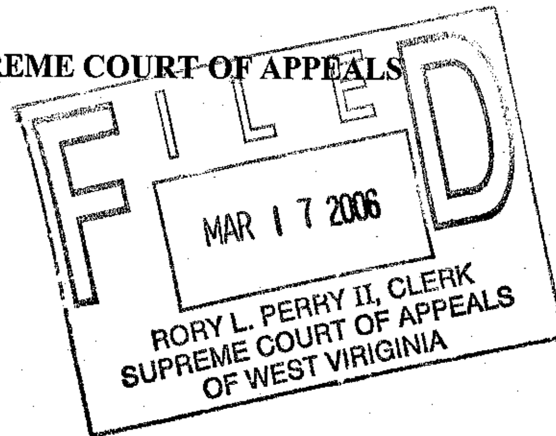
BEFORE THE WEST VIRGINIA SUPREME COURT OF APPEALS



ESTATE OF GARRISON G. TAWNEY, by LELA ANN GOFF, Executrix, LELA ANN GOFF and VERNON B. GOFF, husband and wife, JANICE E. COOPER and CLIFFORD R. COOPER, husband and wife, LARRY G. PARKER, JOHN W. PARKER, RICHARD L. ASHLEY, MYRTLE JONES, by her Attorney-in-Fact, ORTON A. JONES,

Plaintiffs,

v. No. 32966

COLUMBIA NATURAL RESOURCES, LLC, f/k/a COLUMBIA NATURAL RESOURCES, INC., a Texas corporation.

Defendants.

BRIEF OF AMICUS CURIAE, WEST VIRGINA OIL AND NATURAL GAS ASSOCIATION, IN SUPPORT OF COLUMBIA NATURAL RESOURCES

March 17, 2006

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I. WVONGA'S INTEREST IN THE CERTIFIED QUESTIONS

The West Virginia Oil and Natural Gas Association ("WVONGA"), chartered in 1915, is one of the oldest trade associations in West Virginia and is the only association that serves the entire oil and gas industry. WVONGA members are engaged in exploration, production, gathering, processing, transmission, storage, sales and distribution of natural gas. WVONGA's members employ thousands of people across the state, own about 20,000 oil and gas wells, and have thousands of miles of natural gas pipelines across the state. [1]

Columbia Natural Resources ("CNR") is merely one of WVONGA's producer members who will be adversely affected by the law applied by the Circuit Court of Roane County regarding the deductibility of post-production expenses in oil and gas leases. Other producers in the state undoubtedly have entered into oil and gas leases containing provisions calling for royalties to be calculated "at the wellhead," "at the well," "beyond the wellhead," etc., under which those producers too have taken deductions for the lessor's proportionate share of post-production expenses. WVONGA is concerned that if the Plaintiffs prevail on the certified questions, not only will the 2,258 leases at issue in this matter be affected, but thousands more held by landowners and oil and gas producers across the state could also be affected. Indeed, the lower court's adoption of Rogers v. Westerman, 29 P.3d 887 (Colo. 2001), represents a significant departure from existing West Virginia law regarding the deductibility of post-production expenses. For these reasons, WVONGA hereby joins in CNR's Brief on Certified Questions and further offers the following arguments in support of CNR's position.

II. THE CERTIFIED QUESTIONS

The Circuit Court asked the West Virginia Supreme Court of Appeals to review two certified questions regarding the deductibility of post-production expenses. The first question posed to the Supreme Court states

[1] On November 16, 2005, West Virginia Oil and Natural Gas Association filed its Motion for Leave to file a Brief Amicus Curiae. This motion was granted by order of this Court, dated December 15, 2005.

1. Where the royalty language is as set out in Exhibit A, may a lessee of oil and gas in West Virginia deduct money and/or volume from the lessor's 1/8 royalty payments where the lease does not provide specifically that the lessee may take the deductions?

The Circuit Court's second certified question appears to merely reword the first question:

2. Where in an oil and gas lease there is no specific provision allowing for the deduction of post-production expenses does language such as "wholesale market at the well," "amount realized at the well," "net revenue realized," "1/8 of the price," "net of all costs beyond the wellhead," and other language as set forth in Exhibit A, grant to the lessee the right to deduct post-production expenses from the lessor's royalty?

Because the questions certified to the Supreme Court address the same issue, this Brief will address both questions together. Furthermore, WVONGA understands that CNR has requested a reformulation of the certified questions due to (1) the fact that the questions assume that the Supreme Court has adopted Colorado's holding in Rogers v. Westerman Farm Co., 29 P.3d 887 (Colo. 2001); and (2) the fact that it is the denial of CNR's motion for summary judgment upon which the certified questions should be based; therefore, the questions as certified are overly broad. WVONGA agrees with CNR on both points, and it joins in CNR's request for reformulation of the certified questions.

