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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.	Supreme Court No. 20190088

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

PETITION FOR REHEARING

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TABLE OF CONTENTS

TABLE OF AUTHORITIES

Paragraph

CASES

STATUTES AND RULES

SECONDARY SOURCES

INTRODUCTION

[¶ 1] The Court's decision represents a significant and unprecedented shift in North Dakota oil and gas jurisprudence. Since this Court's decision in *Bice v. Petro-Hunt, L.L.C.*, numerous oil and gas companies like Newfield have obtained leases, drilled wells, and sold oil and gas with the understanding that North Dakota is an "at the well" state. The Court's opinion breathes new life into the previously rejected "last marketable product" doctrine and creates uncertainty in lessor-lessee relationships developed over the past ten years. The instability in the law created by the Court's decision will only increase litigation over royalty payments, further burdening the courts of this State with lessors and lessees forced to seek a determination of their now uncertain rights.

STATEMENT OF ISSUES ON REHEARING

[¶ 2] **Point of Law No. 1.** The Court adopts the "first marketable product" doctrine" in direct conflict with its prior rejection of that doctrine in *Bice v. Petro-Hunt, L.L.C.*, 2009 ND 124, ¶ 21, 768 N.W.2d 496, 502 (2009).

[¶ 3] **Point of Law No. 2.** The Court's adoption of a "marketability" standard leads to an interpretation of the term "gross proceeds" that is inconsistent with the law in an "at the well" state like North Dakota.

[¶ 4] **Point of Law No. 3.** The Court erroneously interprets Subpart (f) in isolation from the remainder of the Lease.

[¶ 5] **Point of Law No. 4**. The Court incorrectly concludes that Newfield's gas is not marketable until it is sold by Oneok and fails to articulate a definition of marketability.

STATEMENT OF THE CASE AND THE FACTS

[¶ 6] Paragraph 4 of the Court's Opinion sets forth the procedural history of this case. Newfield incorporates the Statement of Facts from its "Brief of Appellees."

LAW AND ARGUMENT

I. The Court Seemingly Adopts the "First Marketable Product" Doctrine in Direct Conflict with its Prior Rejection of that Doctrine in *Bice*.

[¶ 7] In *Bice v. Petro-Hunt, L.L.C.*, 2009 ND 124, ¶ 21, 768 N.W.2d 496, 502 (2009) this Court announced that it was joining "the majority of states" and "rejecting the first marketable product doctrine." Indeed, the State agrees that marketability "does not control the interpretation of the Lease as North Dakota has rejected the marketable product doctrine." Newfield App. 3. Yet, the Opinion now adopts that very doctrine, stating, for example: "In an oil and gas contract, the term 'gross proceeds' indicates a lessor's royalty is calculated based on the total amount received for the product without deductions <u>for making the product marketable</u>."[1] Opinion, ¶ 6 (emphasis added).

[¶ 8] This erroneous "marketability" language leads to an improper interpretation of the Lease. In "at the well" states like North Dakota a lessee does not have an implied duty to put its gas into a marketable form. *See Bice*, 2009 ND 124, ¶¶ 17, 21. Indeed, there is no case interpreting a "gross proceeds" royalty provision in any "at the well" state that requires payment of royalties on more than the price actually received by the lessee for sale of its gas, <u>wherever</u> that sale occurs. This would be the first.

[¶ 9] Accordingly, this Court should grant rehearing, remove the erroneous "marketability" language from its opinion, and hold that Newfield properly paid royalties on 100% of the gross proceeds from the sale of its gas to Oneok.

[1] The Court's authority for adopting such a doctrine is *West v. Alpar Res., Inc.*, 298 N.W.2d 484, (N.D. 1980), which is inapposite. The *West* case focused on whether costs to remove hydrogen sulfide from "sour" gas prior to sale could be deducted from royalty on a proceeds lease. *Id.* at 487. Here, the record does not indicate that Newfield's gas is sour (in fact it is not) or that it required treatment before sale (again it did not).

II. The Court's Interpretation of Subpart (f) of the Lease Fails to Harmonize all the Terms of the Lease and Leads to a Fatal Conflict.

[¶ 10] To the extent the Opinion is based not on this "marketability" language, but rather on the Court's interpretation of Subpart (f) of the Lease, it is also flawed. Specifically, the Opinion appears to overlook the fact that the Board's regulations are expressly incorporated into the Lease and become part of its terms. *See* App. 27, ¶ 13.

