ky. 1929), the high court reviewed a tax imposed upon the market value of crude petroleum. Market value was to be assessed where the crude petroleum entered the pipeline to market. With no sale at the wellhead, the act mandated that transportation charges should be taken into consideration. The crude petroleum was sold at the terminus of the pipeline, and the pipeline transportation charges were deducted to reach the market value ("statutory work back"). *Cumberland Pipe Line* equates market value at the marketable pipeline with market value at the well.

to get it there" (the "work back method"). (Emphasis in original.) MHP then offers an example which deducts gathering, treating and compressing as part of the "costs to get it there." KOGA (p. 1) mischaracterizes the Kentucky law somewhat less and insists that this work back method has been the law since the 1920s.

In support, MHP and KOGA offer *Cumberland Pipe Line* where the crude petroleum was in marketable condition when it entered the pipeline to market, and the statute mandated deduction for transportation charges. MHP and KOGA each reference *Warfield, Rains* and *Reed,* where the gas was in marketable condition prior to being transported to the market; the gas royalties in each case were paid based on a marketable product at the wellside and transportation was not a part of the royalty calculation.

Neither MHP nor KOGA cites a Kentucky case which sanctions the deduction (or work-back) of transportation of an unmarketable product. Yet, MHP and KOGA make a giant leap, without the aid of logic, and maintain *Cumberland Pipe Line* and the above three Kentucky gas cases are persuasive authority for the deduction of gathering, compression and treatment which are necessary to achieve a marketable product. The MHP leap goes further, again sans logic, and it makes the outlandish assertion (pp. 21-23) that under the doctrine of *stare decisis* this Court must follow the "at the well" approach.

All this hyperbole and over reach - and counsel can cite only one case decided by the Kentucky courts which allows the statutorily imposed deduction for transportation of a marketable product.

II. Post-Production Costs Borne by Lessees Prior to Gas Deregulation

MHP (p. 32-34) and KOGA (p. 13) argue that a construction of "market value at the well" which would obligate the lessee to pay royalty on marketable gas would

"significantly impair" the State's oil and gas industry and would be "against public policy" contrary to the dictates of KRS 353.500(1).[2] To determine if this criticism is well-founded, Appellants' position should be viewed in historical perspective.

The basic document in the oil and gas industry which authorizes the lessee to enter upon the described premises to search for oil and gas is the lease. See generally, Pierce, *Rethinking the Oil and Gas Lease*, 22 Tulsa Law Review 445 (1987). Virtually all of the production of oil and gas is from lands which are leased. *Id.* Very few of the landowners have the expertise or financial wherewithal to drill and produce oil and gas on their lands. *Id.* Without a lease the oil and gas companies would have no legal vehicle for the exploration and development of oil and gas. *Id.*

The common practice is for the oil and gas companies to select an area, prepare the lease form to be used and send in land agents to acquire leases on a selected area. *Bettman v. Harness,* 26 S.E. 271, 276 (W.Va. 1896). This was followed in the instant case.

The KOGA brief (p. 9) correctly states "today there is generally no field [wellhead] price for gas ...." Prior to the 1980s and early 1990s when deregulation of the gas industry was ultimately accomplished, gas was sold at the wellhead and the lessee absorbed "most post-wellhead costs." *Clough v. Williams Production RMT Company,* 179 P.3d 32, 36 (Colo. App. 2007). In Kentucky during the pre-regulation period, these post-wellhead or post-production costs, with the exception of transportation of marketable gas, were borne entirely by the lessee. *Reed,* 287 S.W.2d at 914. In *Reed,* the court equates "fair market

2 Kentucky government still consists of three separate but equal branches. Kentucky Constitution, Sec. 27. Section 28 specifically prohibits one branch from exercising any power over the other except as permitted elsewhere in the Constitution. Judicial enforcement of legislated public policy is not one of the exceptions. "Development of the common law is a judicial function and should not be confused with the expression of public policy by the legislature." *Giuliani v. Guiler,* 951 S.W.2d 318, 319 (Ky. 1997).

value of gas" at the entry of the pipeline to Salyersville without deduction for gathering, compression or treatment with "fair market value of gas at the well." See, also, *Rains v. Kentucky Gas Co.*, 255 S.W. 121 (Ky. 1923), and *Warfield Natural Gas Co. v. Allen*, 88 S.W.2d 989 (Ky. 1935), where in each instance gas was sold at or in the vicinity of the wellhead and the landowner royalties were calculated and paid without deduction for gathering, compression or treatment.

