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STATE OF NORTH DAKOTA

IN THE SUPREME COURT
STATE OF NORTH DAKOTA

Newfield Exploration Company, Newfield Production Company, and Newfield RMI LLC, Plaintiffs-Appellees, v. State of North Dakota, ex rel. the North Dakota Board of University and School Lands, and the Office of the Commissioner of University and School Lands, a/k/a the North Dakota Department of Trust Lands, Defendants-Appellants.	20190088 Supreme Court No. ~~20190063~~

Appeal from a Judgment, Entered March 1, 2019, and the underlying
Opinion, Dated February 14, 2019,
Case No. 27-2018-CV-00143
County of McKenzie, Northwest Judicial District
The Honorable Robin A. Schmidt, District Judge, Presiding

BRIEF OF APPELLEES

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STATEMENT OF ISSUES

[¶ 1] Plaintiffs-Appellees Newfield Exploration Company, Newfield Production Company, and Newfield RMI LLC (collectively, "Newfield") agree with the statement of issues set forth in brief of Defendants-Appellants State of North Dakota, ex rel. the North Dakota Board of University and School Lands (the "Board"), and the Office of the Commissioner of University and School Lands, a/k/a the North Dakota Department of Trust Lands (the "Department") (collectively, the "State").

STATEMENT OF THE CASE

[¶ 2] Newfield agrees with the statement of the case set forth in the State's brief.

STATEMENT OF FACTS

I. The Department's Leasing of Oil and Gas Interests

[¶ 3] Pursuant to N.D.C.C. § 15-05-09, the State has established rules for the leasing of oil and gas located on the Trust Lands. *See* Appendix to Brief of Appellants ("App.") 9, 17–20. The Department's rules for leasing of oil and gas govern the form and terms of any oil and gas lease agreement entered into by the Department. *Id.* at 18. The Department's website also contains guidance specifically regarding the payment of royalties. In a document entitled "Frequently Asked Questions," the Department answers the question "What deductions are allowed on oil?" as follows:

> Royalty on oil is calculated based on the greater of 1) the highest posted price for the field where produced and when run, 2) the highest market price paid for the area where produced and when run, or 3) the gross proceeds of sale.
>
> Gross proceeds of sale means income before deduction of expenses. Basically it means the price you sell the oil for, regardless of what expenses go into arriving at that price. For example, if you transport the oil to an off-lease location for sale and delivery, the royalty is calculated

> based on the gross price you receive at the ultimate point of sale and delivery. In this example you may NOT deduct or "net out" the expenses incurred in transporting the oil to the ultimate point of sale and delivery.

Id. at 21–22. The Department then goes on to answer the question "What deductions are allowed on gas?" as follows:

> Royalty on gas is calculated based on the gross proceeds of sale, where the sale constitutes an arm's length transaction. For a description of what gross proceeds of sale means see "What deductions are allowed on oil." If a sale of gas does not constitute an arm's length transaction, Board of University and School Lands Oil & Gas Rule 85-06-06-08 governs calculation of royalties.

Id. at 22.

II. The Department's Lease Form

[¶ 4] Since 1979, the Board has required the use of a standard Oil and Gas Lease form (the "Lease Form") for all leases of oil and gas located on the Trust Lands. *Id.* at 26–27.

[¶ 5] The Lease Form includes the following gas royalty provisions:

> Lessee agrees to pay lessor the royalty on any gas, produced and marketed, based on gross production or the market value thereof, at the option of the lessor, such value to be based on gross proceeds of sale where such sale constitutes an arm's length transaction.
>
> . . . .
>
> All royalties on oil, gas, carbon black, sulphur, or any other products shall be payable on an amount equal to the full value of all consideration for such products in whatever form or forms, which directly or indirectly compensates, credits, or benefits lessee.

Id. at 26. The oil and gas lease agreements to which the State is a party and in which Newfield has an interest (collectively, the "Newfield Leases") were drafted by the Department based on the Form Lease. *Id.* at 12. As in the district court, Newfield's analysis refers to provisions of the Form Lease with the understanding that such references and analysis apply equally to all the Newfield Leases.

III. The Department's Audit of Newfield's Oil and Gas Activity on Trust Lands

[¶ 6] At some time during the years 2015 and 2016 the Department conducted an audit of Newfield's oil and gas activities on certain Trust Lands relating to certain wells operated by Newfield. *Id.* at 12, 43. Newfield provided the Department full access to the information necessary for the audit including its marketing contracts with third-party purchasers. *See* Appendix of Appellees ("Newfield App.) 16.

[¶ 7] On January 5, 2017, the Department sent a letter to Newfield indicating that, as a result of its audit, the Department believed Newfield had incorrectly calculated the gas royalties payable to the Department. *See* App. 28. The Department based this belief on its comparison of revenues reported in gas plant statements with royalties received by the Department. *Id.* As a result of the audit, the Department claimed that Newfield had underpaid its royalties for the time period covered by the audit. *Id.* Discussions between the Department and Newfield concerning the results of the audit continued throughout the year, but the dispute over payment of royalties was not resolved. *See id.* at 37–40; Newfield App. 1–17.

IV. Newfield's Gas Purchase Agreements

[¶ 8] Newfield has entered into Gas Purchase Agreements (the "Gas Purchase Agreements") with an unaffiliated third-party purchaser, Oneok Rockies Midstream, L.L.C. ("Oneok"), under which Newfield sells gas production from various wells, including wells located on the Trust Lands, to Oneok for 70%, 77.5%, or 80%, as applicable, of the net proceeds received by Oneok from Oneok's sale of the residue gas and natural gas liquids derived from the gas Oneok purchases from Newfield. *See* Newfield App. 18–71.[1]; *see also* App. 37–39; Newfield App. 16–17. The gas royalties paid by Newfield to the Department are based on the amounts Newfield receives from Oneok, without deduction therefrom by Newfield. *See* App. 37–38; Newfield App. 17. Oneok is unaffiliated with Newfield, and their economic interests with respect to the sales of gas at issue in this action are adverse. *See* App. 37–38; Newfield App. 17.

[¶ 9] The material terms and circumstances of these Gas Purchase Agreements are undisputed. The Gas Purchase Agreements constitute arms-length transactions between unaffiliated parties. The Gas Purchase Agreements were entered into for the purpose of selling "Gas". *See* Newfield App. 20, 49. "Gas" is defined as "natural gas as produced from [one or more of Newfield's wells] in its natural state." *See id.* at 33, 50. The Gas Purchase Agreements contemplate payment of consideration by Oneok to Newfield for the purchase of Gas produced by Newfield, and such consideration is to be calculated according to the provisions of Exhibit A to the Gas Purchase Agreements. *See id.* at 20, 49.

[¶ 10] Title, possession, and control of Newfield's Gas passes from Newfield to Oneok at Oneok's "Receipt Point(s)." *See id.* at 20, 51. "Receipt Point" is defined as "the inlet flange of [Oneok's] or [Oneok's] designee's pipeline facilities installed to take deliveries of Gas from [Newfield]." *See id.* at 34, 51. It is undisputed that Oneok does not gather, process, dehydrate, compress, or otherwise perform any service on the Gas prior to acquiring title, possession, and control of the Gas. It is similarly undisputed that

[1] The State included only excerpts from the Gas Purchase Agreements in its appendix. For ease of reference and the convenience of the Court, Newfield has included the Gas Purchase Agreements in their entirety in its appendix.

nothing in the Gas Purchase Agreements indicates that Onoek is agreeing to perform services for Newfield.