[¶ 11] Regulation 85-06-06-08 creates a floor on which royalties must be paid when a lessee enters into a "percentage of proceeds" or POP contract with its affiliate. *See* App. 19. For example, for residue gas, the regulation requires the lessee to pay royalties on the greater of: (1) 80% of the proceeds received downstream by the affiliate, or (2) the amount the lessee actually receives from the affiliate. *Id.* Yet, under the Court's interpretation of Subpart (f), the lessee would be required to pay royalties on the full amount of the affiliates' post-production costs. Those results are in direct conflict.[2]

[¶ 12] "[A] contract must be construed so as to harmonize its various parts whenever reasonably possible." *Keller v. Clark Equip. Co.*, 715 F.2d 1280 (8th Cir. 1983) (applying North Dakota law); *see also Burk v. Nance Petroleum Corp.*, 10 F.3d 539, 543 (8th Cir. 1993) (stating that the "court should attempt to harmonize provisions in an oil and gas lease even if they appear to be contradictory and inconsistent with each other"); N.D. Cent. Code Ann. § 9-07-06. Here, the only way to reconcile Subpart (f) with Regulation 85-06-06-08, is to adopt the interpretation advanced by Newfield.

[¶ 13] Subpart (f) states: "All royalties on . . . gas . . . shall be payable on an amount equal to the full <u>value of</u> all consideration for such products in whatever form or forms, which directly or indirectly compensates, credits, or <u>benefits lessee</u>." App. 26 (emphasis

[2] Even if the Court were to find that there is no conflict, the practical result of the holding is to encourage affiliated transactions over arms-length transactions.

added). This Court concluded that, "Newfield unquestionably benefits from Oneok's expenditures to make the gas marketable." Opinion, ¶ 11. However, the Court did not take the next step and address the "value" of that consideration. The consideration exchanged between the parties in this case is straightforward: Newfield gives Oneok its gas and Oneok pays Newfield. Thus, the "value" of the consideration that Newfield receives is the amount that Oneok ultimately pays Newfield—in other words, its "gross proceeds of sale." Newfield is already paying royalties on that full amount.

[¶ 14] The State's suggestion that the regulation addresses only those situations where the lessee sells less than 100% of the gross production of gas is nonsensical. *See* Appellant's Br. at 36. The regulation presumes that the lessee has already sold its gas to an affiliate who is processing and selling the gas downstream. *See* App. 19 (addressing "a sale of gas" that "does not constitute an arm's length transaction").

[¶ 15] Even if this Court were not persuaded to accept Newfield's interpretation as a matter of law, then the Lease is, at a minimum, ambiguous. "When an ambiguous contract is at issue, the parties' intent becomes a question of fact." *Heitkamp v. Kabella*, 2019 ND 96, ¶ 13, 925 N.W.2d 446, 450.

[¶ 16] Accordingly, the Court should grant rehearing, adopt Newfield's interpretation of Subpart (f) or, in the alternative, remand to the district court for further inquiry into the intent of the parties at the time they entered into the Lease.

III. If the Court Adheres to its Newly-Created Marketability Standard, the Court Should Remand to Determine When the Gas Becomes "Marketable."

A. The Court Lacked Jurisdiction to Reverse, Affirm, or Otherwise Make Findings of Fact as to the Marketability of the Gas.

[¶ 17] The Opinion decides, at least implicitly, that the gas sold by Newfield to Oneok is not marketable at the wellhead but rather only becomes marketable at the tailgate of the processing plant where Oneok sells residue gas and NGLs to a third party. *See, e.g.*, Opinion, ¶¶ 3, 6, 11. This exceeds the limited role the Court has outlined for itself on review of a summary judgment order, where the Court "may only determine if a genuine issue of fact exists and if the law was applied correctly." *Martin v. Martin*, 1997 ND 157, ¶ 6, 568 N.W.2d 280, 282). The Court cannot decide disputed issues of material fact. *See Fed. Land Bank of Saint Paul v. Wallace*, 366 N.W.2d 444, 449 (N.D. 1985).

