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STATE OF NORTH DAKOTA

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IN THE SUPREME COURT
STATE OF NORTH DAKOTA

Virginia Bice, Helen A. and Hillis J. Bice, Helen A. Bice Life Estate, Naomi Brew, Patricia Burian Ingman, Myran S. and Mary C. Burian, Estate of Steve Burian, Arnold and Sharon Burian, Connie F. Burian Heck, Jane Elizabeth Kiker, Elmer L. Glovatsky, Timothy Glovatsky, Shirley and Lawrence W. Jablonsky, Leo and Selina Kaiser, Russell L. Kiker, Russell L. Kiker Trust, Sally A. Kiker Trust, Ardyce Burian Palanuik, Irene E. Scott Mineral Trust, Jane Scott, William D. and Agnes M. Scott, Ervin and Mildred Waldie, Gregory Lynn Waldie, Mary M. Weber, Martin A. Weber, Jerry Zabalotny, William D. Walters, Jr., Imperial Oil Company c/o William D. Walters, Jr., Lillian Hardcastle, a/k/a Lillian Kaiser, Robert T. Smith, Carrie W. Smith,

Plaintiffs-Appellants,

vs.

Petro-Hunt, L.L.C., J.W. Beavers, Jr., as Trustee of William Herbert Hunt Trust Estate,

Defendants-Appellees

Appeal from Judgment entered August 19, 2008 pursuant to Order for Judgment on Motions for Summary Judgment regarding Memorandum Opinion dated April 30, 2007 and Memorandum Opinion and Order Granting Summary Judgment dated July 30, 2008
Honorable Zane Anderson
Billings County District Court, Southwest Judicial District
Supreme Court No. 20080265
Billings County Civil No. 01-C-00001

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Marketable Product

[¶1] Contrary to Petro-Hunt's assertions, Petro-Hunt's "wellhead-value" argument is the minority view. Appellee's Brief (p. 7).[1] Only California, Louisiana, and Texas follow it. The Fifth Circuit has recognized it in diversity cases in Mississippi and Alabama, discussed below. No state has adopted "wellhead-value" since Schroeder v. Terra Energy, Ltd., 565 N.W.2d 887 (Mich. Ct. App. 1997)—quickly limited by a statute, MICH. COMP. LAWS § 324.61503b, prohibiting deductions that Petro-Hunt takes when calculating royalty. Schroeder is "poorly reasoned" because, while correctly concluding that "at the well" means FOB the well, it then erroneously determined that FOB means more than location. Id. at 892. All Schroeder citation history is negative.

[¶2] California adopted "wellhead-value" in Atlantic Richfield Co. v. State, 262 Cal. Rptr. 683 (Cal. App. 1989), erroneously construing past precedent that relied on an Oklahoma non-royalty-valuation case. Oklahoma indisputably follows "marketable-product." For criticism, see Owen L. Anderson, *Royalty Valuation: Should Royalty Obligations Be Determined Intrinsically, Theoretically, or Realistically*? Pt.2, 37 NAT. RES. J. 611, 655-661 (1997) (hereafter Anderson). Atlantic construed a state lease, drafted by lessor for offshore production. Atlantic infamously states that lessees, through royalty accounting, can zero out royalties with deductions. Id. at 687-88.

[¶3] Louisiana's adoption of "wellhead-value" in Wall v. United Gas Pub. Serv. Co., 152 So. 561, 563 (La. 1934), is dicta because the gas was marketable at the wellhead. Id. at 564-65. Moreover, deductions discussed were transportation and gasoline manufacturing. A close reading reveals slanted analysis—e.g., in analogizing the oil-

[1] Unless otherwise noted, (p.) references are to Appellee's Brief.

royalty provision to gas, the court quotes the royalty clause, omitting "free from cost." Id. at 563. Cf., Wemple v. Producer's Oil Co., 83 So. 232 (La. 1919) (not considered in Wall). Wall takes a "property" approach to royalty (valuing gas at severance—where it converts from realty to personalty, rather than "contract" plain-meaning. Wall, 152 So. at 563. Louisiana adheres to the "cooperative-venture" theory of lessor-lessee—essentially treating them as joint venturers, justifying cost/profit-sharing. Frey v. Amoco Production Co., 603 So.2d 166 (La. 1992).