[¶ 11] The State appears to argue that the Gas Purchase Agreements actually require Newfield to make payments to Oneok. Specifically, the State cites an amendment to the Gas Purchase Agreements' Exhibit A, which characterizes a deduction from the total amount payable to Newfield as "consideration payable" by Newfield to Oneok. *See* Brief of Appellants, ¶¶ 16–17. The State did not discuss this provision in any of its briefs or its oral argument before the district court, much less argue as it does now that this amendment changed the Gas Purchase Agreements into service contracts. Accordingly, because the district court did not have a chance to address that argument in rendering its decision below, it would be improper for this Court to address it now. *See, e.g.*, *Heng v. Rotech Med. Corp.*, 2006 ND 176, ¶ 9, 720 N.W.2d 54.

[¶ 12] Furthermore, the State's contention that Oneok charges Newfield for services under the Gas Purchase Agreement mischaracterizes these agreements. As noted above, nothing in the Gas Purchase Agreements obligates Oneok to perform any services for Newfield. The language referred to by the State is an amendment to the calculus for determining the price that Oneok ultimately pays to Newfield for Newfield's gas, not a provision requiring Newfield to pay Oneok for services. *See* Newfield App. 45–46, 69–70. The "Minimum Gathering and Processing Fee Surcharge," as well as the "Actual Gathering and Processing Fee," is like the other "fees" listed in Exhibit A; it represents an amount that Oneok and Newfield agreed to use in calculating the purchase price of the raw gas sold by Newfield under the Gas Purchase Agreements. The only transaction between Newfield and Oneok contemplated by the Gas Purchase Agreements is the sale of Newfield's gas. *See id.* at 20, 49.

[¶ 13] Finally, in its brief the State indicates that Newfield's royalty statements show payments on a net price after deduction for expenses. *See* Brief of Appellants, ¶ 66; Newfield App. 72–79. The items listed as "Deducts" on the royalty statement referred to are not actually deductions taken by Newfield. *See* Newfield App. 80. Instead, the "Deduct" amounts are amounts that Newfield's gas purchaser subtracts from the total price it receives from the sale of its gas products in order to calculate the total amount that it pays to Newfield. *Id.* at 80–81. These amounts are listed on the pay statement that Newfield receives from its gas purchaser pursuant to the applicable percentage of proceeds contracts. *Id*. Thus the State's royalties are calculated based on the total amount received by Newfield from its gas purchaser and, contrary to the State's implications, are not subject to any deductions taken by Newfield. *Id.* at 81.

STANDARD OF REVIEW

[¶ 14] This Court's standard of review for a district court's grant of summary judgment is well-established:

> [Summary judgment] is a procedural device for the prompt resolution of a controversy on the merits without a trial if there are no genuine issues of material fact or inferences that can reasonably be drawn from undisputed facts, or if the only issues to be resolved are questions of law. A party moving for summary judgment has the burden of showing there are no genuine issues of material fact and the moving party is entitled to judgment as a matter of law. In determining whether summary judgment was appropriately granted, we must view the evidence in the light most favorable to the party opposing the motion, and that party will be given the benefit of all favorable inferences which can reasonably be drawn from the record. On appeal, this Court decides whether the information available to the district court precluded the existence of a genuine issue of material fact and entitled the moving party to judgment as a matter of law.

> Whether the district court properly granted summary judgment is a question of law which we review de novo on the entire record.

Maragos v. Newfield Prod. Co., 2017 ND 191, ¶ 7, 900 N.W.2d 44 (quoting *Krenz v. XTO Energy, Inc.*, 2017 ND 19, ¶ 17, 890 N.W.2d 222).

LAW AND ARGUMENT

I. Introduction

[¶ 15] The Court should affirm the district court's decision to grant Newfield's motion for summary judgment and deny the State's motion for summary judgment. As explained in greater detail below, the district court correctly concluded that the Newfield Leases authorize Newfield to calculate the State's gas royalties as a percentage of the gross amount received by Newfield under the percentage-of-proceeds contracts between Newfield and Oneok. The district court's conclusion is supported by the plain language of the Newfield Leases and the State's arguments to the contrary fail to properly apply this language to the undisputed facts in this case. The district court's conclusion is also supported by case law from North Dakota, Texas, and other jurisdictions. And finally, the district court's conclusion is supported the Board's own rules concerning the calculation of royalties for non-arms-length transactions. For all of these reasons, the district court's decision should be affirmed.

II. The State's Gas Royalties Must Be Calculated Based on the Total Amount Received by Newfield from Oneok.

[¶ 16] The district court correctly construed the Newfield Leases and correctly concluded that the Newfield Leases allow Newfield to calculate the State's gas royalties as a percentage of the total amount received by Newfield from its purchaser under the percentage-of-proceeds contracts between Newfield and Oneok. The conclusion of the district court is supported by the plain language of the Newfield Leases, insofar as the phrase "gross proceeds of sale" is understood to mean the total consideration received by an oil and gas lessee for the sale of gas. The State's arguments regarding the plain language of the Newfield Leases fail insofar as they misinterpret and misapply the phrase "gross proceeds of sale," and they mischaracterize material facts. The State's arguments regarding the plain language of the Newfield Leases are improper because they would require the addition of a point-of-sale limitation to the gas royalty provision of the Newfield Leases. And finally, if the Court concludes that both the State and Newfield offer reasonable interpretations of the Newfield Leases, the Court must determine the Newfield Leases are ambiguous and construe them against the State.

A. The Plain Language of the Newfield Leases Unambiguously Authorizes Calculation of Gas Royalties Based on the Total Amount Received by Newfield from Oneok.

[¶ 17] "The same general rules that govern interpretation of contractual agreements apply to oil and gas leases." *Egeland v. Cont'l Res., Inc.*, 2000 ND 169, ¶ 10, 616 N.W.2d 861. Interpretation of a written contract to determine its legal effect is a question of law. "The language of a contract is to govern its interpretation if the language is clear and explicit and does not involve an absurdity." N.D.C.C. § 9-07-02. The intention of the parties to a written contract must be obtained from the writing alone, if possible. *Id.* § 9-07-04. If the intent of the parties is clear from the face of the contract, "there is no room for construction." *Huether v. Nodak Mut. Ins. Co.*, 2015 ND 272, ¶ 6, 871 N.W.2d 444 (quoting *Stuhlmiller v. Nodak Mut. Ins. Co.*, 475 N.W.2d 136, 138 (N.D. 1991)). A contract must be read as a whole, to give effect to every part if reasonably practicable, and each clause should be used to help interpret the others. N.D.C.C. § 9-07-06. The words used in a written contract should be understood "in their ordinary and popular sense rather than according to their strict legal meaning, unless used by the parties in a technical sense, or unless a special meaning is given to them by usage, in which case the latter must be followed." *Id.* § 9-07-09. When called upon to interpret a contract, a court may not add to or modify the terms of such contract. *Cf. Martin v. Allianz Life Ins. Co. of N. Am.*, 1998 ND 8, ¶ 11, 573 N.W.2d 823; *Biteler's Tower Serv., Inc. v. Guderian*, 466 N.W.2d 141, 144 (N.D. 1991).

