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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 and Appellees, vs. 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 and Appellants.	)	Supreme Court Case No. 20190088 McKenzie County District Court Case No. 27-2018-CV-00143

Appeal from Judgment Entered on March 1, 2019
Case No. 27-2018-CV-00143
County of McKenzie, Northwest Judicial District
The Honorable Robin A. Schmidt, Presiding

AMICUS CURIAE BRIEF OF NORTH DAKOTA PETROLEUM COUNCIL IN SUPPORT OF NEWFIELD AND PETITION FOR REHEARING

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STATEMENT OF IDENTITY AND INTEREST

[¶1] The North Dakota Petroleum Council ("NDPC") respectfully submits this brief as *amicus curiae*, in support of Newfield's pending petition for rehearing. NDPC is a trade association representing more than 500 companies involved in all aspects of the oil and gas industry. NDPC members produce 98 percent of the oil in North Dakota. NDPC member companies have since 1979 entered into oil and gas leases with the State of North Dakota, acting through the Board of University and School Lands ("Land Board"), using the same lease form ("State Lease") at issue in this case. The Land Board owns a significant portion of the mineral acreage in North Dakota. The Court's decision as it stands is of major concern to the state's oil and gas industry and is likely to create material disincentives to investments in gas production, gas capture, and the reduction of flaring.

RULE 29(a)(4)(D) STATEMENT

[¶2] This brief was authored by NDPC's counsel, and not the counsel for any other party. No other party, party's counsel, or any person other than NDPC contributed money to fund preparing or submitting this brief.[1]

ARGUMENT

[¶3] The crux of this case is interpreting a gas royalty "based on <u>gross proceeds of sale where such sale constitutes an arm's length transaction</u>." App. 26, State Lease ¶ 4.C. The Court's opinion in this case ("Opinion") "overlooked or misapprehended" several important points of fact and law, and is therefore ripe for rehearing under N.D.R.App.P. 40.

[1] Encana Corporation, Newfield's parent company, is one of NDPC's more than 500 dues-paying members but did not contribute any money to this brief.

A. **The Opinion rests on an incorrect assumption that the gas at issue must be processed to remove hydrogen sulfide or that it is otherwise "unmarketable" when sold by Newfield in an arm's length sale.**

[¶4] The Court's reasoning in this case begins with the following statement: "Typically, when natural gas is extracted, it contains hydrogen sulphide, which requires removal to make the product marketable." Opinion ¶ 6 (citing *West v. Alpar Res., Inc.*, 298 N.W.2d 484, 487 (N.D. 1980)). This statement is factually incorrect. NDPC can locate no evidence in the record that Newfield's gas at issue contained hydrogen sulfide at a level requiring removal. Rarely does gas produced from the Bakken formation (and thus the vast majority of gas production in North Dakota) contain hydrogen sulfide at levels requiring removal before sale. According to a study commissioned by the North Dakota Transmission Authority, which is governed by the North Dakota Industrial Commission: "Bakken natural gas is predominantly sweet, which means it has lower levels of hydrogen sulfide. The key difference between sweet and sour natural gas is that sweet gases can be directly sold to consumers while sour natural gas must first be treated."[2] North Dakota Transmission Authority, Kadrmas, Lee & Jackson, *Power Forecast 2012*, *available at* https://www.nd.gov/ndic/ic-press/Power2012.pdf.

[¶5] Here, both gas purchase contracts attached to the State's summary judgment affidavit have "Quality Specifications" limiting hydrogen sulfide to low levels. Newfield App. 43 and 68. The Land Board has not contended Newfield's gas exceeded the Quality Specifications for hydrogen sulfide or any other impurity, or that any expenses were incurred for removing hydrogen sulfide. By contrast, the gas at issue in *West*, from a single

[2] NDPC believes this proposition is a legislative fact, or alternatively a fact not subject to reasonable dispute and thus proper for judicial notice.

well, "contain[ed] hydrogen sulfide which is known in the oil and gas industry as 'dirty' or 'sour' gas." 298 N.W.2d at 487. "In order to obtain 'clean' or 'sweet' gas which is a usable and marketable product it [was] necessary to extract the hydrogen sulfide from the sour gas." *Id.* As a result, the lessee in *West* had to construct <u>its own</u> amine plant on the lease premises to remove hydrogen sulfide <u>before it could sell the gas</u> to a third party. *Id.* This distinction places *West* in sharp contrast with this case, as Newfield produced gas of a sufficient quality that it was able to sell the gas to a third party in an arm's length transaction.

[¶6] That Newfield sold its gas to Oneok in an arm's length transaction means the gas was marketable. "Marketable" means "Of commercially acceptable quality; fit for sale and in demand by buyers." Marketable, Black's Law Dictionary (11th ed. 2019). The parties agree Newfield sold its gas to a buyer, Oneok. The parties agree it was an arm's length transaction and ownership of the gas passed to Oneok at the point of sale. That Oneok took delivery suggests the gas was of commercially acceptable quality as defined in the contract's quality specifications, and the record contains no evidence to the contrary. *See* Quality Specifications, Newfield App. 43 and 68. The buyer then took the gas it purchased and further enhanced its value by separating residue gas from natural gas liquids such as ethane, propane, methane, and butane, and selling those products separately. *See* Newfield App. 34 (defining "NGL's"). This is common in the Bakken, which has an active market for natural gas. That natural gas is marketable when produced in the Bakken is demonstrated not only by Oneok's purchases from Newfield but also by the fact that there are nearly 20 companies owning dozens of natural gas facilities that purchase and process billions of cubic feet of natural gas daily. *See* North Dakota Pipeline Authority, "Gas Plants," https://northdakotapipelines.com/gas-plants/.

