20190088

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SEPTEMBER 4, 2019
STATE OF NORTH DAKOTA

IN THE SUPREME COURT

STATE OF NORTH DAKOTA

Newfield Exploration Company, Newfield Production Company, and Newfield RMI LLC,	)	
	)	**Supreme Ct. No. 20190088**
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,	)	**District Ct No. 27-2018-CV-143**
Appellants.	)	

APPEAL FROM THE MARCH 1, 2019
JUDGMENT OF THE DISTRICT COURT
MCKENZIE COUNTY, NORTH DAKOTA
NORTHWEST JUDICIAL DISTRICT

HONORABLE ROBIN A. SCHMIDT

RESPONSE TO PETITION FOR REHEARING

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INTRODUCTION

[¶1] The North Dakota Supreme Court requested that Appellants, North Dakota Board of University and School Lands ("Board") and North Dakota Department of Trust Lands ("Department") (Board and Department collectively "State"), submit a brief in response to the Petition for Rehearing ("Petition") filed by Appellees, Newfield Exploration Company, Newfield Production Company, and Newfield RMI LLC (collectively "Newfield"), and the Amicus Curiae Briefs filed in support thereof by the North Dakota Petroleum Council ("NDPC") and Western Energy Alliance ("WEA"). The District Court granted summary judgment in favor of Newfield. This Court reversed. Newfield contends this Court's decision "represents a significant and unprecedented shift in North Dakota oil and gas jurisprudence," and, thus, the Petition should be granted. Petition ¶ 1. The State disagrees. For the following reasons, this Court should deny the Petition and uphold its decision reversing the District Court's judgment. The State requests, however, that this Court clarify its position to provide that regardless of whether post-production costs are incurred by a lessee pre or post-marketability of gas, such costs are not deductible from royalties paid under the Board's Lease, as the State argued in detail in its Briefs to this Court.

STATEMENT OF CASE AND STATEMENT OF FACTS

[¶2] The State incorporates the "Statement of Case" and the "Statement of Facts" from its "Brief of Appellants."[1] For the purposes of this Brief, however, the

[1] All capitalized terms in this Brief have the meaning ascribed to them in the Brief of Appellants filed with this Court.

State adds the following:

[¶3] This Court's decision can only be understood properly when considered within the context of the facts of the case. Both Newfield, during oral argument, and the NDPC, in its Brief, argue the gas produced by Newfield was marketable at the well. NDPC Br. ¶ 6. Newfield, however, elected to contract with Oneok pursuant to the Oneok Agreements for the sale of the processed gas downstream to increase the value of the gas. In other words, notwithstanding Newfield's claim there was a market for the gas at the well, it elected to remain a party to the downstream sale of the processed gas and benefitted from the sale.

[¶4] As part of the Oneok Agreements, Newfield agreed to pay Oneok for numerous costs, including all costs to process the gas incurred prior to the downstream sale, irrespective of when the gas actually became marketable. Had Newfield *sold the gas at the well* and *received payment at the well*, Newfield would have owed royalties on that amount. Once Newfield elected to remain part of the downstream sale by paying Oneok for all post-production costs associated with the downstream sale, the price upon which royalties had to be paid was increased pursuant to the royalty provision requiring royalties to be paid on the gross proceeds of sale.

[¶5] The State argued that West controls the analysis of how royalties are paid under a gross proceeds lease. West v. Alpar Res., Inc., 298 N.W.2d 484 (N.D. 1980). This Court agreed with the State. Based on West, "[a] royalty provision that provides for payments based on the gross proceeds of sale does not require the lessor to bear any post-production costs." Appellants' Br. ¶ 20. See West, 298