[¶ 18] The Newfield Leases provide that royalties on gas must be paid "based on gross production or the market value thereof, at the option of the lessor, such value to be based on <u>gross proceeds of sale</u> where such sale constitutes an arm's length transaction." App. 26 (emphasis added). The Newfield Leases further provide that "[a]ll royalties on . . . gas . . . shall be payable on an amount equal to the full value of all consideration for such products in whatever form or forms, which directly or indirectly compensates, credits, or benefits <u>lessee</u>." *Id.* (emphasis added). The word "proceeds" refers to "[t]he money obtained by an actual sale." Patrick H. Martin & Bruce M. Kramer, *Williams & Meyers Manual of Oil and Gas Terms*, 821 (16th ed. 2015). The phrase "gross proceeds," particularly in the context of royalty payment calculation, refers to "the total monies and other consideration accruing to an oil and gas lessee for the disposition of the oil [or gas]." *Id.* at 463.

[¶ 19] North Dakota case law has thus used the term "gross proceeds" to refer to the money received "from the sale of the gas without deduction for the costs of extracting hydrogen sulfide or other costs incurred by [a lessee] <u>prior to the sale of the gas</u>." *West v. Alpar Res., Inc.*, 298 N.W.2d 484, 487 (N.D. 1980) (emphasis added). In other words, the plain language of the Newfield Leases requires that Newfield, the lessee, calculate royalty payments due as a percentage of the total amount of consideration for which gas from the Newfield Leases is sold by Newfield. Accordingly, the Newfield Leases authorize Newfield to calculate gas royalties as a percentage of the total amount received by Newfield from its gas purchaser, Oneok. *Cf. Alpar Res., Inc.*, 298 N.W.2d at 491 (concluding that an oil and gas lease providing a gas royalty based on "proceeds from the sale of the gas" should be construed in favor of the lessor to require "royalty payments based upon a percentage of the total proceeds received by [the lessee] from the sale of gas without deduction for . . . [any] cost incurred by [the lessee]").

[¶ 20] The foregoing interpretation of the phrase "gross proceeds" is supported by the decisions of other courts, which have recognized that "gross proceeds," for purposes of gas royalty calculation, is equivalent to the price paid by a gas purchaser to the producer. In *Mittelstaedt v. Santa Fe Minerals, Inc.*, the Supreme Court of Oklahoma construed a gas royalty clause that included the phrase "gross proceeds." Discussing prior case law, the *Mittelstaedt* Court reasoned as follows:

> Using the plain meaning of the phrase "gross proceeds" suggests that the payment to the lessor is without deductions. . . . Consistent with this approach, we have explained that when the lease requires payment of the "market value" of the gas this value "means the gas purchase contract price."

Mittelstaedt v. Santa Fe Minerals, Inc., 1998 OK 7, ¶¶ 9–10, 954 P.2d 1203, 1206 (citations omitted). In a more succinct fashion, the U.S. District Court for the Western District of Michigan has observed that "[t]he meaning of 'gross proceeds' is self-evident[; i]t is the contract price settled on by the producer and the buyer purchasing the wet gas stream." *Old Kent Bank & Tr. Co. v. Amoco Prod. Co.*, 679 F. Supp. 1435, 1445 (W.D. Mich. 1988). The Court should likewise interpret the phrase "gross proceeds" used in the Newfield Leases to denominate the amount received by Newfield from Oneok.

B. The State Misapplies the Plain Meaning of the Newfield Leases.

[¶ 21] In spite of the foregoing, the State has asserted in its brief that its interpretation of the Newfield Leases is "strongly supported" by the plain meaning of the phrase "gross proceeds." *See* Brief of Appellants, ¶ 21. But the State fails to acknowledge the importance of the point of sale for the gas at issue in this case. It is undisputed that, per the Gas Purchase Agreements, title to the gas passes at the wellhead, immediately upon the gas entering Oneok's pipeline facilities. It is likewise undisputed that the gas being sold by Newfield to Oneok is raw, unprocessed natural gas. Nothing in the Newfield Leases prohibits Newfield from selling raw natural gas at the wellhead and nothing in the Gas Purchase Agreements gives Newfield the right to compel a sale by Oneok further downstream. Accordingly, there is no reason the Court should determine that the State's gas royalties must be based on the proceeds of a sale occurring after Newfield's point of sale, and in which Newfield does not participate or have any control.

[¶ 22] The State argues that "[b]ecause Newfield benefits from the downstream sale of its gas under the Oneok Agreements, it must pay royalties on the downstream sales price." Brief of Appellants, ¶ 31. This argument fails because it misunderstands the concept of "benefit" utilized in the Newfield Leases. *See* Transcript of Proceedings ("Trans."), pp. 28–29. The relevant provision of the Newfield Leases is Paragraph 4.F: "All royalties on . . . gas . . . shall be payable on an amount equal to the full <u>value</u> of all consideration for such products in whatever form or forms, which directly or indirectly compensates, credits, or <u>benefits lessee</u>." App. 26 (emphasis added). Though Newfield may "benefit," from Oneok's sale of gas to a third party, the "value" of that benefit to Newfield consists solely of the amount paid by Oneok to Newfield. Newfield does not benefit from the portion of Oneok's sale price that Oneok retains. If, hypothetically, Oneok sold Newfield's gas to a third party but then failed or refused to pay Newfield, the value of the benefit accruing to Newfield for the downstream sale would be nothing. Accordingly, because Newfield does not benefit from the consideration Oneok receives from its downstream sales except to the extent that Newfield is paid by Oneok for raw natural gas, the plain language of the Newfield Leases does not require payment of royalties based on sales beyond Newfield's original point of sale at the wellhead.

[¶ 23] The State also asserts in its brief that Newfield has contracted with Oneok to perform services, or that Oneok charges Newfield for post-production costs. *See, e.g.*, Brief of Appellants, ¶¶ 16–17, 24, 26–28. But as explained in Paragraphs 9–12, *supra*, the Gas Purchase Agreements do not obligate Oneok to perform services on Newfield's behalf, nor do they obligate Newfield to pay consideration to Oneok in exchange for services. The Gas Purchase Agreements likewise do not obligate Oneok to sell the products of Newfield's gas downstream, nor do they give Newfield the right to compel such a sale. Instead, the Gas Purchase Agreements are agreements to purchase and sell raw, natural gas. Newfield and Oneok have agreed that the purchase price for Newfield's gas is to be calculated with reference to Oneok's subsequent sale of products it derives from Newfield's gas, minus costs incurred by Oneok in deriving such products. This is recognized as a reasonable means of calculating the value of raw, natural gas. *See, e.g.*, *Bice v. Petro-Hunt, LLC*, 2009 ND 124, ¶ 20, 768 N.W.2d 496. Accordingly, the State's characterization of the Gas Purchase Agreements is incorrect, and the State's arguments based on this mischaracterization should thus be disregarded by the Court.