III. POINTS AND AUTHORITIES

1. The West Virginia Supreme Court of Appeals has acknowledged the significance of "at the mouth of the well" language, stating " the language of the leases in the present case indicat[e] that the 'proceeds' shall be from the 'sale of gas as such at the mouth of the well where gas ... is found' might be language indicating that the parties intended that the Wellmans, as lessors, would bear part of the costs of transporting the gas from the

wellhead to the point of sale." Wellman v. Energy Resources, Inc., 210 W. Va. 200, 211, 557 S.E.2d 254, 265 (2001).

2. If an oil and gas lease provides for a royalty based on proceeds received by the lessee, unless the lease provides otherwise, the lessee must bear all costs incurred in exploring for, producing, marketing, and transporting the product to the point of sale. Id. at Syl. pt. 4.
3. It is a basic tenet of contract law that "where the express intention of contracting parties is clear, a contrary intent will not be created by implication." Barn-Chestnut, Inc. v. CFM Development Corp., 193 W.Va. 565, 572, 457 S.E.2d 502, 509 (1995).
4. Where the terms of an oil and gas lease are clear and unambiguous, a court must apply the language as it appears and may not otherwise interpret or construe the terms of the lease. Cotiga Dev. Co. v. United Fuel Gas Co., 147 W.Va. 484, 128 S.E.2d 626 (1963).
5. If an oil and gas lease provides that the lessor shall bear some part of the costs incurred between the wellhead and the point of sale, the lessee shall be entitled to credit for those costs to the extent that they were actually incurred and they were reasonable. Before being entitled to such credit, however, the lessee must prove, by evidence of the type normally developed in legal proceedings requiring an accounting, that he, the lessee, actually incurred such costs and that they were reasonable. Syl. pt. 5, Wellman, 210 W.Va. 200, 557 S.E.2d 254 (2001).
6. Contract provisions "should be so construed, if possible, as to give meaning to every word, phrase and clause and also render all its provisions consistent and harmonious." Henderson Development Co. v. United Fuel Gas Co., 3 S.E.2d 217, 217 (W.Va. 1939).

7. The Supreme Court "will not interpret a contract in a manner that creates an absurd result." Dunbar Fraternal Order of Police, Lodge #119 v. City of Dunbar, 624 S.E.2d 586, 591 (W.Va. 2005), see, also, Ashland Oil, Inc. v. Donahue, 159 W.Va. 463, 223 S.E.2d 433 (1976).

8. A law diminishing an individual's rights should not be applied retroactively. See, e.g., Dalton v. Doe, 208 W. Va. 319, 322, 540 S.E.2d 536, 539 (2000) (holding that an opinion regarding the recovery of uninsured motorists benefits should not be applied retroactively because it represented "a drastic departure" from existing law), Coffman v. West Virginia Board of Regents, 182 W. Va. 73, 386 S.E.2d 1 (1988) (holding that rule requiring employers to notify employees of potential job opportunities would not be applied retroactively because it "would be unfair and would punish the defendant for what might have been an attempt to comply with the law as it existed at the time…").

IV. ARGUMENT

A. THE IMPLIED COVENANT TO MARKET DOES NOT APPLY WHERE "AT THE WELLHEAD" AND SIMILAR ROYALTY LANGUAGE IS PRESENT.

A discussion of the issues to be addressed by the Supreme Court of Appeals must necessarily start with an explanation of the implied covenant to market cited by the Circuit Court of Roane County in its Order of Certification.

In 1964, Kansas held in several cases that oil and gas lessees are alone responsible for costs incurred between the wellhead and the point of sale or to the point at which the gas becomes a "marketable product" in the absence of express contractual language to the contrary. See, Gilmore v. Superior Oil Co., 192 Kan. 388, 388 P.2d 602 (1964), Schupbach v. Continental Oil Co., 193 Kan. 401, 394 P.2d 1 (1964). In the following years, several states followed suit,

also adopting an implied covenant to market, which rendered lessees responsible for post-production expenses where the oil and gas lease did not provide otherwise. See, e.g., Hanna Oil & Gas Co. v. Taylor, 297 Ark. 80, 759 S.W.2d 563 (1988), Garman v. Conoco, Inc., 886 P.2d 652 (Colo. 1994).

In 2001, the West Virginia Supreme Court of Appeals had an opportunity to determine whether it would also imply into oil and gas leases a covenant to market, and in Wellman v. Energy Resources, Inc., 210 W. Va. 200, 557 S.E.2d 254 (2001), the Supreme Court adopted the following rule of law:

> If an oil and gas lease provides for a royalty based on proceeds received by the lessee, unless the lease provides otherwise, the lessee must bear all costs incurred in exploring for, producing, marketing, and transporting the product to the point of sale.

Thus, the Wellman Court also determined that where express language to the contrary could not be found in an oil and gas lease, the lessee has an implied duty to market the gas produced. However, the Wellman Court also made sure that its opinion was known regarding the sufficiency of certain royalty language in allocating post-production expenses despite the newly-adopted implied covenant to market: "at the mouth of the well" language "might be language indicating that the parties intended that the Wellmans, as lessors, would bear part of the costs of transporting the gas from the wellhead to the point of sell." Id. at 211, 265. It is this language that shows the Supreme Court's intention to depart from Colorado, Oklahoma and Kansas courts on the deductibility issue.