[¶4] Texas adopted "wellhead-value" in Heritage Resources v. Nationsbank, 939 S.W.2d 118, 122 (Tex. 1996) but deadlocked 4-4 on rehearing. Deductions involved transportation costs, not costs to make gas physically marketable. Piney Woods Country Life School v. Shell Oil Co., 726 F.2d 225 (5th Cir. 1984), a federal case, adopts "well-head value" by construing Mississippi law without citing relevant Mississippi cases, and primarily concerns gross valuation and secondarily, deductions. For criticism, see Anderson at 620-631 and 635-648.

[¶5] Although Petro-Hunt argues (p.8) that "'market value at the well' has a clear and unambiguous meaning," it has several! Compare: Nationsbank, 939 S.W.2d at 122 ("'royalty' and 'market value at the well' have well accepted meanings in the oil and gas industry," but failing to state the meaning, yet implicitly accepting industry's wellhead definition with Butler v. Exxon Corp., 559 S.W.2d 410, 414 (Tex. Civ. App 1977) (accepting industry's definition that "at the well" as "understood in the industry . . . means gas delivery ... anywhere in the vicinity of the field") and Exxon Corp. v. Middleton, 613 S.W.2d 240, 244-45 (Tex. 1981) (rejecting industry's meaning, holding "at the well" means on the lease); Yzaguirre v. KCS Resources, 53 S.W.3d 368, 372-73

(Tex. 2001) (holding market value means 30-day reference prices, not higher short-term contract price); Texas Oil & Gas Corp. v. Vela, 429 S.W.2d 866 (Tex. 1968) (holding royalty owed on recent long-term contracts, about 13¢/mcf., even though lessee was bound to vintage contract, about 3¢/mcf); Montana Power Co. v. Kravik, 586 P.2d 298 (Mont. 1978) (holding "market-price" royalty means hypothetical current free-market unregulated price (provisionally 85¢/mcf.) although lessee received regulated price (10-40¢/mcf.)); Middleton, 613 S.W.2d at 246 (holding market value/price means current regulated price); Tara Petroleum Corp. v. Hughey, 630 P.2d 1269 (Okla. 1981) (holding royalty owed on actual arm's-length contract price—best evidence of "market price). Agreeing with Tara: Hillard v. Stephens, 637 S.W.2d 581 (Ark. 1982) ("prevailing market price") and Henry v. Ballard & Cordell Corp., 418 So.2d 1334 (La. 1982) ("market value").

[¶6] Oklahoma, Arkansas, and Louisiana recognize that gas, like other commodities, is sold in real markets for real prices. Texas and Montana create fictional markets, allowing experts to establish market value/price. Middleton, 613 S.W.2d at 246-249; Kravik, 586 P.2d at 303. Piney held current value, not contract price, constitutes "market value at the well," but after explaining why lessors prefer current value, (gambler's bargain), the court gave the trial court discretion to use contract price. Piney, 726 F. 2d at 233-39.[2] See Kravik, 586 P.2d at 303.

[¶7] Similar cases show no well-accepted meaning of "market value at the well" for either gross-value (starting point and primary issue in most cases) or cost-deductions,

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[2] On remand, the trial court used contract price and remarkably allowed Shell to deduct a 15% profit after income tax. 539 F.Supp. at 964, note 10. Compare: Matzen v. Hugoton Prod. Co., 321 P.2d 576, 583-84 (Kan. 1958) and Babin v. First Energy Corp., 693 So.2d 813, 816 (La. App. 1997).

the primary issue in this case. At one extreme, Texas, Louisiana, and California define "market value at the well" as fictional, intrinsic wellhead value when no actual wellhead market exists.