[¶ 24] Based on the foregoing, the Court should conclude as the district court did that the terms of the Newfield Leases are unambiguous, and that they only require

Newfield to pay royalties based on the gross proceeds Newfield receives from the sale of gas. *See* App. 89. Newfield should not be required to pay royalties based on what a third party receives for the sale of processed gas and gas products. *Id.* If the state had wished to require payment of royalties for gas based on gross proceeds at the tailgate of a gas processing plant, it could have so required. *See id.* at 19 (providing under 85-06-06-08 for the calculation of royalties for "gas processed in a gasoline plant or other plant" based on "eighty percent (80%) . . . of total plant production of residue gas attributable to gas produced from the leased premises, and on forty percent (40%) . . . of the total plant production of liquid hydrocarbons attributable to the gas produced from the leased premises"); *see also Yturria v. Kerr-McGee Oil & Gas Onshore, LLC*, 291 F. Appx. 626, 628 (5th Cir. 2008) (analyzing an oil and gas lease granting a royalty of "one-fourth (1/4th) of seventy-five percent (75%) of all plant products, or revenue derived therefrom, attributable to gas produced by [the lessee] from the leased premises").

C. The State's Reading of the Newfield Leases Is Improper Insofar as It Adds to or Modifies Their Terms.

[¶ 25] Newfield's reading of the plain language of the Newfield Leases is also superior to the State's because it does not result in the addition of terms not otherwise included in the Newfield Leases. The Newfield Leases base gas royalties on "gross production or the market value thereof," meaning that the "market value" upon which royalties are set is the market value of "gross production" or the raw gas produced from a given well. *See* App. 26; *Williams & Meyers Manual of Oil and Gas Terms* 830 (16th ed. 2015) ("In the United States the word production is frequently used to describe the product of a well or lease, *viz.*, the crude oil or natural gas produced."). The Newfield Leases then go on to state that market value should be calculated based on "gross proceeds of sale where such sale constitutes an arm's length transaction." App. 26. Because the market value to be calculated is the market value of the raw gas produced, then the "sale" referred to in the royalty provision could logically be a sale of the raw gas produced, where such sale is an arm's length transaction. Thus, if a lessee were to sell the raw gas produced from a well at arm's length, then the gross proceeds of that sale would be used to calculate the market value of the raw gas, or gross production, as required by the royalty provision cited above. The foregoing directly aligns with Newfield's reading of the Newfield Leases' gas royalty provision, as it is undisputed that Newfield sells raw gas at the wellhead to Oneok, and bases its royalty payments to the State on the proceeds of such sales.

[¶ 26] The State's reading of the gas royalty provision, on the other hand, attempts to read a limitation on the point of valuation into the Newfield Leases. Specifically, the State's position appears to be that valuation must be based on sales that occur downstream, rather than at the wellhead. *See, e.g.*, Brief of Appellants, ¶ 29. But the Newfield Leases contain no such limitation. In fact, the materials presented by the State indicate that the Board previously acted to remove the express point of valuation limitation that was contained in its lease forms. *See* App. 73, 81 (removing the words "at the well" from the sample lease form). The removal of the words "at the well" from the gas royalty provision does not prohibit valuation based on gross proceeds of sale from actually occurring at the well; rather, it renders the lease silent as to the point of valuation. *Cf. Marcia R. Sickler Mineral Tr. v. LoneTree Energy & Assocs., LLC*, No. 4:12-CV-077, 2013 WL 4508429, at *7 (D.N.D. Aug. 23, 2013) (explaining that the striking of an express warranty from an oil and gas lease is not the same as disclaiming any warranty). Accordingly, because the Court's interpretation of the Newfield Leases should not add to or modify their terms, the Court should accept Newfield's reading over the State's.

D. If the Court Concludes the Newfield Leases Are Ambiguous, Such Ambiguity Must Be Construed Against the State.

[¶ 27] If the Court concludes that the readings advanced by Newfield and the State are both reasonable, this would necessitate a conclusion that the gas royalty provision of the Newfield Leases is ambiguous. *See West*, 298 N.W.2d at 490. In such a case the Court must construe the Newfield Leases in favor of Newfield because ambiguous language in a contract must be construed against the drafter. *See, e.g.*, *Northstar Founders, LLC v. Hayden Capital USA, LLC*, 2014 ND 200, ¶ 47, 855 N.W.2d 614. Though the *West* Court did indicate that an oil and gas lease should generally be construed against the lessee, the circumstances warranting such construction are not present in this case where it is undisputed that that the terms of the Newfield Leases were set by the State. *See West*, 298 N.W.2d at 490–91. The State argues that this doctrine should not apply in this case because Newfield is a sophisticated oil and gas operator. But regardless of Newfield's sophistication, it had no opportunity to negotiate the terms of the Newfield Leases. As noted in the State's brief, state leases are bid on at auction and the terms thereof are set and only available for review prior to bidding. *See* Brief of Appellants, ¶ 69. Because Newfield had no part in drafting the Newfield Leases, the doctrine of construing ambiguity against the drafter still applies in this case, and if the Court concludes that the Newfield Leases are ambiguous, it must adopt the construction advocated by Newfield.

III. Case Law from North Dakota, Texas, and other Jurisdictions Supports Newfield's Interpretation of the Newfield Leases.

[¶ 28] The State's brief addresses a number of the cases discussed in the parties' summary judgment briefing before the district court. As explained below, case law in North Dakota, Texas, and other jurisdictions interpreting "gross proceeds" leases (or leases with similar gas royalty language) supports Newfield's interpretation of the Newfield Leases.

A. North Dakota Case Law Supports Newfield's Interpretation of the Newfield Leases.

[¶ 29] The only North Dakota decision the parties have argued is relevant to this case is *West v. Alpar Resources, Inc.*, 298 N.W.2d 484 (N.D. 1980). The *West* Court reasoned as follows regarding the interpretation of a royalty provision based on "proceeds from the sale of the gas":

> We are of the opinion that the royalty clause involved herein is ambiguous. The royalty clause simply provides that the lessor is entitled to receive "one-eighth of the proceeds from the sale of the gas" without further explanation. Rational arguments can be made in support of the view that the term "proceeds" means gross proceeds without deduction for expenses as well as in support of the view that the term "proceeds" means net proceeds derived by deducting production and processing expenses from the price received for the gas. Rational arguments can also be made to support the view that the royalty obligation is to be determined at the wellhead as well as to support the view that the royalty obligation is to be determined at the location of the sale of the gas.

Id. at 490. The *West* court construed the above-outlined ambiguity against the lessee and construed the royalty provision as a "gross proceeds" provision. *Id.* at 491. The *West* court thus concluded that "the Wests [the lessors] are entitled to royalty payments based upon a percentage of the <u>total proceeds received by Alpar</u> [the lessee] from the sale of the gas without deduction for the cost of extracting hydrogen sulfide and without deduction for any other cost incurred by Alpar." *Id.* (emphasis added) The *West* decision thus unambiguously construes "gross proceeds" language in royalty provisions to refer to the gross proceeds received <u>by the lessee</u> for gas produced, not by the third party purchasing the gas from the lessee or by some future party purchasing from the third party.