N.W.2d at 490 (stating gross proceeds means without deduction of any kind); see also Chesapeake Expl., L.L.C. v. Hyder, 483 S.W.3d 870, 873 (Tex. 2016) ("The gas royalty in the lease does not bear postproduction costs because it is based on the price [lessee] actually receives for the gas . . . after postproduction costs have been paid. Often referred to as a 'proceeds lease', the price-received basis for payment in the lease is sufficient in itself to excuse the lessors from bearing postproduction costs." (footnote omitted)). Thus, this Court correctly concluded Newfield must pay royalties based on the downstream sales price without deduction for any post-production costs. Further, other jurisdictions that follow the "at the well" rule, when interpreting leases with royalty provisions similar to those in the Board's Lease, have held that post-production costs are not deductible irrespective of the point of marketability. See id.; see also Yturria v. Kerr-McGee Oil & Gas Onshore, LLC, 291 F. App'x 626, 634 (5th Cir. 2008). Thus, in rendering its decision, this Court did not need to distinguish between costs incurred pre and post-marketability.

I. This Court's decision is consistent with its prior rejection of the marketable product doctrine.

[¶6] Newfield argues this Court adopted the marketable product doctrine based on its statement that "'[i]n an oil and gas lease contract, the term "gross proceeds" indicates a lessor's royalty is calculated based on the total amount received for the product without deductions for making the product marketable.'" Petition ¶ 7 (quoting Opinion ¶ 6). "The first marketable product doctrine requires the lessee to pay any costs incurred in turning the unmarketable gas into a marketable product. . . . Once the gas is marketable, additional costs incurred to enhance the products marketability are shared between the lessee and the lessor." Bice v. Petro-Hunt L.L.C., 2009 ND 124, ¶ 16, 768 N.W.2d 496.

[¶7] By focusing on the term "marketable," however, Newfield fails to consider the context in which this Court uses this term based on the parties' arguments and the fact Newfield's sale of the gas was not final until the gas was sold downstream. Opinion ¶ 11. The State never limited its argument to costs incurred before or after the point of marketability. In fact, the State argued that *all* post-production costs must be borne solely by the lessee under a gross proceeds lease, regardless of whether they are incurred before or after the product has become marketable.

[¶8] The State argued specifically:

> Newfield pays the consideration due to Oneok under the [provisions of the] Oneok Agreements by accepting a downstream sales price net of all post-production costs. App. 57-68. There is no material difference between this provision and a provision requiring Newfield to pay post-production costs directly. Simply put, Newfield pays for the post-production costs required to sell the gas downstream. Thus, the West holding supports the State's position that Newfield cannot require the State to share in post-production costs which include all costs, expenses, and fees under the Oneok Agreements because it requires royalties be paid based on the downstream price prior to deduction of post-production costs, i.e., gross proceeds. 298 N.W.2d at 491. Payment of royalties on the price actually paid to Newfield, after reducing the price by post-production costs charged to Newfield, would transform the Board's Lease from a "gross proceeds" lease into a "net proceeds" lease, contrary to the West holding. Id.

Appellants Br. ¶ 24.

> Contrary to Newfield's position, gross price is not the price it received from Oneok. Index # 28 ¶ 13. Newfield contends that it is complying with the Board's Lease by paying royalties based on the price it receives from Oneok because Newfield does not deduct any of the post-production costs from this price. Id. Pursuant to the Oneok Agreements, however, Newfield has agreed to accept a price for the sale of its gas, less post-production costs it incurs for gathering,

> transporting, processing, and fractionating. App. 57-68. Thus, Newfield's statement it pays royalties based on the price it receives from Oneok is misleading. The price Newfield receives for the gas is actually the price Oneok receives from the sale of the gas downstream. That price is then reduced by post-production costs charged to Newfield as compensation payable to Oneok for services it provides in accordance with the Oneok Agreements. The Board's Lease requires royalties be paid based on gross proceeds and, thus, Newfield is not adhering to this requirement when it pays royalties based on a price reduced by post-production costs. . . . Based on the West holding and the reasoning applied by the Texas courts, the State's royalty must be "without deduction for expenses" including post-production costs incurred by its lessee such as those incurred by Newfield under the Oneok Agreements. West, 298 N.W.2d at 490.