1. Colorado's Rogers Opinion Is A Radical Departure From The Implied Covenant To Market Adopted In Wellman And Should Not Be Followed By West Virginia.

Merely a few days before the Wellman opinion was filed, Colorado filed its opinion in Rogers v. Westerman Farm Co., 29 P.3d 887 (Colo. 2001), in which that court expanded the

implied covenant to market beyond those decisions considered by the West Virginia Supreme Court in Wellman. The Rogers Court held that (1) "at the well" and "at the mouth of the well" language is silent with regard to post-production expenses, and (2) the marketable condition rule refers not only to the quality of gas, but also to the location of gas. Importantly, this decision was not considered by the Wellman Court, and the Rogers opinion unquestionably represents an extreme minority position which no other jurisdiction has seen fit to adopt to date. It is the Rogers view that the circuit court in the current matter asks the Supreme Court to adopt. The circuit court asks the Supreme Court to adopt Rogers despite the Wellman Court's express recognition that "at the mouth of the well" language is not silent with regard to the allocation of post-production expenses between the lessor and the lessee, but, in fact, likely calls for a sharing of such expenses. It is likely that the Wellman Court's decision to state its opinion regarding the significance of "at the mouth of the well" language stems from Colorado's extreme position in Rogers issued merely days before Wellman and the Wellman Court's desire to separate itself from this Colorado decision before West Virginia could be said to have whole-heartedly subscribed to the radical Colorado view.

Since Colorado rendered its decision in Rogers, legal scholars have wasted no time in offering a critique of this radical minority view because it goes much further than is necessary or proper to protect the interests of oil and gas lessors. These legal scholars agree that the Rogers Court's attempt to utilize the implied covenant to market to override express language contained in royalty provisions contrary to existing law. The comments of Williams & Meyers are typical of the views expressed by many legal scholars:

> In the marketing covenant, the question generally asked by the courts heretofore has been whether the lessee has *marketed as a prudent operator,* looking to the business judgment standards of other similarly situated prudent operators. The Colorado Supreme Court has taken the implied covenant *to market as a prudent*

> *operator* and made it an independent duty not concerned with whether the operator has acted prudently. What the court has actually done is to create an entirely new implied covenant, an *implied covenant to prepare for market.* In its discussion of "marketability," we believe the court has misunderstood the nature of natural gas marketing and has operated under an assumption that most sales take place in commercial marketing centers to which producers move gas for competitive transactions. As to property law, Colorado has ignored a century of oil and gas law development in which it has been recognized that royalty has come into existence and ownership when oil or gas has been reduced to possession. Royalty has been treated as a cost-free share of production because it does not vest as a corporeal thing until the point of production. It appears that the Colorado Supreme Court has done nothing less than fashion a new rule for the purpose of enhancing royalty values throughout Colorado.

3-6 Williams & Meyers, "The Royalty Clause And Related Provisions," Oil and Gas Law § 645 (2005). Likewise, Thomas Jepperson believes that the Colorado Supreme Court has gone too far in Rogers, stating "Colorado has stepped off the proverbial cliff, creating a 'marketable location' rule that has absolutely nothing to do with the parties' intentions. 24 J. Land Resources & Envtl. L. 323 (2004), 324. Jepperson continues his commentary on Rogers by noting the ironic effect that it could have on the industry's ability to market gas given the fact that the very federal policy changes spurring the move toward the implied covenant to market were implemented to encourage natural gas production. Id.

No criticism of the Rogers decision is quite as compelling, however, as that of Professor Owen L. Anderson. The Rogers Court relied in large part on Professor Anderson in holding that "at the well" and "at the mouth of the well" language is silent with regard to post-production expenses and that the marketable condition rule should be expanded to require that lessees not only bear the expense of bringing gas to a marketable quality, but also of getting gas to a marketable location. Significantly, after the Rogers opinion was published, Professor Anderson wrote to the Rogers court asking it to modify the portion of its opinion citing him in support of its holding because he believed the court had misinterpreted his commentary. Owen L.

Anderson, 2001: A Royalty Odyssey, Institute for Energy Law, 53rd Annual Institute (February 21, 2002). Although the Colorado Supreme Court agreed to modify its reference to Professor Anderson's legal theories, the court did not otherwise change its opinion.

Criticisms such as those shown above, seriously call into question the Colorado Supreme Court's decision to expand the implied covenant to market and to hold that "at the well" and similar royalty language is silent with regard to the allocation of post-production expenses. When considering such criticisms in light of the West Virginia Supreme Court of Appeals' acknowledgment that "at the mouth of the well" might be language calling for the allocation of post-production expenses, the circuit court's determination that West Virginia would likely subscribe to the law as stated in Rogers is unsupported. For this reason, and for the reasons discussed below, the Supreme Court should not adopt Rogers as the law of West Virginia.