[¶ 30] This reading of the *West* decision is corroborated by the concurrence of Justice Pederson:

> I concur, but only because of an apparent stipulation that "sour" gas has no market value at the "wellhead." If Montana-Dakota Utilities Company [the purchaser of processed gas from Alpar], instead of Alpar, had constructed the amine plant, the holding in this case would not be applicable. In my opinion, "sour" gas at a "wellhead" is marketable and has a market value.

Id. at 492–93; *see also id.* at 487 (explaining Alpar's attempt to deduct costs for construction and operation of its own amine plant, which was intended to remove hydrogen sulfide from the raw gas produced under Alpar's leases, from the royalty payments owed to the Wests). Justice Pederson's concurrence thus clarifies that when raw gas is sold by a lessee at the wellhead there is no need to consider whether costs are subsequently incurred by a purchaser to increase the resale value of the gas, e.g., costs for hydrogen sulfide removal, because the only sale proceeds relevant to the royalty provision are those actually received by the lessee. The State's reading of *West* not only neglects the significance of the foregoing concurrence, but also neglects the key language of the Court's conclusion that a gross proceeds royalty should be based on the "total proceeds received by" the lessee. *See* Brief of Appellants, ¶ 24. The State instead focuses on its erroneous assertion that Newfield pays Oneok for processing and transporting gas. *Id.* The *West* decision makes plain that the only relevant amount under a "gross proceeds" lease is the total amount of sale proceeds received by the lessee. Accordingly, Newfield's reading of the plain language of the Newfield Leases is proper under North Dakota law and the State's reading is unpersuasive.

B. Texas Case Law Supports Newfield's Interpretation of the Newfield Leases.

[¶ 31] The State asserts that its interpretation of the Newfield Leases is supported by Texas case law and that the Court should consider such case law persuasive in interpreting the Newfield Leases. Brief of Appellants, ¶ 32. The State relies on *Chesapeake Exploration, L.L.C. v. Hyder*, 483 S.W.3d 870 (Tex. 2016), and *Judice v. Mewbourne Oil Company*, 939 S.W.2d 133 (Tex. 1996). As explained below, however, neither of these cases provides support for the State's position, and thus neither should be regarded by this Court as persuasive. To the contrary, the Court of Appeals of Texas' decision in *Commissioner v. SandRidge Energy, Inc.*, 454 S.W.3d 603 (Tex. App. 2014), provides a detailed analysis of a gas royalty provision materially identical to the one in this case under Texas law that supports Newfield's interpretation of the Newfield Leases.

1. *Chesapeake Exploration, L.L.C. v. Hyder*

[¶ 32] First, the State argues that the Texas Supreme Court's decision in *Chesapeake Exploration, L.L.C. v. Hyder*, 483 S.W.3d 870 (Tex. 2016) supports their position in this case. The *Hyder* Court construed a provision for gas royalties based on "25% 'of the price actually received by [the lessee]' for all gas produced from the leased premises". Brief of Appellants, ¶ 33. The State asserts that *Hyder* stands for the proposition that "a royalty based on the price actually received by the lessee must be based on the price received for the sale of gas downstream prior to the deduction of post-production costs, rather than on the price received by the lessee net of all post-production costs." *Id.* at ¶ 35. This gloss immediately follows a quote from *Hyder* in which the Texas Supreme Court states that a gas royalty payable under such a provision is "based on the price actually received by the lessee, not the market value at the well." *Id.* (quoting

Hyder, 483 S.W.3d at 875). The State's argument overlooks the possibility that a sale of gas can occur at the wellhead, and that the "price actually received" for gas by a lessee may, under such circumstances, coincide with the market value of such gas "at the well."

[¶ 33] Furthermore, despite Newfield already identifying the problems with the *Hyder* decision in its briefing before the district court, the State fails to acknowledge that the gas royalty provision the State refers to in its brief was not actually before that court on appeal, and thus any discussion of it by the Texas Supreme Court is dicta. *See Hyder*, 483 S.W.3d 870, 871–72, 873 nn.17 & 18 (Tex. 2016) (explaining that the parties did not dispute the intermediate appellate court's interpretation of the gas royalty provision on appeal to the supreme court); Brief of Appellants, ¶ 33–34. The appellate court decision that actually interpreted this gas royalty provision reveals the true basis for the resolution of the gas royalty provision issue:

> Appellees [the lessors] also argue the sale at the wellhead between the affiliated companies, COI [the lessee] and CEMI [the purchaser], is the point where appellants [the lessee] obtain the "price actually received" for such gas. Although the parties stipulated that a sale between COI and CEMI takes place at the wellhead, the parties also stipulated COI and CEMI are affiliated companies. In addition to the language cited by appellees, the lease also defines appellees' royalty interest as free of all costs and expenses prior to a sale of such gas "to a third party." As such, we conclude that even if production is measured at the wellhead, such sale between COI and CEMI does not constitute a sale to a "third party."

Chesapeake Exploration, L.L.C. v. Hyder, 427 S.W.3d 472, 482 (Tex. App. 2014). In other words, the sale at the wellhead that occurred in *Hyder* was between two affiliated parties and for that reason the Court determined that the point of valuation, the point at which a price was actually received by the lessee, was upon resale by the affiliate purchaser. *See also Hyder*, 483 S.W.3d at 873 ("Chesapeake does not dispute in this Court that 'the price actually received by the Lessee' for purposes of the gas royalty is the gas sales price its affiliate, Marketing, received . . . ."). Because it is undisputed that the sale at the wellhead that occurred in this case was at arm's length, the factual basis for the Texas courts' decision to place the point of valuation for the gas royalty downstream from the wellhead is not present in this case. Accordingly, the Court should not regard *Hyder* as persuasive authority.

2. *Judice v. Mewbourne Oil Company*

[¶ 34] *Judice v. Mewbourne Oil Company* decision is a case involving deductions made by a lessee for the costs of compression incurred by the lessee, not a case involving the sale of raw gas by the lessee to a purchaser for a percentage of the purchaser's subsequent resale. *See Judice v. Mewbourne Oil Co.*, 939 S.W.2d 133, 134–35 (Tex. 1996). The *Judice* Court's conclusion is not ultimately different from the decision in *West*, namely, that where a gas royalty is to be based on the gross price received by the lessee, the lessee may not deduct costs that it incurred prior to selling the gas. *Compare id.* at 136–37, *with West*, 298 N.W.2d at 491. Accordingly, the Court should disregard *Judice* as irrelevant to the specific issues presented by this case.

3. *Commissioner v. SandRidge Energy, Inc.*

[¶ 35] Unlike the two cases discussed above, the Court of Appeals of Texas' decision in *Commissioner v. SandRidge Energy, Inc.* does provide useful and persuasive authority for the Court's decision in this case. The *SandRidge* Court considered state oil and gas leases containing the following gas royalty provision, in relevant part:

> NON PROCESSED GAS. Royalty on any gas . . . shall be 25% part of the <u>gross production or the market value thereof</u>, at the option of the owner of the soil or the Commissioner of the General Land Office, <u>such value to be based on</u> the highest market price paid or offered for gas of comparable quality in the general area where produced and when run, or <u>the gross price paid or offered to the producer</u>, whichever is the greater . . . .