[¶7] In sum, the Opinion incorrectly assumes all gas sales are analogous to the single well in *West*, and that incorrect assumption pervades the Opinion. Whereas the lessee in *West* had to remove hydrogen sulfide before it could sell its gas, Newfield produced marketable gas that it sold to Oneok in an arm's length sale. The reasoning in *West* should be limited to situations in which a lessee must treat impurities before it can sell its gas. This alone is ample reason for rehearing.

B. The Opinion incorrectly assumes that Newfield would have borne all processing expenses had it processed the gas itself.

[¶8] The Court's reasoning also rests in part on the following statement: "[I]f Newfield had directly paid Oneok to make the product marketable for Newfield to sell, the State would be compensated based on the price received from the sale of the gas after it was made marketable and without reduction for the costs required to make the product marketable." Opinion ¶ 9. The Opinion states the parties agree. NDPC is unsure the source of such agreement, but the statement is factually and legally incorrect. The statement both wrongly assumes Newfield's production was unmarketable, and also overlooks the lease clause governing gas royalties where an arm's length transaction is absent.

[¶9] In contrast to Newfield, some companies process their own natural gas, usually through a non-arm's length transaction with an affiliated gas plant that separates the gas into natural gas liquids and residue gas before selling it to third parties. Anticipating this situation, the State Lease adopts a distinct royalty valuation rule for such transactions, which accounts for the value-enhancing midstream operations by requiring the lessee to pay royalties on only a percentage of the liquids and residue gas derived.

[¶10] State Lease paragraph 4.E contains the following term: "If a sale of gas . . . does not constitute an arm's length transaction the payment of royalties . . . shall be governed by the rules and regulations of the Board of University and School Lands in effect on the date of this lease." App. 26. In turn, Land Board Rule 85-06-06-08, entitled "Royalties," sets forth royalty rates and methods of valuation for any sale that "does not constitute an arm's length transaction." App. 19. In relevant part, the rule defines the "royalty on any gas processed in a gasoline plant or other plant for the recovery of gasoline or other liquid hydrocarbons" (i.e., a plant such as the Oneok facility here). Land Board Rule 85-06-06-08(2). This subpart sets forth a royalty rate depending on county, and then provides:

> All royalties due herein 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 lessee, whichever is greater, of the total plant production of liquid hydrocarbons attributable to the gas produced from the leased premises[.]

Id. In other words, when a lessee processes gas at an affiliated gas plant, the State Lease requires the lessee to pay royalties on <u>only a percentage of total plant production</u>. Finally, the rule sets forth an exception and alternative calculation for situations in which one or more third parties are "processing gas through the same plant pursuant to arm's length transaction[s]" at certain threshold levels. *Id.*

[¶11] Thus, it is incorrect to say Newfield would bear all processing expenses had it built an affiliated gas plant rather than selling its gas to Oneok. Ironically, if the Opinion stands, lessees like Newfield who sell their gas in arm's length transactions will be forced to pay royalties at a higher rate than lessees who process their gas through an affiliate in non-arm's length transactions. Under the Opinion, Newfield will pay royalties on 100% of Oneok's total plant production. Meanwhile, lessees who transfer their gas to an affiliate for processing will pay royalties on as little as 80% of the derived residue gas and 40% of the derived natural gas liquids. Such a result perversely penalizes companies who sell their natural gas in arm's length transactions and strongly suggests the Opinion misapprehended the royalty term governing arm's length gas sales.

C. In focusing on when the gas becomes a marketable product, the Opinion overlooks or misapprehends this Court's precedents and ignores the plain meaning of "gross proceeds."

[¶12] As shown above, Newfield's gas was "marketable" when sold, as illustrated by the fact that it was of acceptable quality and in demand by an arm's length purchaser. Even so, marketability is <u>not</u> the standard for royalty calculation under the State Lease. Rather, the Court should look to the plain meaning of the contractual language.

[¶13] Because this Court has "join[ed] the majority of states" in "rejecting the first marketable product doctrine," North Dakota law contains no general requirement that a lessee pay the costs incurred in turning unmarketable gas into a difficult-to-determine "marketable product." *Bice v. Petro-Hunt, L.L.C.*, 2009 ND 124, ¶¶ 16-17, 21. Accordingly, the Court should interpret the State Lease without any presumption that a lessee like Newfield bears costs in excess of what it is paid for the gas it sells. This point distinguishes any "gross proceeds" case law from jurisdictions that have adopted the marketable product doctrine.