[¶ 18] Though there appears to be no North Dakota case law analyzing the issue of marketability, other states recognize that marketability presents a question of fact. *See, e.g., Rogers v. Westerman Farm* Co., 29 P.3d 887, 905–06 (Colo. 2001); *Mittelstaedt v. Santa Fe Minerals, Inc.*, 954 P.2d 1203, 1213–14 (Okla. 1998) (Opala, J., dissenting in part) (explaining that "[t]reating marketability as a question of law ignores market realities"). In other words, the marketability of gas production is not appropriate for resolution by summary judgment, or by appellate review of summary judgment.

[¶ 19] In this case there were no conclusions by the district court as to the marketability of the gas at issue in this case, and the parties did not present evidence to the district court on this specific issue. *See* App. 87–90.

B. The Opinion Does Not Define Marketability.

[¶ 20] In addition to assuming the gas is marketable, the Opinion does not actually set forth a legal standard for determining "marketability" of oil and gas, even though such a standard is necessary to apply the Court's holding to future cases and to this case should the Court remand. The Opinion states, "[g]ross proceeds from which the royalty payments under the leases are calculated may not be reduced by an amount that either directly or indirectly accounts for post-production costs <u>incurred to make the gas marketable</u>." Opinion, ¶ 12 (emphasis added). In other words, in order to determine which costs may or may not be deducted from the "gross proceeds" for the sale of gas, a court must determine whether the costs were incurred before or after gas became marketable. To make this determination, a court must decide when the gas became marketable. The absence of a standard for determining marketability will cause difficulties in this case and beyond. *See* Alexander K. Obrecht et al., *Chapter 6 High-Stakes Royalty Litigation: Class Actions and Federal Royalty Demands*, 64 ROCKY MTN. MIN. L. SPECIAL INST. 6, *6-8 & n.38 (2018) (commenting that lack of judicial clarity regarding when gas is marketable has led to "an endless wave of expensive, burdensome, and wasteful litigation"); *Bice*, 2009 ND 124, ¶ 17, 768 N.W.2d 496 (acknowledging the difficulty that can arise from failure to articulate a marketability standard).

[¶ 21] On appeal, Newfield identified for the Court a case from which a standard for determining marketability could be drawn. In *Fawcett v. Oil Producers, Inc. of Kansas*, 352 P.3d 1032 (Kan. 2015), the court upheld a producer's calculation of royalties based on the total price it received under a percentage of proceeds contract, and recognized that gas can be "sold" or "marketed" at the wellhead under a percentage of proceeds contract. *Id.* at 1041–42. It also recognized generally that gas is "marketable" when "the operator delivers the gas to the purchaser in a condition acceptable to the purchaser in a good faith transaction." *Id.* at 1042; *cf. Amerada Hess Corp. v. Conrad*, 410 N.W.2d 124, 129 (N.D. 1987) (defining "fair market value" as "the highest price for which property can be sold in the open market by a willing seller to a willing purchaser, neither acting under compulsion and both exercising reasonable judgment"). This was the only case law presented to the Court from which a standard of marketability could be derived, and such a standard is necessary to apply the Court's holding to the facts of this case. The Court appears to have overlooked or misapprehended this case law to the extent that, as explained in Part III.A, *supra*, the Opinion suggests that that Newfield's gas was not marketable when it was sold to Oneok.

[¶ 22] Accordingly, should the Court decide to adhere to its newly-created marketability standard, the Court should grant Newfield's petition for rehearing, expressly set forth the standard by which courts should determine the marketability of gas, and remand this case to the trial court to determine when the gas at issue is marketable.

REQUEST FOR RELIEF

[¶ 23] For the foregoing reasons, Newfield respectfully requests that this Petition for Rehearing be granted, and that the Court hold that Newfield properly paid royalties on 100% of the gross proceeds from the sale of its gas to Oneok or, in the alternative, clarify its statements in the Opinion concerning marketability of gas and remand this case to the trial court to determine when the gas at issue is marketable.

Dated this 25th day of July, 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 40(b) of the North Dakota Rules of Appellate Procedure. The total number of pages in the brief, excluding the certificate of service and this certificate of compliance is ten (10) pages.

Dated this 25th day of July, 2019.

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

CERTIFICATE OF SERVICE

I, the undersigned, hereby certify that the Petition for Rehearing was, on July 25th, 2019, filed electronically with the Clerk of North Dakota Supreme Court and served by e-mail on the following:

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