Comm'r v. SandRidge Energy, Inc., 454 S.W.3d 603, 608 (Tex. App. 2014) (emphasis added). The issue presented in this case was whether the Texas General Land Office, among other lessors, was entitled to royalties on carbon dioxide extracted from gas produced on its lands. SandRidge Energy had, for a period of time, extracted carbon dioxide from raw gas produced under the leases at its own plant before selling the carbon dioxide and paying its lessors a royalty thereon. *Id.* at 609. Eventually, SandRidge began selling the raw gas directly to a plant owned by Oxy USA, Inc. *Id.* SandRidge gave Oxy the carbon dioxide extracted from the sour gas and, in exchange, Oxy did not charge SandRidge for extraction of the carbon dioxide. *Id.* SandRidge then informed its lessors that it would no longer be paying a royalty on carbon dioxide because it was no longer selling the carbon dioxide. *Id.* The lessors then sued claiming they were entitled to royalties on the carbon dioxide that was given to Oxy. *Id.*

[¶ 36] The *SandRidge* Court ultimately concluded that the gas royalty provision quoted above required a determination of the market value of the gas sold at the well for several reasons. *Id.* at 612. First, the *SandRidge* Court noted that the above-quoted royalty clause contained a wellhead measurement requirement (not quoted above), which the Newfield Leases admittedly do not contain. *Id.* at 612–13. But second, and more importantly, the *SandRidge* Court indicated that the language specifying that the royalty stems from "gross production," or the market value thereof, meant that the royalty, whether taken in-kind or as a payment, must be based on a share of the raw gas produced. *Id.* at 613. The Court stated, "the substance to be valued by its gross price continues to be 'gross production,'" so the "gross price" received for such substance might simply be the price received by the lessee for raw gas sold at the well. *Id.* at 614.

[¶ 37] The *SandRidge* Court also pointed out that valuing gas under the above-quoted provision based on sales beyond the wellhead was inappropriate in light of subsequent provisions of the state oil and gas leases, which provided for specific royalties based on "processed gas" and "other products" later produced or manufactured from gas. *Id.* at 615. In light of all of this, the Court held that the above-quoted provision did not entitle the Texas General Land Office to royalties on carbon dioxide later extracted by SandRidge's purchaser from the raw gas sold by SandRidge at the wellhead, concluding that the gas royalty provision as applied in that case was the functional equivalent of a market value at the well clause. *Id.* at 616.

[¶ 38] The *SandRidge* Court's reasoning is useful in this case because of the similarities between this case and *SandRidge*. Like the state oil and gas leases in *SandRidge*, the Newfield Leases contain gas royalty provisions based on "gross production or the market value thereof," with the specification that market value is to be calculated based on "the gross proceeds of sale" (compared to the "gross price paid or offered to the producer"). *See* App. 26. Also like the state oil and gas leases in *SandRidge*, the Newfield Leases contain subsequent provisions providing separate royalties for "other products produced or manufactured from gas." *Id.* at 26 (¶ 4.D). Also, like the lessee in *SandRidge*, Newfield sells raw gas produced under the Newfield Leases at the wellhead and calculates royalties based on the price it receives for such raw gas from its unaffiliated purchaser. *See* Newfield App. 16–17. Accordingly, the Court should consider the *SandRidge* decision to be persuasive authority in this case and, like the *SandRidge* Court, conclude that Newfield is permitted to calculate gas royalties under the Newfield Leases based on the price it actually receives from its purchaser, in this case Oneok, rather than the price paid by a subsequent purchaser downstream.

[¶ 39] The State argues *SandRidge* is inapplicable because Newfield benefits from the downstream sale of processed gas and gas products by Oneok. Brief of Appellants, ¶ 50. This argument was already addressed in Paragraph 22, *supra*, and to reiterate, Newfield only benefits from the downstream sale insofar as it is paid by Oneok. The State further asserts that "[n]either the volume nor value upon which consideration payable to Newfield is based is determined at the well." But this again ignores the undisputed fact that the <u>actual sale occurs at the wellhead</u>. Newfield does not dispute that the proceeds of sale it receives for its gas are derived from Oneok's downstream sale of processed gas and gas products, but this does not change the point of sale in the Gas Purchase Agreements. Finally, the State argues that *Hyder* undermines *SandRidge*, but *Hyder* should not be relied upon for the reasons set forth in Paragraph 33, *supra*.

C. Case Law from Other States Supports Newfield's Interpretation of the Newfield Leases.

[¶ 40] The State asserts that its interpretation of the Newfield Leases is supported by case law from other states and that the Court should consider such case law persuasive in interpreting the Newfield Leases. Brief of Appellants, ¶¶ 30–31, 41–47. As explained below, however, none of these cases provides meaningful support for the State's position, and thus neither should be regarded by this Court as persuasive. To the contrary, as also explained below there is persuasive, material case law from other jurisdictions that supports Newfield's interpretation of the Newfield Leases in this case.

1. *Naylor Farms, Inc. v. Anadarko OGC Co.*

[¶ 41] The State cites *Naylor Farms, Inc. v. Anadarko OGC Co.* as support for its interpretation of the Newfield Leases. But the decision of the court in *Naylor Farms* is almost entirely dependent upon Oklahoma's adoption of the first marketable product doctrine, under which an implied covenant to market production imputed into every oil and gas lease under Oklahoma law. *See Naylor Farms, Inc. v. Anadarko OGC Co.*, No. CIV-08-668-R, 2011 WL 7053782, at *1 (W.D. Okla. May 9, 2011); *see also Bice v. Petro-Hunt, L.L.C.*, 2009 ND 124, ¶ 16, 768 N.W.2d 496 (recognizing Oklahoma as one of the states that had adopted the first marketable product doctrine). The *Naylor Farms* Court's analysis is focused on whether the language of the relevant gas royalty provisions "negative[s] the implication of the lessee's duty to market which includes making (and bearing the cost of making) the gas marketable." *Id.* at *3. North Dakota is not a first marketable product doctrine state, and no North Dakota decision has recognized a similar implied duty to market production. *See, e.g.*, *Bice v. Petro-Hunt, L.L.C.*, 2009 ND 124, ¶¶ 15–16, 21, 768 N.W.2d 496. Accordingly, the *Naylor Farms* decision is neither useful nor persuasive for this Court's interpretation of the Newfield Leases under North Dakota law.

[¶ 42] The State contends that *Naylor Farms* is relevant because it analyzes whether a lessee could deduct costs that it was obliged to incur from royalty payments to its lessor. The State further asserts that this analysis is useful "regardless of whether the marketable product doctrine is applicable, as Newfield has an obligation to incur costs under the [Gas Purchase Agreements] in the gas sale, similar to costs imposed on the lessee in *Naylor Farms I*." Brief of Appellants, ¶ 31. The State's reasoning is incorrect, however, for several reasons. First, there is nothing in the Newfield Leases that obligates

Newfield to incur the "costs" referred to by the State. Merely characterizing the Newfield Leases as "gross proceeds" leases does not automatically create an obligation for Newfield to sell gas downstream when it has an unaffiliated buyer of raw gas at the wellhead. Second, though the lease in *Naylor Farms* was a "gross proceeds" lease like the Newfield Leases, the "obligation to incur costs" identified in *Naylor Farms* arose from an implied duty to make gas marketable. As explained in the preceding paragraph such an obligation would not be implied in a North Dakota oil and gas lease because North Dakota is not a first marketable product doctrine state. Accordingly, *Naylor Farms* is not relevant to the Court's analysis of the Newfield Leases, and should be disregarded.