[¶8] Oklahoma and Kansas define "market value at the well" as actual arm's-length price in the field vicinity. If unprocessed gas is actually marketable in the locale, deductions may be allowed to extract NGLs from otherwise physically marketable gas (compressed, gathered, dehydrated, and sweetened). Mittlestaedt v. Santa Fe Minerals Inc., 954 P.2d 1203 (Okla. 1994); Sternberger v. Marathon Oil Co., 894 P.2d 788 (Kan. 1995). Colorado regards "at the well" as silent on necessary accounting details. Rogers v. Westerman Farm Co., 29 P.3d 887, 896-98 (Colo. 2001). Thus, it means an actual arm's-length price at the first real marketplace, regardless of location. Lessee may deduct subsequent costs if lessee sells further downstream, if it can prove that similar gas was marketable upstream, and if lessor gains. Id. at 903; Garman v. Conoco, Inc., 886 P.2d 652, 660-61 (Colo. 1994).

[¶9] At the other extreme, West Virginia views "at the well" as ambiguous. Thus, lessee owes royalty on lessee's arm's-length price at the marketplace. Estate of Tawney v. Columbia Natural Resources, L.L.C., 633 S.E.2d 22 (W.Va. 2006); Wellman v. Energy Resources, Inc., 557 S.E.2d 254 (W. Va. 2001).

[¶10] Michigan, Nevada, and Wyoming royalty-valuation statutes are close to "marketable product" but far from "wellhead value." MICH. COMP. LAWS § 324.61503b; NEV. REV. STAT. ANN. § 522.115; WYO. STAT. ANN. § 30-5-301 through 305. For certainty, they define marketability as a matter of law. Hence, a lessee may be unable to deduct certain post-marketable costs but is likely unable to deduct costs necessary to

make gas marketable. Wold v. Hunt Oil Co., 52 F. Supp.2d 1330, 1331-1337 (D. Wyo. 1999).

[¶11] Oklahoma, Kansas, Michigan, Nevada, Wyoming, and, to a somewhat lesser extent, Colorado, represent the sensible middle ground. These jurisdictions, along with the federal "marketable-condition" rule for federal leases, are all similar. Today federal regulations implement the marketable-condition rule based on statutory royalty language. BP America Prod. Co. v. Burton, 549 U.S. 84, p. 90, note 2 (2006). Many cases so indicate. The statutory language, establishing this rule provides that for royalty on "value of the production removed or sold from the lease," 30 U.S.C. § 226 (onshore) and on "value of the production saved, removed, or sold." 43 U.S.C. § 1331(a)(1) (offshore). How does "from the lease" and "removed" differ materially from "at the well?" Federal statutes do not say "at the well" because, in the 1930s, the government demanded royalty on gas flared or used on the lease, prompting lessees to successfully lobby for statutory amendments.

[¶12] Petro-Hunt quotes Williams and Meyers Terms Manual defining "at the well" (p. 9) but neglects to quote the definition's beginning: "The most common usage of this phrase ... " Generally, lessors are not bound by industry usage. See, e.g., TXO Production Corp. v. Page Farms, Inc., 698 S.W.2d 791, 792 (Ark. 1985). Not even Piney bound lessors to industry usage. Piney, 726 F.2d at 236. Lessors are bound by plain meaning. Absent plain meaning, they are entitled to have ambiguities construed in their favor.

[¶13] While wellhead-valuation may have been industry intention, plain meaning was not achieved with "at the well." Compare the royalty clause in Maddox v.

Texas Co., 150 F. Supp. 175, 179 (E.D. Tex. 1957) (construing gas-royalty clause in 1945 lease providing royalty on "current market price at the wells . . . , Lessor's interest shall bear its proportion of any compression, treating, and other expenses necessary to render the gas marketable"). Perhaps lessees avoided this language because it drew attention to their motive and alerted lessors to insert the word "not" after "shall."