Id. ¶ 40.

[¶9] This Court agreed with the State and aptly characterized its argument stating "[t]he State contends it is being required to share in the post-production costs contrary to the leases." Opinion ¶ 9. This Court concluded that "[w]hile title to the gas passes at the well, the transaction is not complete, and full value of the consideration paid to Newfield is not determined until Oneok has incurred the cost of making the gas marketable *and subsequently sold the marketable gas. Newfield's compensation is calculated based on the amount Oneok receives for the marketable gas."* Id. ¶ 11 (emphasis added). Thus, this Court was basing its decision on the amount received for the marketable gas, irrespective of both when the gas was made marketable and whether post-production costs were incurred before or after the point of marketability.

[¶10] This Court's decision did not reject the State's argument that costs incurred by a lessee after a product is marketable are not deductible if they are incurred as part of a downstream sale. It merely limited its decision to those costs to make the gas marketable based on its assumption the gas was not marketable at the well.

It is worth repeating that "'[a]ll activities that take place after the oil and gas are severed from the land at the wellhead are post-production activities....[P]ost-production activities "add value to production in its raw state at the location of the wellhead prior to a final sale." Post-production expenses include treatment costs to render the gas marketable, compression costs, dehydration costs, and transportation costs....'" Appellants' Br. ¶ 20 (citation omitted).

[¶11] The spirit of this Court's decision is clear in that the State cannot be required to share in any of these costs. Therefore, if this Court clarifies its decision to eliminate the need for a determination of when gas becomes marketable as part of determining whether post-production costs are deductible, it should reject Newfield's argument that this Court has adopted the marketable product doctrine.

[¶12] Newfield and WEA reargue that North Dakota's status as an "at the well" state should dictate the outcome of this case. Petition ¶ 8; WEA Br. ¶ 7. The State does not deny that North Dakota is an "at the well" state. This Court's decision, however, is premised upon its acknowledgment that, through the Board's Lease, the State and Newfield have elected to contract around the general "at the well" rule.[2] Opinion ¶ 6.

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[2] "Courts . . . recognize the ability of lessees and lessors to contract around the general rules regarding the deduction of post-production costs." Appellants' Br. ¶ 20. In other words, the terms of a royalty provision, rather than the general rule, govern whether a lessee can deduct post-production costs. A royalty provision that provides for payments based on the gross proceeds of sale does not require the lessor to bear any post-production costs. <u>See</u> <u>West</u>, 298 N.W.2d at 490 (stating gross proceeds means without deduction of any kind).

II. **<u>This Court's decision does not require a determination of when gas becomes marketable.</u>**

[¶13] This Court was not required to determine when the gas became marketable as the decision did not adopt the marketable product doctrine. See Petition ¶ 20. Under the "at the well" rule, a lessee is required to pay royalties on the "net proceeds" of sale which does not require a determination of marketability as all pre and post-production costs are "netted out" of the sales price. Under a gross proceeds lease, even in jurisdictions following the "at the well" rule, a lessee is required to pay royalties on the sales price without deduction for pre and post-production costs. This too does not require a determination of marketability. As noted above, this Court concluded the parties chose to contract around the "at the well" rule by inclusion of the phrase "gross proceeds of sale." Opinion ¶ 6. Thus, there is no reason for this Court to determine the point of marketability. The parties do not dispute North Dakota has rejected the marketable product doctrine; however, If this Court would distinguish between deduction of costs based on whether they were incurred by a lessee pre or post-marketability, it would essentially be following the marketable product doctrine. Only in marketable product doctrine jurisdictions is the point of marketability relevant in determining the deductibility of post-production costs. Thus, this Court should clarify its decision to conclude that all post-production costs incurred by Newfield are not deductible given that the parties have contracted around the general rule.