2. Implied Covenants Apply Only Where No Language Contrary To The Covenant Is Found In the Lease.

It is a basic tenet of contract law that "where the express intention of contracting parties is clear, a contrary intent will not be created by implication." Barn-Chestnut, Inc. v. CFM Development Corp., 193 W.Va. 565, 572, 457 S.E.2d 502, 509 (1995). This principle applies to covenants implied into oil and gas leases. See, e.g., Croston v. Emax Oil Co., 195 W.Va. 86, 91, 464 S.E.2d 728, 733 (1995) (holding that "in the absence of an express provision to the contrary in a lease, there is an implied covenant in the lease that the lessee will protect lessor's property against substantial drainage"), Thompson Dev., Inc. v. Kroger Co., 186 W. Va. 482, 413 S.E.2d 137 (1991) (noting that the implied covenant of continuous operation is only applied where the covenant is not contrary to the express terms of the lease).

Wellman acknowledged this principle of law in its holding that the implied covenant to market only applies where the lease contains no language indicating that a lessor's proportionate

share of post-production expenses may be deducted from his or her royalty. Pursuant to Wellman and other West Virginia cases regarding implied covenants, the implied covenant of marketability will disallow deductions made by CNR and other oil and gas producers if "at the wellhead" and similar royalty language is insufficient to allocate post-production expenses. As illustrated below, "at the wellhead" and similar royalty language is clear and unambiguous that deductions for post-production expenses may be taken.

3. "At The Well" Is Neither Silent Nor Ambiguous With Regard To The Allocation Of Post-Production Expenses.

Apart from the fact that Exhibit A to the certified questions contains a laundry list of royalty provisions not addressed in CNR's Motion for Summary Judgment, the certified questions posed by the Circuit Court miss the mark – "at the wellhead" and similar language do provide specifically that the lessee may take deductions where gas is sold downstream of the wellhead after expenses have been incurred to increase the value of gas. The significance of "at the wellhead" language has not only been acknowledged by the oil and gas industry, but also by courts throughout the nation. The authorities cited and discussed below illustrate that "at the wellhead" and similar royalty language is neither silent nor ambiguous with regard to the deductibility of post-production expenses. Courts, therefore, must not construe "at the wellhead" language, but simply enforce it.

Where the terms of an oil and gas lease are clear and unambiguous, a court must apply the language as it appears and may not otherwise interpret or construe the terms of the lease. Cotiga Dev. Co. v. United Fuel Gas Co., 147 W.Va. 484, 128 S.E.2d 626 (1963). To be sure, the Supreme Court has stated that "it is not the right or province of the court to alter, pervert or destroy the clear meaning and intent of parties as plainly expressed in their written contract or to make a new and different contract for them." Id. In accordance with this rule, "at the wellhead"

language must be applied and given its clear meaning unless it is found that such language is ambiguous.

Due to the deregulation of the interstate pipeline system, gas is generally no longer sold at the wellhead, but at the point where gas enters into the interstate pipeline system. However, it is after gas comes to the surface at the wellhead that costs are incurred for transportation, gathering, compression, dehydration, etc. ("post-production expenses"). The only logical way to calculate royalties where the lease provides that royalties are expressly calculated "at the wellhead," therefore, is to permit gas lessees to deduct the lessor's proportionate share of post-production expenses from the total price received at the point of sale. To do otherwise is to ignore the presence of "at the wellhead" language in a royalty provision.

A majority of courts have agreed that "at the wellhead" language directs that an oil and gas lessor should receive something less than a portion of the full sales price where gas is sold beyond the wellhead. In Piney Woods Country Life School v. Shell Oil Co., 726 F.2d 225, 231 (5th Cir. 1984), the Fifth Circuit held that deductions for post-production expenses were proper where "at the wellhead" language was used, reasoning

> [T]he purpose is to distinguish between gas sold in the form in which it emerges from the well, and gas to which value is added by transportation away from the well or by processing after the gas is produced. The royalty compensates the lessor for the value of the gas at the well: that is, the value of the gas after the lessee ... produce[s] gas at the surface, but before the lessee adds to the value of this gas by processing or transporting it. When the gas is sold at the well, the parties to the lease accept a good-faith sale price as the measure of value at the well. But when the gas is sold for a price that reflects value added to the gas after production, the sale price will not necessarily reflect the market value of the gas at the well. Accordingly, the lease bases royalty for this gas not on actual proceeds but on market value.

Ten years later, the Eighth Circuit found this reasoning persuasive in holding that where "at the wellhead" language is used, an oil and gas lease expressly calls for the deduction of post-

production expenses for all gas sold beyond the wellhead. Sondrol v. Placid Oil Co., 23 F.3d 1341 (8th Cir. 1994). In 2000, a New Mexico court also expressed its agreement with the Piney Woods Court's reasoning, holding that "at the well" language was sufficient to require the allocation of post-production expenses between a lessor and lessee. Creson v. Amoco Production Co., 129 N.M. 529, 534, 10 P.3d 853, 858 (N.M.App. 2000).