When deregulation hit the gas industry, gas was no longer sold at the wellhead. *Clough, supra.* Despite the industry change of sales location, the KOGA brief (p.1) notes the royalty provisions generally have remained the same "[f]or many decades." For example, *Poplar Creek*, 636 F.3d at 238, involved a 1951 lease with a royalty based upon the "market value of such gas at the well ...." *Wood v. TXO Production Corp.*, 854 P.2d 880 (Ok. 1992), reviewed two 1978 leases with a royalty on "the market price at the well for gas ...." In the instant case, the 2004 Baker and Jackson Leases both provide for royalty based upon the "market price at the well for gas ...."

The royalty provision in the Leases of Appellants is the same used in pre-deregulation leases when the lessee paid post-production costs (except for transportation). Despite the use of the same lease language, KOGA (p. 12) indicates an adverse decision "would call into question millions of other oil and gas leases with similar language."

Notwithstanding past industry custom and usage,[3] KOGA and MHP argue that an interpretation of this pre-deregulation form of lease NOW requires the lessor to pay his pro-rata share of all post-production costs necessary to achieve a marketable product.

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3 Kentucky recognizes that "any usage of trade" may be competent to explain any ambiguities in a contract. *Martin v. Ben P. Eubank Lumber Company*, 395 S.W.2d 385, 386 (Ky. 1965); *Brooks v. The Lexington-Fayette Urban County Housing Authority*, 132 S.W.3d 790, 800 (Ky. 2004).

Unless this Court sanctions an about face to the demonstrated understanding of "market price at the well for gas," MHP and KOGA claim it will have a "devastating effect," "significantly impair" the industry and destroy settled property rights.[4] The MHP and KOGA approach has all the consistency of a weathervane and lacks only credibility.

III. Implied Covenant to Market Obligates Lessee to Provide Marketable Product

MHP (p. 18 *et seq*) and KOGA (p. 12) point out that a number of other jurisdictions have adopted the "at the well" rule and hold that the "market price at the well" is calculated by working back from the sales price at the market and deducting gathering, compression and treatment (in addition to transportation). There is a marked difference between the underlying law recognized in such jurisdictions and Kentucky, and it is noted by the Colorado Supreme Court in *Rogers v. Westerman Farm Co.*, 29 P.3d 887, 901 (2001):

> these jurisdictions fail to recognize that the implied covenant to market controls the lessee's duty to make the gas marketable. Instead, these jurisdictions have adopted the rule that the lessee's duty has ended once the gas is severed from the wellhead, and thus, any costs incurred subsequent to that physical removal are to be shared by the parties.

Contrary to the position and cases cited by MHP and KOGA, Kentucky for more than 85 years has recognized the implied covenant to market obligates the lessee to provide a marketable product. In *Carroll Gas & Oil Co. v. Skaggs,* 21 S.W.2d 445, 447 (Ky. 1929), the court approves the rule in a quote from Summers, the *Law of Oil and Gas,* page 420, Sec. 131:

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4 In the instant case, any devastation or impairment is self-induced – the 2004 Baker and Jackson Leases were both prepared by the Vice President, Acquisitions and Legal Affairs, for the lessee. The royalty language of the Leases could have been revised to reflect the industry change where natural gas is no longer sold at the wellhead. Equity dictates that between two innocent parties, "he must suffer, who by his acts or laches, has made a loss possible." *Tile House, Inc. v. Cumberland Federal Savings Bank,* 942 S.W.2d 904, 906 (Ky. 1997) (quoting from *Akers v. Cushman Construction Co., Inc.*, 487 S.W.2d 60 (Ky. 1972)).

> An oil and gas lease may, in general terms, expressly state that the lessee is under a duty to market the oil and gas found in the land. In the absence of such a provision, there is an implied duty of the lessee to market the product, in order that the lessee may realize the principal consideration of the lease; that is, the royalties.