2. *Yturria v. Kerr-McGee Oil & Gas Onshore, LLC*

[¶ 43] The State also cites *Yturria v. Kerr-McGee Oil & Gas Onshore, LLC* as support for its interpretation of the Newfield Leases. As noted by the State, the Fifth Circuit has expressly determined that the *Yturria* decision is not intended to serve as precedent except as res judicata, collateral estoppel, or law of the case. *See Yturria v. Kerr-McGee Oil & Gas Onshore, LLC*, 291 F. App'x 626, 627 n.* (5th Cir. 2008). Hence the Fifth Circuit's own cautious acknowledgment that it is "construing unique language in four particular oil and gas leases," that lacks the judicially defined terms commonly found in the majority of oil and gas leases. *Id.* at 630. For example, the relevant royalty provision requires calculation of the royalty based on "seventy-five percent (75%) of all plant products," rather than based on "gross production" as in the Newfield Leases. *Id.* at 629–30. The *Yturria* Court's analysis and conclusion further underscores the unique circumstances of the case: the Court's interpretation of the relevant lease provisions is based almost entirely on specific amendments to the lease terms following the parties settlement of a previous dispute in which it had been alleged that the lessee was allowing its affiliate processor to retain excessive amounts of natural gas liquids so as to deliberately reduce the base for lessee's royalty payments. *Id.* at 633–34 ("Based on the forgoing discussion, we conclude that only Lessors' interpretation gives effect to the specific manner in which the parties amended the royalty provisions following settlement of their 1993 dispute."). The *Yturria* Court even acknowledges the "unusual breadth" of the interpretation that it ultimately adopts. *Id.* at 634. Because such circumstances and lease language are not present in this case, *Yturria* is of little persuasive value.

[¶ 44] Nonetheless, the State places much emphasis on the *Yturria* decision, claiming that it is "directly on point" in analyzing the Newfield Leases. It is unclear how the *Yturria* Court's analysis could be directly on point when the gas royalty provision under consideration is for "one-fourth (1/4th) of seventy-five percent (75%) of all plant products, or revenue derived therefrom, attributable to gas produced by [Kerr-McGee] from the leased premises," and makes no mention of "gross proceeds" or similar language. *Id.* at 628; *cf. id* at 630 (noting that the court's analysis in *Yturria* concerned the previously unconstructed phrase "revenue derived therefrom," rather than judicially defined terms such as "market value at the well" or "amount realized," and thus "cases construing leases that use judicially defined terms provide <u>little guidance</u> concerning how the uniquely worded leases [in *Yturria*] should be construed" (emphasis added)). The State fails to explain how a royalty provision based on revenue derived from plant products is analogous to a "gross proceeds" royalty provision. The reasoning of the *Yturria* Court would only be relevant in this case if the factual and legal premises of such reasoning were present. These factual and legal premises do not exist in the present case, and thus the they were, these factual and legal premises do not exist in the present case, and thus the *Yturria* decision should be disregarded.

3. *Sondrol v. Placid Oil Co.*

[¶ 45] Newfield has previously relied on the Eighth Circuit's decision in *Sondrol v. Placid Oil Co.*, 23 F.3d 1341 (8th Cir. 1994), as support for its interpretation. The *Sondrol* Court determined that a royalty based on "proceeds received for gas sold" must be based upon the sales by the lessee to its purchaser, even though those sales were pursuant to a percentage of proceeds contract. *Id.* at 1342–43, 1344. In rejecting arguments that the lessee received "credit" beyond the cash price for the gas sold, the *Sondrol* Court concluded that "[i]n this type of royalty clause, 'proceeds' means 'the money obtained from an actual sale.'" *Id.* at 1344. In rejecting arguments that the lessors' royalties were improperly reduced by the gas purchaser's processing fees, the *Sondrol* Court concluded that "1/6 of the proceeds received . . . expressly limits the [lessors'] royalty to one-sixth of whatever [the purchaser] paid [the lessee]." There does not appear to any material difference between "the proceeds received for gas sold" language as applied in *Sondrol* and the "gross proceeds of sale" language in the Newfield Leases, and the State has identified none. Accordingly, the Court should conclude that the *Sondrol* decision is persuasive and rule in favor of Newfield.

[¶ 46] The State asserts, "[t]he [*Sondrol*] court relied entirely on the lease language requiring royalties be based on the proceeds received for gas sold at the wellhead." Brief of Appellants, ¶ 55. The State is incorrect, however, because the royalty provision considered by the *Sondrol* Court, like the royalty provision in the Newfield Leases, did not require valuation at the wellhead; rather, the lease required the lessee "[t]o pay lessor 1/6 of the proceeds received for gas sold from each well where gas only is found . . . ." *Sondrol*, 23 F.3d at 1343. Though the lessee in *Sondrol* happened to be selling raw gas at the wellhead, it could just as easily have been selling gas after incurring costs to process or transport the gas, in which case the above-quoted provision would have required payment based on proceeds received for this processed or transported gas. The State appears to misunderstand this aspect of the case insofar as they suggest that the *Sondrol* Court declared the applicable gas royalty provision to be a "market value at the well" provision. In fact, the *Sondrol* Court expressly decided <u>not</u> to apply the "market value at the well" portion of the royalty provision to the gas sold by the lessee to its purchaser. *Id.* at 1344. Accordingly, the *Sondrol* decision provides persuasive authority for construction of the Newfield Leases.

4. *Fawcett v. Oil Producers, Inc. of Kansas*

[¶ 47] Newfield has also previously relied on the Kansas Supreme Court's decision in *Fawcett v. Oil Producers, Inc. of Kansas*, 352 P.3d 1032 (Kan. 2015), as support for its interpretation. The *Fawcett* Court considered "whether [an] operator may take into account the deductions and adjustments identified in … third-party purchase agreements when calculating royalties." Kansas is a first marketable product doctrine state, and in *Fawcett* the Kansas Supreme Court considered the effect of this doctrine on a producer's sale of gas at the wellhead using percentage of proceeds contracts. *Id.* at 1034–35. The lessors in *Fawcett* made an argument that appears to be the same as, or at least analogous to, the argument made by the State in the present case: gas is not "marketable," for purposes of the first marketable product doctrine, until it is in a condition sufficient to enter into interstate pipelines, regardless of where the first sale of such gas occurs. *Id.* at 1039. The *Fawcett* lessors further argued that, where the producer sold its gas at the wellhead the percentage of the gas's resale value retained by the purchaser could not be "deducted" from the lessors' royalty. *Id.* After analyzing its own prior case law, and the case law of other first marketable product doctrine states, the *Fawcett* Court rejected the lessors' arguments and concluded:

> [W]hen gas is sold at the well it has been marketed; and when the operator is required to pay royalty on its proceeds from such sales, the operator may not deduct any pre-sale expenses required to make the gas acceptable to the third-party purchaser . . . . But post-sale, post-production expenses to fractionate raw natural gas into its various valuable components or transform it into interstate pipeline quality gas are different than expenses of drilling and equipping the well or delivering the gas to the purchaser.