California, Louisiana, Michigan, and Texas have also noted that "at the wellhead" language contemplates the value of gas at the point at which it is brought to the surface, not the sales price after post-production expenses have increased the gas's value. See, e.g., Atlantic Richfield Co. v. State, 214 Cal. App.3d 533, 262 Cal. Rpt. 683, 688 (1989), Merritt v. Southwestern Elec. Power Co., 499 So.2d 210 (La. Ct. App. 2d Cir. 1986), Schroeder v. Terra Energy, Ltd. 223 Mich. App. 176, 565 N.W.2d 887 (Mich. App. 1997), Judice v. Mewbourne Oil Co., 939 S.W.2d 133 (Tex. 1996).

West Virginia has even taken an opportunity to note that the price received by oil and gas lessors "at the wellhead" would be less than that received at the point on sale. See, Cotiga Development Co. v. United Fuel Gas Co., 147 W. Va. 484, 128 S.E.2d 626 (1962) (holding that a provision calling for royalties to be based on the rate received required a proportionate share of the sales price rather than "just the wellhead price"). Thus, the rule of law the Roane County Circuit Court asks the Supreme Court to adopt is in direct conflict with West Virginia law upon which oil and gas producers in the state have relied in drafting their contracts for decades.

Perhaps it was the Supreme Court's earlier decision in Cotiga and the holdings of the many courts cited above that prompted the West Virginia Supreme Court of Appeals to include Syllabus Point 5 in its opinion in Wellman v. Energy Resources, Inc., 210 W. Va. 200, 557 S.E.2d 254 (2001). Syllabus Point 5 directs:

> If an oil and gas lease provides that the lessor shall bear some part of the costs incurred between the wellhead and the point of sale, the lessee shall be entitled to credit for those costs to the extent that they were actually incurred and they were reasonable. Before being entitled to such credit, however, the lessee must prove, by evidence of the type normally developed in legal proceedings requiring an accounting, that he, the lessee, actually incurred such costs and that they were reasonable.

Syl. pt. 5, Wellman, 210 W.Va. 200, 557 S.E.2d 254 (2001). The conclusion that Syllabus Point 5 acknowledges the significance of "at the wellhead" and similar language seems a logical one when read in conjunction with the Supreme Court's statement that "at the mouth of the well" language, "might be language indicating that the parties intended that the Wellmans, as lessors, would bear part of the costs of transporting the gas from the wellhead to the point of sale...," which is found in the body of the Wellman opinion directly after the Court's adoption of the rule of law found in Syllabus Point 5.

Regardless of whether the cases cited above influenced the Supreme Court's holding in Wellman, one thing is clear from the Supreme Court's adoption of Syllabus Point 5: West Virginia intends to hold fast to its long history of giving meaning to all words in written contracts. This rule of construction maintains that contract provisions "should be so construed, if possible, as to give meaning to every word, phrase and clause and also render all its provisions consistent and harmonious." Henderson Development Co. v. United Fuel Gas Co., 3 S.E.2d 217, 217 (W.Va. 1939). In fact, the Supreme Court has stated that it "will not interpret a contract in a manner that creates an absurd result." Dunbar Fraternal Order of Police, Lodge #119 v. City of Dunbar, 624 S.E.2d 586, 591 (W.Va. 2005). See, also, Ashland Oil, Inc. v. Donahue, 159 W.Va. 463, 223 S.E.2d 433 (1976).

The answer to the certified questions that the Circuit Court and the Plaintiffs urge requires the Supreme Court to go against these rules of construction. In particular, the lower

court's suggested adoption of Rogers would require the Supreme Court to overlook the significance of "at the well" and similar royalty language. As discussed above, the Rogers Court, rather than giving any meaning to "at the wellhead" language, simply held that the language was silent as to the deductibility of post-production expenses and then applied the marketable condition and location rule to render the lessee responsible for all post-production expenses to the point of sale. Rogers, 29 P.3d at 899.

The flaw in the Rogers Court's reasoning becomes apparent when applying West Virginia's rules of construction. First, if *every word* is to have meaning in a royalty clause calling for a 1/8 royalty "at the wellhead" or "at the mouth of the wellhead," the "at the wellhead" portion of the royalty provision cannot simply be deemed silent and overlooked. Second, if such language is overlooked, an absurd result occurs – the lessor is entitled to 1/8 royalty at the point of sale. A lease calling for royalties "at the wellhead" is now read to call for royalties at a point a long distance from the wellhead after many expenses have been incurred to enhance the value of the gas after it has left the point named in the provision for valuation.

Because "at the wellhead" and similar royalty language is clear and unambiguous and has been recognized by West Virginia and other states as having express meaning with regard to the allocation of post-production expenses, the Supreme Court should decline the Circuit Court's invitation to adopt the extreme views expressed in Rogers and answer the certified questions in such a manner that allows for the allocation of post-production expenses where "at the wellhead" and similar royalty language is used.