To the same effect, see *Hails v. Johnson,* 263 S.W. 679, 680 (Ky. 1924). One thing is for certain, if the product is not in marketable condition, it cannot be sold. *Carroll Gas & Oil* and *Hails* make quite clear that it is the obligation of the lessee to market a salable product. *Warfield Natural Gas Co. v. Allen,* 88 S.W.2d 989, 991 (Ky. 1935), fully supports *Carroll Gas & Oil* and *Hails.* In *Warfield,* the Kentucky high court held that the landowner was entitled to a royalty based upon the sale of marketable gas in the vicinity of the wellside. The *Warfield* opinion reflects that no deductions were permitted from the $.12 per mcf sales price for gathering, compression, treatment or anything else.

KOGA acknowledges (pp. 9-11) the *Warfield* landowner bore no post-production costs and then asserts the landowner did not "receive any of the higher sales price achieved by those costs." There is nothing in *Warfield* which in any way suggests the landowner did not benefit from the increased sales price resulting from gathering, compression and treatment. This KOGA statement is *contra* to the conditions which commonly exist in the gas industry. In *Merritt v. Southwestern Electric Power Co.,* 499 So.2d 210, 213 (La.App. 1986), cited by KOGA (p. 12) and MHP (p. 3), the court concludes: "Thus, gas was useless and had no market value at the wellhead until it could be moved into the gathering line by compression." See, also, *ConocoPhillips, Inc. v. Lyons,* 299 P.3d 844, 849 (N.M. 2012), where the State high court discusses 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 and treating the gas.

The gas in *Warfield* was merchantable, otherwise it could not have been bought and sold. The *Warfield* court makes quite clear who is to bear the cost of providing a marketable product that can be bought and sold:

> Defendant [lessee] had the exclusive right to produce and 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 certainly gets the lion's share.

Warfield, 88 S.W.2d at 991.

The Supreme Courts of Colorado and West Virginia both cite *Warfield* for the proposition that the lessee bears the cost of compliance with the implied covenant to market the gas. *Garman v. Conoco, Inc.*, 886 P.2d 652, 659 (Colo. 1994); *Wellman v. Energy Resources, Inc.*, 557 S.E.2d 254, 264 (W.Va. 2001).

Poplar Creek correctly points out that the jurisdictions which recognize the implied covenant to market are in agreement that such covenant imposes upon the lessee the duty to make the gas marketable. *Poplar Creek*, 636 F.3d at 240. Notwithstanding that *Poplar Creek* declined to discuss the Kentucky adherence to this covenant, *Warfield*, *Carroll Gas & Oil*, and *Hails* confirm that Kentucky recognizes and follows this covenant to provide a marketable product.

IV. Implied Covenant to Market Not in Conflict with Royalty Clause

MHP (p. 24-25) and KOGA (p. 11-12) urge that the implied covenant to market enunciated in *Warfield* does not apply in the instant case because it is inconsistent with an express provision of the Leases – "at the well." In support, KOGA (p. 11) cites *Swiss Oil Corp. v. Riggsby*, 67 S.W.2d 30, 34 (Ky. 1933), and other cases for the general proposition

that an implied covenant must yield to an express covenant. *Swiss Oil* sets forth limitations of this rule which prevent its application in the instant case:

> The rule applies only where the express and the asserted implied provisions **relate to the same subject-matter or some particular part thereof,** and there is a conflict, in which case the express agreement would supersede the implied one. It is otherwise when there is no conflict. (Emphasis added.)

The express provision "at the well" is a part of the gas royalty provision whereby a royalty is to be paid the landowner based on "market price of gas at the well ... ." The implied covenant obligates the lessee to provide a product which can be marketed (bought and sold). In no way do the covenants relate to the same subject matter - one relates to the payment of the landowner royalties and the other relates to the operating requirements of the lessee.[5] "At the well" does not prevent the application of Kentucky's long recognized implied covenant to place the product in marketable condition.

V. "Market Price at the Well" Requires a Marketable Product

If the Baker and Jackson Leases did not intend for the gas royalty to be based on a product that could be bought and sold in the marketplace, they would have used some term other than "market price at the well." MHP does not take issue with the cases cited in support of the initial argument that the plain meaning of "market price at the well" requires that gas royalty be paid on gas that is in marketable condition.

Instead, MHP (p. 27) contends that the flaw in the logic of the Appellants is confusion between market and marketable product. MHP states correctly that many natural resources require valuation to occur elsewhere because the market is elsewhere. In support,

[5] In *Carroll Gas & Oil Co. v. Skaggs*, 21 S.W.2d 445, 447 (Ky. 1929), a case cited by KOGA (p. 11), the court points out the required relationship between the implied and expressed covenants: "An oil and gas lease may, in general terms, expressly state that the lessee is under a duty to market the oil and gas found in the land. In the absence of such a provision, there is an implied duty to market the product ... ."