[¶14] Petro-Hunt's reliance on Hurinenko and Amerada Hess (pp.10-12) to justify the meaning of "at the well" is misplaced. Hurinenko v. Chevron, USA, 69 F.3d 283, 285 (8th Cir. 1995); Amerada Hess v. Conrad, 410 N.W.2d 124, (N.D. 1987). Hurinenko, a federal decision, does not bind our State's courts. North Dakota Fair Housing Council v. Peterson, 2001 ND 81¶45, 625 N.W.2d 551, 563 (2001). The Court in Amerada Hess did not even consider the question of when the lessee's obligation to produce ends. Further, there is no basis for applying production-tax case law to a royalty-valuation dispute. Revenue statutes should be construed against the government and in favor of the taxpayer. Stern v.Gray, 5 N.W.2d 299 (N.D. 1942). Lessee-drafted royalty provisions should be construed in favor of the lessor.

[¶15] Petro-Hunt complains Representatives ignore Hurinenko. (pp.11-12) Hurinenko is poorly reasoned because it adopts "wellhead-value," which Representatives amply criticize by discussing similar cases. Hurinenko, citing Sondrol, relied only on North Dakota tax cases. Sondrol v. Placid Oil Co., 23 F.3d 1341 (8th Cir. 1994). Sondrol cited one North Dakota tax case and Piney. For further criticism of Sondrol and Hurinenko, see OIL AND GAS REPORTER Discussion Notes, cited in Appellants' Brief ¶ 43. Petro-Hunt complains that "Anderson, one of plaintiffs' counsel." wrote the criticism. True! The criticism was written and published years before this case was filed. Anderson

joined this appeal in October 2008. Petro-Hunt argues (p.14) that Little Knife gas is marketable in fact, citing self-serving testimony of a Petro-Hunt employee, though ample evidence in the record is contrary. Appellants' Brief, ¶10. If Petro-Hunt is serious, then there is a genuine issue of material fact.

[¶16] Petro-Hunt (pp.6, 15) mischaracterizes Representatives' primary argument as an implied-marketing covenant argument. Appellants maintain that "market value at the well" plainly means that royalty is owed on a marketable product. Appellants' Brief ¶¶ 36-39. Representatives cite cases relying on the implied-marketing covenant but do so for legal support. Appellants' Brief ¶¶ 46-47. Petro-Hunt argues that an implied-marketing covenant is not recognized in North Dakota. <u>See</u>, Appellants' Brief, ¶ 50. If Petro-Hunt is correct, North Dakota stands alone.

[¶17] Representatives have not "missed a few" wellhead-value cases.(pp.16-17). <u>Kravik</u>, discussed above, concerned gross value, not post-wellhead costs. Representatives did not cite <u>Piney</u> because it is a federal case construing Mississippi law that cited no Mississippi case on point. Representatives did not cite <u>Taslog</u> because it is a federal case interpreting Alabama law that cites no Alabama case on point. <u>Scott Paper Co. v Taslog,</u> 638 F.2d 790 (5th Cir. 1981). <u>Creson</u> did not construe a lease royalty clause but construed a royalty provision in a standard-form unit agreement providing for "<u>net</u>-proceeds" at the well. Thus, the court found costs beyond <u>transportation</u> were deductible. The court neither adopted nor rejected "marketable-product," noting that some carbon-dioxide gas was actually marketed at the wellhead. <u>Creson v. Amoco Production Co.</u>, 10 P.3d 853 (N.M. 2000).

[¶18] To clarify Petro-Hunt's discussion of Mittelstaedt (p.18) Oklahoma, like Colorado, allows deductions for certain costs after gas becomes marketable if lessee proves that the gas was marketable before such costs were incurred, if lessee sells it further downstream of the first market, and if lessor gains. Mittelstaedt, 954 P.2d at 1207. In Oklahoma, transportation costs to move physically marketable gas to a distant first market might be deductible. Johnson v. Jernigan, 475 P.2d 396 (Okla. 1970) (not applied but not overruled).