[¶14] Other than by clarifying its decision, this Court should not modify the outcome of this case even if the product is marketable at the well given that Newfield is compensated for the alleged at the well sale based on the downstream sale of the processed gas. As the State has repeatedly argued, "only under a lease requiring payments based on net proceeds or market value at the well can a lessee pay a royalty reduced by post-production costs it incurs from the downstream sale. Based on this reasoning, if a lessee purports to sell gas at the well but is paid based on a downstream sales price less post-production costs, those costs are not deductible from the royalty payment as the lessor is entitled to a royalty payment based on the gross proceeds, not net proceeds, of the sale." Appellants' Br. ¶ 25.

III. This Court's decision properly addresses the terms of the Board's Lease including the Board's Oil and Gas Rules.

[¶15] The NDPC reargues the point Newfield argued throughout the course of this litigation that Newfield's gross proceeds are only the amount it receives from Oneok. NDPC Br. ¶¶ 14-16. This Court already rejected this argument as it recognized that, under the facts of this case, the transaction is not complete until the downstream sale occurs and that "Newfield's compensation is calculated based on the amount Oneok receives for the marketable gas." Opinion ¶ 11. This Court emphasized that "[s]ubpart (f) of the lease unambiguously provides the State's royalty must include the value of any consideration, in whatever form, that directly or indirectly compensates, credits, or benefits Newfield." Id. This Court stated that "the term 'gross proceeds' [in Section 4(c) of the lease] indicates a lessor's royalty is calculated based on the total amount received for the product without deductions for making the product marketable." Id. ¶ 6. As such, this Court should reject Newfield's argument that it only benefits from the sale of the gas to the extent of the amount it receives from Oneok unless it reaches the following conclusions: (1) post-production costs incurred by Newfield as part of the downstream sale are deductible from royalties under a gross proceeds lease; (2) the replacement of the phrase "at the well" with "gross proceeds of sale" has no impact on the payment of royalties in this case even though the lessee continued to incur costs and benefit from the downstream sale of its gas; and (3) "gross proceeds" and "net proceeds" mean the same thing when a sale is alleged to have occurred at the well but the lessee continues to incur post-production costs as part of the downstream sale from which it benefits. None of these conclusions have any merit and should not be adopted by this Court. Moreover, as one court has cautioned, "nonworking interest owners (royalty owners) have no input into the cost-bearing decisions. These owners have no input on the marketing decisions. If costs were imposed on royalty owners they 'would be sharing the burdens of working interest ownership without the attendant rights.'" Mittelstaedt v. Santa Fe Minerals, Inc., 954 P.2d 1203, 1207 (Okla. 1998) (citations omitted).

[¶16] Additionally, Newfield and the NDPC continue to argue the State's interpretation of the Board's Lease cannot be reconciled with Board Rule 85-06-06-08 relating to non-arm's length transactions. Petition ¶ 11; NDPC Br. ¶¶ 10-11. Specifically, they contend this provision amounts to a percentage of proceeds deduction in the sale of gas to an affiliated purchaser and, under the State's interpretation, affiliated purchasers are treated more favorably than third parties in an arm's length transaction. This is a fundamental misinterpretation of this rule. The Board's Rules do not provide for a percentage of proceeds deduction for the sale of gas in a non-arm's length transaction but rather are designed to protect the lessor in a situation where the lessee sells less than 100% of the total plant production of gas, i.e., volumes saved after processing. The Board's Rules provide in relevant part:

> 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 . . . . Respective royalties on residue gas and on liquid hydrocarbons where the requirements for using third party transactions cannot be met shall be determined by 1) the highest market price paid for any gas (or liquid hydrocarbons) of comparable quality and quantity under comparable conditions of sale in the general area F.O.B. at the plant after processing, 2) the gross proceeds of sale for such residue gas (or the weighted average gross proceeds of sale for the respective grades of liquid hydrocarbons), F.O.B. at the plant after processing, or 3) the gross proceeds of sale paid to a third party processing gas through the plant, whichever is greater. . . .