MHP cites *Cumberland Pipe Line.* The logic in the MHP argument is de-railed by fact that in *Cumberland Pipe Line,* and the cases upon which it is premised, *Campbellsville Lumber* and *Log Mountain Coal,* the product was in marketable condition before it was transported to the markets. This is also true for *Warfield, Reed* and *Rains* - in each instance the gas was in marketable condition before it was transported to the market. MHP fails to cite any Kentucky authority which permits the deduction of gathering, compression or treatment in the calculation of market price at the well for gas.[6]

In the instant case, the gas is not marketable at the wellhead.[7] Once a marketable product is obtained, the Bakers and Jacksons have never contested the deduction of reasonable transportation to the market.[8]

VI. Transportation Does Not Include Gathering, Compression or Treatment

MHP (p. 8) and KOGA (p. 5-6) both make reference to the statement set forth in *Poplar Creek* that "[w]e fail to see, however, how gathering, compression and treatment are materially distinguishable from 'transportation costs.'" 636 F.3d at 245. *Poplar Creek* does not cite any precedent from Kentucky[9] or elsewhere in support of its failed observation and neither does MHP or KOGA.

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6 Apparently, MHP relies on the definition of "market value at the well" from Black's which indicates that transportation and processing may be deducted. Such definition is contradicted by Merriam-Webster Dictionary which defines "wellhead price" as "the price less transportation charges by the producer …."

7 MHP suggests that the gas in the instant case has market value ((p. 27) which is contrary to its earlier assertion (p. 3) that gas is useless at the wellhead, citing *Merritt v. Southwestern Electric Power Co.*

8 In what can only be described as a fabrication of Appellants' position," MHP makes the statement (p. 7) that Appellants now concede that transportation of a marketable product should be shared ratably by the parties. The position of the Appellants on this point has been consistent throughout this litigation. See, i.e., Brief of Appellants in the Court of Appeals (pp. 5-6).

9 MHP and KOGA fail to reference *Cumberland Pipe Line* where a 1% tax was imposed on the "market value of all crude petroleum" where it was first transported from the storage tanks to the pipeline to market. In making the tax assessment, the tax commission under Section 6 of the act was required to "take into

The initial Brief (pp. 18-19) sets forth case precedent and other authority that gathering, compression and treatment are not part of "transportation costs" – this precedent and authority remain unchallenged. In our system of jurisprudence, past precedent has not been replaced by failed observation. The U.S. Supreme Court points out that *stare decisis* permits society to presume that legal principles "are founded in the law rather than in the proclivities of individuals ... .", *Vasquez v. Hillery*, 474 U.S. 254, 265-66, 106 S.Ct. 617, 88 L.Ed.2d 598 (1986), because consistency promotes "efficiency, fairness and legitimacy." *Weiner v. Wasson*, 900 S.W.2d 316, 320 (Tex. 1995).

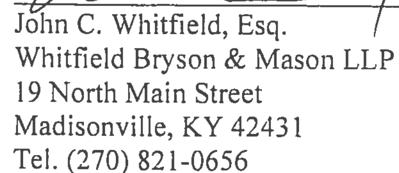
VII. Quality of Production at Well Not Sufficient to Perpetuate Leases

In response to requirement that production at the well must be in marketable condition to extend the Leases, MHP cites a factually different case, *Blackmon v. XTO Energy*, 276 S.W.3d 600 (Tex.App.2008), which allows a well to be shut-in (and the lease extended) if it is "capable of producing in paying quantities."[10]

Conclusion

For the reasons set forth in the Brief and above, the Court of Appeals should be reversed and MHP should be prohibited from the deduction of gathering, compression and treatment in the calculation and payment of royalties due the Bakers and Jacksons based upon the market price of gas at the well.

Respectfully submitted,



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consideration transportation charges." Despite the fact that the crude petroleum was gathered from the wellhead to the storage tanks and to the pipeline to market, there was no deduction for gathering.

10 In Kentucky, the term or habendum clause prevails over the shut-in gas clause. *Vaughn v. Hearell*, 347 S.W.2d 542, 545 (Ky. 1961).