[¶14] Here, the lease requires a gas royalty based on market value, with "such value to be based on <u>gross proceeds of sale where such sale constitutes an arm's length</u>

transaction." App. 26 State Lease ¶ 4.C (emphasis added). The "sale" referred to is plainly Newfield's sale to Oneok, not Oneok's sale to its own customers. The question then becomes what constitutes Newfield's "gross proceeds" in its sale to Oneok. As this Court characterized the claim in *West,* the term means "the gross proceeds received from the sale of the gas without deduction for the costs of extracting hydrogen sulfide or for other costs incurred by [the lessee] prior to the sale of the gas." 298 N.W.2d at 487 (emphasis added). In *West*, the lessee had to remove hydrogen sulfide in order to make the gas saleable to a third party. *Id.* at 491. The Court accordingly concluded West was entitled to a royalty "based upon a percentage of the total proceeds received by Alpar from the sale of the gas" to a third party. *Id.* (emphasis added). Nothing in *West* suggests a "gross proceeds" lease can result in the lessee owing royalty based on more than "the total proceeds received" by the lessee in an arm's length transaction.

[¶15] In fact, federal courts interpreting North Dakota law and applying *West* have sided with the lessee in a dispute strikingly similar to that here, involving proceeds received under a percentage of proceeds (or "POP") contract. *Sondrol v. Placid Oil Co.* implicated a royalty of "1/6 of the proceeds received for gas sold." 23 F.3d 1341, 1343 (8th Cir. 1994) (emphasis added). The lessee, Placid, sold its gas under a POP contract to a midstream company named Koch Hydrocarbon Company, and Koch in turn gathered and processed the gas before selling it to Montana Dakota Utilities Company. The contract between lessee Placid and midstream company Koch provided that "Koch paid Placid seventy-five per cent of the proceeds Koch received from MDU, less Koch's processing and fuel fees." *Sondrol*, 23 F.3d at 1344. In applying the royalty to this POP contract, the Eighth Circuit held the lease "expressly limits the Sondrols' royalty to one-sixth of whatever Koch [the midstream company] paid Placid [the lessee].” *Id.* at 1345. The Court therefore rejected the Sondrols’ allegation “that their royalties were improperly reduced by Koch’s processing fees.” *Id.* at 1344-45. The Sondrols raised an argument just like the Land Board’s, but the federal district court (later affirmed by the Eighth Circuit) rejected their reasoning:

> *West v. Alpar* is clearly distinguishable on the facts involved as it speaks to the costs of processing and compression, in that Alpar deducted those costs from its “proceeds”. Here, the price or proceeds received and distributed by Placid were passed through as received, without deduction. No claim is made that the purchase and sale agreement between Placid and Koch Hydrocarbon was not an arms length valid agreement.

874 F. Supp. 267, 269-70 (D.N.D. 1993), *aff’d*, 23 F.3d 1341 (8th Cir. 1994). The same reasoning applies to the similar POP agreements between Newfield and Oneok. The Opinion is directly at odds with the reasoning of these federal courts, and yet fails to consider these long-standing interpretations of North Dakota law. This Court will “respect a federal district court opinion if it is persuasive and based upon sound reasoning.” *Bice*, 2009 ND 124, ¶ 19 (adopting federal interpretation of royalty clause). Even greater respect is due a persuasive and on-point opinion from the Eighth Circuit.

[¶16] Finally, the Opinion buttresses its reasoning by noting that the State Lease requires payment of royalty on “the full value of all consideration for such products in whatever form or forms, which directly or indirectly compensates, credits, or benefits lessee.” Opinion ¶ 11 (quoting State Lease ¶ 4.F). The record is devoid of any evidence that Newfield receives additional indirect benefits beyond what Oneok pays. For instance, there is no evidence Newfield received reimbursements, credits, other consideration of value in excess of what Oneok paid for Newfield’s gas. Rather, both Oneok contracts contain the following term: “**<u>Total Consideration</u>.** As total and complete consideration for the purchase of SELLER's Gas, BUYER shall pay SELLER for each month during the term of this Agreement an amount to be calculated in accordance with the provisions described in [the contract's pricing formula]." Newfield App. 20, 49. The Opinion suggests Newfield benefits from Oneok's expenditures. If so, there is a precise way to measure the extent of all benefits Newfield derives: the amount of money that Oneok pays to Newfield under their arm's length contract.

CONCLUSION

[¶17] NDPC respectfully requests that the Court grant Newfield's petition for rehearing.

Dated July 26, 2019.

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CERTIFICATE OF COMPLIANCE

[¶18] This Brief contains 2569 words, excluding the caption, table of contents, table of authorities, and addenda and therefore complies with the length limit in N.D.R.App.P. 29(b)(4). I certify that this Brief complies with the typeface requirements of N.D.R.App.P. 32 and the type style requirements of that rule, because it has been prepared in a proportionally-spaced typeface using a Microsoft Word, Times New Roman, 12 point font.

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CERTIFICATE OF SERVICE

[¶19] I hereby certify that on July 26, 2019, the following document: *Amicus Curiae* Brief of North Dakota Petroleum Council in Support of Newfield and Petition for Rehearing was filed electronically with the Clerk of Supreme Court and served by electronic mail upon the following:

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