Appellants' App. 19.

[¶17] Newfield previously argued the above quoted language is consistent with agreements where lessees accept payment for gas on only a percentage of the proceeds received for the sale of the gas. This is incorrect. Under the rule for non-arm's length transactions, gas royalties must be based on 80% of the total plant production of residue gas produced or 40% for liquid hydrocarbons attributable to such gas, or the percent accruing to lessee, whichever is greater. Thus, if lessee is incapable of selling 80% of residue gas or 40% of liquid hydrocarbons saved after processing, at a minimum it must pay royalties on those percentages. If lessee sells over 80% or 40%, as applicable, royalties are due on the actual volumes sold. Thus, the argument that the Board's rule for non-arm's length transactions allows for a percentage of proceeds deduction must fail.

IV. <u>Cases analyzing "at the well" leases do not control this Court's analysis of the Board's Lease</u>.

[¶18] The NDPC and WEA raise arguments already raised by Newfield, and Newfield reargues, that cases involving "at the well" royalty provisions control the interpretation of the Board's Lease. NDPC Br. ¶ 15; WEA Br. ¶ 14, Petition ¶ 21. Specifically, Newfield and WEA ask this Court to reconsider <u>Fawcett v. Oil Producers, Inc.</u>, 352 P.3d 1032 (Kan. 2015), and the NDPC asks this Court to reconsider <u>Sondrol v. Placid Oil Co.</u>, 23 F.3d 1341 (8th Cir. 1994), after this Court has already reviewed and rejected both cases as controlling its interpretation of the Board's Lease. In response to these arguments, the State incorporates its Brief of Appellant ¶¶ 53-58 and Defendant's Reply to Plaintiffs' Brief in Opposition to Cross-Motion for Summary Judgment ¶¶ 26-28. Index # 59.

<u>CONCLUSION</u>

[¶19] For the foregoing reasons, the State respectfully requests the Court deny the Petition for Rehearing and clarify its decision that regardless of when the gas became marketable, post-production costs incurred by Newfield as part of the downstream sale cannot be deducted from royalties under the Board's Lease. All arguments raised can be resolved by the analysis of the State and Newfield in their Briefs and the discussion at oral argument, without the need for a rehearing.

Dated this 4th day of September, 2019.

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IN THE SUPREME COURT

STATE OF NORTH DAKOTA

Newfield Exploration Company, Newfield Production Company, and Newfield RMI LLC,	)	**CERTIFICATE OF COMPLIANCE**
Appellees,	)	**Supreme Ct. No. 20190088**
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,	)	**District Ct No. 27-2018-CV-143**
Appellants.	)	

[¶1] The undersigned certifies that pursuant to written request from the Clerk dated August 20, 2019, the Response to Petition for Rehearing contains 14 pages.

[¶2] This brief has been prepared in a proportionally spaced typeface using Microsoft Office Word 2016 word processing software in Arial 12 point font.

Dated this 4th day of September, 2019.

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STATE OF NORTH DAKOTA

Newfield Exploration Company, Newfield Production Company, and Newfield RMI LLC, Appellees,	)	**CERTIFICATE OF SERVICE**
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[¶1] I hereby certify that on September 4, 2019, the following documents: **RESPONSE TO PETITION FOR REHEARING and CERTIFICATE OF COMPLIANCE** were filed electronically with the Clerk of Supreme Court through the E-Filing Portal and served by electronic mail upon Lawrence Bender at lbender@fredlaw.com, Spencer Douglas Ptacek at sptacek@fredlaw.com, John W. Morrison Jr. at jmorrison@crowleyfleck.com, Craig Cordell Smith at ccsmith@ crowleyfleck.com, Paul Jonathan Forster at pforster@crowleyfleck.com, and Ryan Andrew Pittman at rpittman@gablelaw.com.

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