Tank Batteries – Gas Use

[¶19] Petro-Hunt argues the provision, "lessee shall have the right to use, free of cost, gas ... found on same land for its operations thereon," allows Petro-Hunt to freely use gas for tank-battery operations located off-lease because they are "lease operations." (p.19) As to policy and purpose, Representatives agree; however, that is not what the provision plainly means. Compare Petro-Hunt's twisted "plain meaning" of "market value at the well" to its functional construction of the free-gas clause.

[¶20] Tank batteries are "lease operations" whenever storage is necessary to crude-oil marketing, like sweetening sour gas is necessary in gas marketing. Building central tank batteries and central sweetening facilities is reasonable. Lease provisions should be construed accordingly. The "upstream" part of the petroleum industry ends when production is marketed to a purchaser/user. Without marketing, there are no proceeds or market value/price. Thus, the point of marketing, less any off-field transportation costs, is where royalty is owed. "At the well" should be construed like Petro-Hunt construes "on same land for its operations thereon," so that the lease's business purpose (marketing) is fulfilled. If "at the well" plainly means FOB the well

(transportation term), then the free-gas clause can also be construed functionally. This illustrates why leases must include an implied-marketing obligation. Traditional leases do not expressly "oblige" lessees to extract or market, but extraction and marketing- matters exclusively resting with lessees – are necessary to the lease's business purpose. Marketing requires salable production. Even where oil is taken in kind, lessee owes lessor marketable oil. Clark v. Slick Oil Co., 211 P. 496 (Okla. 1922).

[¶21] In denying an implied-marketing covenant, Petro-Hunt denies any obligation to market gas or make gas marketable, but if it chooses to market, it can then charge Representatives for sweetening not done "at the well," because sweetening is not "lease operations." If leases allow Petro-Hunt full discretion to classify functions as "lease-" or "non-lease operations," then Petro-Hunt is right. But if lease operations are classified in functional/business-purpose terms, then making gas marketable is an essential "lease operation."

Excess Deductions

[¶22] Petro-Hunt wrongly depreciated the 3.3 million dollar salvage value of the plant down to $650,000 in 2007. Hunt's deductions for "unrecovered risk capital" should have ended when the risk did. Considering that, by taking these excess deductions, Petro-Hunt and predecessors breached the Settlement (Royalty) Agreement – an agreement reached to stop Gulf's, Petro-Hunt's predecessor, prior creative accounting, there is great wisdom in the marketable-product view.

Conclusion

[¶23] The marketable-product view is the traditional default view long supported by most legal scholars, it is good policy, it is plain meaning, it recognizes a

marketing duty, and it supports the lease business purpose. Representatives respectfully urge this Court to reverse the District Court.

Dated this 3rd day of February, 2009.

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As Trustee Of William Herbert Hunt Trust Estate
Supreme Court No. 20080265
Billings County Civil No. 01-C-00001

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) ss.
COUNTY OF CASS)

The undersigned, being first duly sworn, deposes and says that she served the attached

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s/ Jane L. Dynes
Jane L. Dynes

Subscribed and sworn to before me this 3rd day of February, 2009.

s/ Robyn Maxwell
(SEAL) Robyn Maxwell, Notary Public
State of North Dakota
My Commission Expires April 5, 2012

CERTIFICATE OF COMPLIANCE

The undersigned, as attorneys for the Appellants in the above matter, and as the author of the above brief, hereby certify, in compliance with Rule 32(a)(5) and (7)(A) of the North Dakota Rules of Appellate Procedure, that the above brief was prepared with proportional typeface and the total number of words in the above brief, excluding words in the table of contents, table of authorities, signature block, certificate of service and this certificate of compliance, totals 2,490.

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