Id. at 1041–42. Thus the *Fawcett* Court upheld a producer's calculation of royalties based on the total price it receives under a percentage of proceeds contract, and recognized that gas can be "sold" or "marketed" at the wellhead under a percentage of proceeds contract.

[¶ 48] Based on the arguments presented in the State's brief, the State would likely argue *Fawcett* is not persuasive authority in this case. Specifically the State would argue that *Fawcett* is inapposite because it is a case dealing with the first marketable product doctrine. But this fact does not prevent the Court from applying the reasoning of *Fawcett* as outlined above. The State is effectively trying to get the Court to read an implied duty to market into the Newfield Leases insofar as it argues that Newfield, rather than Oneok, must incur the costs necessary to sell the gas downstream *See, e.g.*, Brief of Appellants, ¶ 24. Second, the State would argue that *Fawcett* is inapposite because the royalty provisions at issue therein involve "proceeds from the sale of gas . . . at the mouth of the well" or "proceeds if sold at the well." *Fawcett*, 352 P.3d at 1036. As explained above, however, even though the royalty provision in the Newfield Leases does not specifically refer to gross proceeds of sale "at the well," there is no limitation in the Newfield Leases as to where the point of sale must occur. *See* App. 26–27. The fact that sale of gas in this case does occur at the wellhead thus renders the reasoning in cases like

Fawcett applicable and persuasive despite the difference in royalty provision language. Accordingly, the *Fawcett* decision contains persuasive authority in support of Newfield's position and should guide the Court's decision in this case.

IV. The State Mischaracterizes the Board's Rules Concerning Royalties Paid on Non-Arms' Length Transactions.

[¶ 49] The State errs in its reading of the Board's rules applicable to royalties on non-arm's length gas transactions. The rules provide, in relevant part:

> All royalties due [on non-arm's length transactions] shall be based on eighty percent (80%) or that percent accruing to lessee, whichever is greater, of the total plant production of residue gas attributable to gas produced from the leased premises, and on forty percent (40%) or that percent accruing to the lessee, whichever is greater, of the total plant production of liquid hydrocarbons attributable to the gas produced from the leased premises.

App. 19. The State contends that this provision exists in case a "lessee is incapable of selling 80% of residue gas or 40% of liquid hydrocarbons produced, it still must pay royalties on at least those percentages." Brief of Appellants, ¶ 68. This is incorrect. The above-quoted provision says nothing about the percentage of residue gas or liquid hydrocarbons "sold" by a lessee. Instead, the provisions refer to the "percent . . . of total plant production . . . attributable to gas produced from the leased premises" that accrues to the lessee. The provision assumes that a lessee already produced raw gas and conveyed it to a gas plant, and that a certain percentage of that gas plant's production of residue gas or liquid hydrocarbons will then "accrue" to the lessee. This is exactly the arrangement contemplated by a percentage of proceeds contract, in which a percentage of the proceeds realized by a purchaser, who has invested money into the gas to increase its value in various ways, are remitted to the lessee as payment for the raw gas. Patrick H. Martin &

Bruce M. Kramer, *Williams & Meyers Manual of Oil and Gas Terms*, 761 (16th ed. 2015) (defining a percentage of proceeds contract).

[¶ 50] All of this is to show that the interpretation of the gas royalty provision in the Newfield Leases currently advanced by the State is inconsistent with the foregoing provision insofar as it would result in parties to arm's length transactions being treated *more harshly* than parties to non-arm's length transactions. By way of example, one of the gas purchase agreements originally entered into between Newfield and Bear Paw Energy, LLC contemplated that Newfield would receive seventy percent (70%) of Bear Paw Energy's net proceeds from the sale of its natural gas liquid products and residue gas products attributable to the gas sold to it by Newfield. *See* Newfield App. 39. Contrast this with a hypothetical lessee who sold to an affiliate purchaser under a percentage of proceeds contract with the same terms as Newfield's. Under the State's interpretation of the Newfield Leases, Newfield is obligated to pay royalties on one hundred percent (100%) of proceeds realized by its purchaser, even though it receives only seventy percent (70%) under its percentage of proceeds contract. Under the above-quoted provision from the Board's rules, the hypothetical lessee is only obligated to pay royalties on eighty percent (80%) of the proceeds realized by its affiliate purchaser, even though it, like Newfield, still receives seventy percent (70%) of those proceeds. There is no reasonable basis for incentivizing non-arm's length transactions in the manner that the State's interpretation would. Accordingly, because contracts should be construed to avoid absurd results, *see* N.D.C.C. § 9-07-02, the Court should reject the State's construction and instead construe the Newfield Leases in favor of Newfield.

V. The State Has Not Been Underpaid Royalties and Is Not Entitled to an Accounting.

[¶ 51] For all of the foregoing reasons Newfield has correctly interpreted the Newfield Leases as to the payment of gas royalties. Newfield calculates the gas royalties it pays to the State by taking the agreed-upon gas royalty percentage from the total amount of proceeds it receives from Oneok for a given quantity of gas. *See* Newfield App. 17. Newfield does not take any deductions from this amount for any costs incurred by Newfield in producing and marketing such gas. *Id.* Accordingly, Newfield does not owe any additional gas royalty payments to the State. And because Newfield has not underpaid the State, the State is not entitled to an accounting. *Cf. Ritter, Laber & Assocs., Inc. v. Koch Oil, Inc.*, 2004 ND 117, ¶¶ 30–32, 680 N.W.2d 634.

CONCLUSION

[¶ 52] For the reasons stated above, Newfield respectfully request that the Court affirm the decision of the district court and direct that judgment be entered accordingly.

Dated this 7th day of June, 2019.

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CERTIFICATE OF COMPLIANCE

The undersigned, as attorney for the Plaintiffs-Appellees Newfield Exploration Company, Newfield Production Company, and Newfield RMI LLC, hereby certifies the above brief is in compliance with Rule 32(a)(8)(A) of the North Dakota Rules of Appellate Procedure. The total number of pages in the brief, excluding the certificate of service and this compliance totals thirty-seven (37) pages.

Dated this 7th day of June, 2019.

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IN THE SUPREME COURT
STATE OF NORTH DAKOTA

Rhonda Pennington, Steven Nelson, Donald Nelson, and Charlene Bjornson, Plaintiffs-Appellants, v. Continental Resources, Inc., Defendant-Appellee.	Supreme Court No. 20190063

STATE OF NORTH DAKOTA)
) ss.
COUNTY OF BURLEIGH)

CERTIFICATE OF SERVICE

I, the undersigned, hereby certify that the Brief of Appellees and Appendix of Appellees were, on June 7th, 2019, filed and served electronically with the Clerk of the North Dakota Supreme Court and served by e-mail on the following:

David Garner
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Dated this 7th day of June, 2019.

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