B. EVEN IF "AT THE WELLHEAD" AND SIMILAR LANGUAGE FAILS TO ALLOCATE POST-PRODUCTION EXPENSES ACCORDING TO WELLMAN, DEDUCTIONS TAKEN BEFORE WELLMAN SHOULD NOT BE SUBJECT TO THAT RULE.

WVONGA requests that should the Supreme Court believe that the Wellman Court's adoption of the implied covenant to market prohibits deductions for post-production expenses where "at the wellhead" and similar royalty language is used, the Supreme Court should also find that producers are not liable for deductions made before the Wellman opinion was filed in 2001. As such a holding would constitute a radical departure from existing law regarding the deductibility of post-production expenses in West Virginia and in a majority of states, limiting lessors' ability to collect such deductions to those taken after Wellman was issued would serve to provide oil and gas producers with fair notice of this change. The leases at issue in the current matter reach as far back as 1990, and a decision by the Supreme Court prohibiting deductions where "at the wellhead" and similar language is used would undoubtedly spur future litigation against producers other than CNR reaching at least as far back. Forcing producers across the state to pay for all deductions taken for post-production expenses over a long period of time will no doubt have a devastating impact on the oil and gas industry since all producers have worked for a number of years under the assumption that "at the wellhead" and similar language was clear that deductions could be taken.

Taking such measures is not unprecedented under West Virginia law. West Virginia recognizes that "a statute that diminishes substantive rights or augments substantive liabilities should not be applied retroactively to events completed before the effective date of the statute." Smith v. West Virginia Division of Rehabilitative Services and Division of Personnel, 208 W. Va. 284, 287, 540 S.E.2d 152, 155 (2000). The rule that law diminishing an individual's rights should not be applied retroactively has been applied to law adopted by courts as well. See, e.g., Dalton v. Doe, 208 W. Va. 319, 322, 540 S.E.2d 536, 539 (2000) (holding that an opinion regarding the recovery of uninsured motorists benefits should not be applied retroactively

because it represented "a drastic departure" from existing law), Coffman v. West Virginia Board of Regents, 182 W. Va. 73, 386 S.E.2d 1 (1988) (holding that rule requiring employers to notify employees of potential job opportunities would not be applied retroactively because it "would be unfair and would punish the defendant for what might have been an attempt to comply with the law as it existed at the time…").

The same concern regarding fairness to those who believed they were complying with existing law applies to the current matter as does the concern that the Supreme Court's decision here would be a drastic departure from the law existing before Wellman regarding the deductibility of royalties. For these reasons, WVONGA respectfully requests that should the Supreme Court determine that Wellman prohibits deductions where "at the wellhead" and similar language is used, it should also hold that Wellman will not be applied retroactively to render oil and gas producers liable for deductions taken before the filing of that opinion.

C. PROHIBITION OF DEDUCTIONS FOR POST-PRODUCTION EXPENSES WILL LIKELY HAVE A NEGATIVE IMPACT ON THE OIL AND GAS INDUSTRY.

Aside from the fact that the Rogers decision ignores the significance of "at the wellhead" language, strong public policy concerns favor reading "at the wellhead" and similar language as allocating post-production costs between a gas lessor and lessee. These concerns range from a reduction in the supply of natural gas to higher gas prices for consumers. This is a far-reaching consequence of attempts to provide oil and gas lessors with undeserved windfalls.

Oil and gas lessors participate in the natural gas supply chain only to the extent necessary to grant the lessee the right to explore for and produce natural gas on the lessors' leased premises. Byron C. Keeling and Karolyn King Gillespie, "The First Marketable Produce Doctrine: What is the 'Product?,'" 37 St. Mary's L.J. 1, 95 (2005). Where the lessor does not

assume any risks downstream of the wellhead, including gathering, processing, transporting, and marketing, the lessee alone is saddled with such risks. Where value has been added downstream of the wellhead by the gas lessee, calculating royalties based on prices at the point of sale – without taking any deductions for the lessor's proportionate share of post-production expenses – results in an unwarranted windfall to lessors who have contributed nothing since gas was extracted at the wellhead. See, Judith M. Matlock, "Payment of Gas Royalties in Affiliate Transactions," 48 Inst. On Oil & Gas L. & Tax'n § 9.06[3], 9-46 (1997); John Bratland, "Economic Exchange as the Resquisite Basis for Royalty Ownership of Value Added in Natural Gas Sales," 41 Nat. Resources J. 685, 705-11 (2001).

As a result of failing to require cost-sharing where "at the wellhead" language is used, oil and gas lessees must pay lessors the same amount for gas, whether that gas was or was not suitable for sale at the wellhead. For example, where post-production expenses are not shared, a lessor is entitled to the same amount for sweet gas as it is for gas containing high levels of hydrogen sulfide requiring the lessee to spend additional monies downstream of the wellhead to remove impurities from the gas. Scholars note that this result is irrational and could affect gas prices in areas where costs for post-production activities are not shared. See, e.g., Bratland, at Note 3. Bratland even suggests that royalties on the value added downstream of the wellhead will likely "induce operators to invest less and to waste some of the gas resources that would otherwise be recovered." Id. at 708. Bratland even goes on to state that "[m]arginal, lower quality gas deposits will remain undeveloped because the royalty collected on value added makes the expected net present value of projects either negative or too small to warrant development." Id.

Further, requiring royalty payments on post-production expenses will ultimately encourage the creation of what may be inefficient markets. Lessees would have an incentive to sell their production at the wellhead to purchasers who would take responsibility for processing the gas and transporting it to the interstate pipelines. Keeling and Gillespie at n. 1. A market for such intermediaries could develop if the lessees were able to realize greater net proceeds from selling gas to an intermediary at the wellhead for a discounted price and the price that the intermediary received from selling the gas to a pipeline was sufficient to cover the cost of buying the gas from the lessee, transporting the gas, and processing it. Interposing such intermediaries in the supply chain will inevitably increase the cost of transactions involved in bringing natural gas to the market and inevitably will increase the cost to the end user.

Ultimately, prohibiting deductions for post-production expenses in royalty calculations as urged by Plaintiffs is contrary to the basic principles on which the U.S. natural gas industry has been premised. The Plaintiffs' position relies on a tenuous, vastly expansive interpretation of the implied covenant of a lessee to market gas extracted from a lessor's property. Traditionally, the implied covenant to market required that the lessee market the gas within a reasonable period of time for a reasonable price. Keeling and Gillespie, supra, n.1, 22-25. The covenant gave effect to what a reasonable lessee would do after gas was discovered and produced in sufficient quantities to justify marketing. Id. It was applied only where necessary to fulfill the reasonable expectations of *both* the lessor and lessee, thereby providing a mutual benefit, since a lessee would presumably act to market gas from a productive well. David W. Hardymon, "Adrift on the Implied Covenant to Market: Regulation By Implication," 24 Energy & Min. L. Inst., 249 (2004). Where, as discussed above, courts such as Colorado expand the implied covenant to

market and the first-marketable-product doctrine, a number of other detrimental consequences arise that will likely undermine fundamental energy policy objectives.

First, these approaches would move free market transactions between lessors and lessees "away from property and contract law principles toward regulation." David W. Hardymon, "Adrift on the Implied Covenant to Market: Regulation By Implication," 24 Energy & Min. L. Instit., n. 12 (2004). The intentions of the parties embodied in gas leases would be subverted, after the fact, by an artificial judicial construct – a vastly expanded notion of the implied duty of a lessee with regard to the gas extracted from leased property. Instead of giving force to agreements reached in a market environment, the courts adopting this approach in effect are regulating those transactions in accordance with their own conception of what constitutes a desirable result. However, the courts have no mandate to impose such regulation.

Any such changes should be considered with due deliberation in a legislative process or in a formal regulatory setting pursuant to appropriate legislation. In fact, Wyoming and Nevada have enacted statutes governing royalty calculations. See, Wy. St. §30-5-304 (1977); Nev. St. §522.115(b) (1991). Additionally, the U.S. Mineral Management Service has codified regulations specifying the procedure for determining royalties on oil and gas produced on federal lands. 30 C.F.R. Pt. 202.

Movement away from contract and property principles toward after-the-fact regulation by courts in individual states undermines the fundamental national policy of deregulating natural gas wellhead prices. As discussed above, deregulation was implemented in stages over a twenty-year period after various attempts at regulating wellhead prices proved to be unworkable. The effort to artificially inflate the royalties received by lessors is tantamount to partial re-regulation of those prices. Where this approach is adopted, it interferes with free market forces and will

raise wellhead prices above the levels that would otherwise prevail. Such interference with national energy policy is untenable.

The U.S. is facing shortfalls in natural gas supplies and is also facing the prospect of making up those shortfalls by importing more gas from politically unstable areas. Further, continuation of high natural gas prices is likely to slow down general economic activity. Under these circumstances, it is essential that steps be taken to expand natural gas supplies and moderate the cost of this critical source of energy. However, the Plaintiffs' royalty calculation would have precisely the opposite effect. It would discourage the exploration for and production of natural gas and would drive up natural gas prices.

D. HISTORICAL USE OF WELLHEAD PRICES FOR DETERMINATION.

It is important for the Court to understand that historically the royalty paid under numerous gas leases was calculated based upon a wellhead price. Until the advent of unbundling in 1992, the sale of gas historically occurred at the wellhead and thus the wellhead price was the natural price to use in royalty clauses in gas leases. Large, interstate pipeline companies bought gas at the wellhead and transported the gas for sale to local distribution companies. The interstate pipelines took title to the gas at the wellhead and resold the gas in most instances hundreds of miles away to a local distribution company. For leases requiring royalties based upon wellhead prices, the wellhead price was the sale price from the producers to the pipeline.

With the Federal Energy Regulatory Commission's issuance of Order 636 on April 8, 1992, interstate gas pipelines were required to unbundle their operations and shift away from their traditional role as buyers and sellers of gas to a new role simply as transporter of gas through their interstate pipelines. See generally NorAm Gas Trans. Co. v. F.E.R.C., 148 F.3d 1158, 1159-60 (D.C. Cir. 1998) (discussion of unbundling); United Distr. Cos. v. F.E.R.C., 88

F.3d 1105, 1122-27 (D.C. Cir. 1996) (background history of regulated wellhead prices for sales by producers to pipelines). This unbundling resulted in new buyers of the gas and caused a shift in the point of sale for gas. When producers sold to pipelines, the traditional point of sale was at the wellhead. With unbundling and the change in buyers from pipelines to endusers or gas marketers, the new point of sale became the producers' gathering system interconnect with the interstate pipeline.

This shift in the point of sale required producers to determine a sales price at the wellhead in order to calculate royalties due under leases that provided for payment of a royalty based upon a wellhead price. Many producers calculated this wellhead sales price by deducting post-production expenses from the interconnect sales price to arrive at a sales price at the wellhead. Clearly, the method utilized by CNR of deducting post-production expenses from the interconnect sales price more closely replicates the historical practice of paying royalties based upon the sales price at the wellhead versus the new method sought by the Plaintiffs to use the sales price at the interstate pipeline interconnect.

Under numerous historical leases, royalties were calculated based upon wellhead prices. This method was utilized because the wellhead was the point of sale and a wellhead price was readily available. For decades, the wellhead price was regulated by the federal government. Regulation of gas prices at the wellhead began with the Natural Gas Act of 1938[1] and the Supreme Court's ruling in Phillip's Petroleum Co. v. Wisconsin, 347 U.S. 672 (1954). In Phillips, the Court determined that the Federal Power Commission ("FPC") had both the authority and duty to regulate natural gas prices at the wellhead. See Penniman, "Natural Gas Pricing Regulation: The Market Ordering Problem," 4 Eastern Min. L. Inst. ch. 18 (1985);

[1] 15 U.S.C.A. §§ 717-717w.

Pierce, "Natural Gas Regulation, Deregulation, and Contracts," 68 Va. L. Rev. 63 (1982). For the next 25 to 40 years, depending upon the type of wells, the FPC or its successor, the Federal Energy Regulatory Commission ("FERC"), set prices for interstate gas sales at the wellhead under either the Natural Gas Act of 1938 or the Natural Gas Policy Act of 1978 ("NGPA").[2]

With the passage of the NGPA came the deregulation of wellhead prices and ultimately the FERC mandate in Order 636[3] that pipelines no longer act as buyers and sellers of gas but instead serve solely as transporters. Producers no longer sold their gas to pipelines at a regulated wellhead price. Instead, most producers began selling to endusers or gas marketers at a point downstream from the well where the gas entered interstate pipelines. This point is known as the interconnect to the interstate pipeline and is often miles from the wellhead. The resulting shift in the producer's point of sale from the wellhead to the interconnect with interstate pipeline required a determination of the actual wellhead price for leases that provided for payment of royalty based upon wellhead prices. Accordingly, producers began deducting the post-production expenses from the interconnect sales price to arrive at a wellhead price - the same result achieved for decades under regulated wellhead pricing. The position urged by CNR achieves a continuity of this historical practice accepted by numerous lessors for years throughout West Virginia.

V. CONCLUSION

For the foregoing reasons, WVONGA hereby respectfully requests that the West Virginia Supreme Court of Appeals answer both certified questions in a manner allowing for the deduction of post-production expenses where "at the wellhead" and similar royalty language is

[2]15 U.S.C.A. §§ 3301-3432.

[3]F.E.R.C. Stats. & Regs. (CCH) para. 30, 939 (1992).

used. In the alternative, WVONGA requests that any prohibition on deductions where "at the wellhead" or similar language is used, which this Court believes is based on the Wellman decision, not be applied retroactively, but that producers such as CNR are only responsible for the repayment of deductions taken after the issuance of Wellman.

Respectfully submitted,

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BEFORE THE WEST VIRGINIA SUPREME COURT OF APPEALS

ESTATE OF GARRISON G. TAWNEY, by LELA ANN GOFF, Executrix, LELA ANN GOFF and VERNON B. GOFF, husband and wife, JANICE E. COOPER and CLIFFORD R. COOPER, husband and wife, LARRY G. PARKER, JOHN W. PARKER, RICHARD L. ASHLEY, MYRTLE JONES, by her Attorney-in-Fact, ORTON A. JONES,

Plaintiffs,

v. **No. 32966**

COLUMBIA NATURAL RESOURCES, LLC, f/k/a COLUMBIA NATURAL RESOURCES, INC., a Texas corporation.

Defendants.

CERTIFICATE OF SERVICE

I, Richard L. Gottlieb, Counsel for The West Virginia Oil and Natural Gas Association, does hereby certify that on this 17th day of March, the foregoing **Brief of *Amicus Curiae*, West Virginia Oil and Natural Gas Association, in Support of Columbia Natural Resources** was served upon all parties of record, by placing the same in the United States Mail, postage pre-paid, to the following:

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