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STATE OF NORTH DAKOTA

IN THE SUPREME COURT

STATE OF NORTH DAKOTA

David A. Blasi and Paula J. Blasi, as Trustees of the Blasi Living Trust, on behalf of themselves and a class of similarly situated persons, Plaintiffs, vs. EOG Resources, Inc., Continental Resources, Inc., Kraken Development III LLC, Lime Rock Resources Operating Co., Inc., Lime Rock Resources III-A, L.P., Bruin E&P Partners, LLC, and Bruin E&P Operating, LLC Defendants,	)	Supreme Court Case No. 2020 0327 U.S. District Court Case Nos. 3:20-CV-00085; 3:20-CV-00091; 3:20-CV-00092; 3:20-CV-00093; 3:20-CV-00094

CERTIFIED QUESTION OF LAW SUBMITTED NOVEMBER 30, 2020,
CASE NOS. 3:20-CV-85; 3:20-CV-91; 3:20-CV-92; 3:20-CV-93; 3:20-CV-94
UNITED STATES DISTRICT COURT FOR THE DISTRICT OF NORTH DAKOTA
THE HONORABLE PETER D. WELTE, CHIEF JUDGE

AMICUS CURIAE BRIEF OF THE NORTH DAKOTA PETROLEUM COUNCIL IN SUPPORT OF DEFENDANTS' INTERPRETATION OF THE LEASE LANGUAGE

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STATEMENT OF THE ISSUE

I. Whether the instant oil royalty provision is interpreted to mean the royalty is based on the value of the oil "at the well:"

> Lessee agrees . . . "[t]o deliver to the credit of the lessor, free of cost, in the pipeline to which lessee may connect wells on said land, the equal [fractional] part of all oil produced and saved from the leased premises."

I. STATEMENT OF IDENTITY AND INTEREST

[¶1] The North Dakota Petroleum Council (NDPC) submits this brief, as *Amicus Curiae*, to support the position that the certified question should be answered "Yes." The NDPC is a trade association representing more than 500 companies involved in all aspects of the oil and gas industry. NDPC members produce 98% of the oil in North Dakota. NDPC member companies have entered into numerous oil and gas leases in North Dakota containing the same standard oil royalty provision before the Court. Plaintiffs' arguments concerning the interpretation of this royalty provision are inconsistent with North Dakota law, with the law in other oil and gas producing jurisdictions, and with promoting enhancement of the value of the oil for the benefit of both lessors and lessees. NDPC members rely on uniform and consistent application of standard lease provisions to conduct their operations and obtain the best value for oil produced in North Dakota, which benefits both the lessors and lessees. The NDPC requests the Court interpret the standard lease provision at issue to mean the royalty is based on the value of the oil at the well.

II. 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 the NDPC contributed money to fund preparing or submitting this brief.

III. STATEMENT OF THE CASE

[¶3] The United States District Court for the District of North Dakota has certified the following question of law to the Court:

> Whether the instant oil royalty provision is interpreted to mean the royalty is based on the value of the oil "at the well:"

> Lessee agrees . . . "[t]o deliver to the credit of the lessor, free of cost, in the pipeline to which lessee may connect wells on said land, the equal [fractional] part of all oil produced and saved from the leased premises."

The plaintiffs and *Amicus Curiae* White River Royalties, LLC and Sara Cammack contend the Court should answer "No" to the certified question. Defendants contend the Court should answer "Yes" to the certified question. The NDPC requests the Court answer "Yes."

[¶4] The crux of the question before the Court is where the in-kind oil royalty is valued when the lessor receives a monetary payment instead of taking actual physical possession of the oil. The answer to this question determines whether reasonable post-production costs can be deducted from the royalty payment to the lessor. An "at the well" royalty provision means "any costs incurred by the lessee after the [oil] reaches the wellhead, whether to improve the quality of the [oil] or to transport it to a market where it may be sold may be deducted before the royalty is calculated." Bice, et al. v. Petro-Hunt, L.L.C. et al., 2009 ND 124, ¶ 13, 768 N.W.2d 496.

[¶5] The exemplar lease at issue was executed in 2006. *Order for Certification* at ¶¶ 1-3 & Exhibit A. While the exemplar lease is from 2006, other leases containing the same standard royalty provision may be much older since the standard provision at issue has been in use for over one hundred years. The plaintiffs contend the defendants cannot deduct post-production costs from oil royalty payments under the lease. Id. at ¶ 3. The defendants are lessees and contend post-production costs may be deducted from oil royalty payments. In addition to the parties, White River Royalties, LLC and Sara Cammack have submitted an *Amicus Curiae* brief in support of the plaintiffs' position. They are the named plaintiffs in *White River Royalties, LLC, et al. v. Hess Bakken*

Investments II, LLC, 1:19-cv-218, United States District Court for the District of North Dakota, and assert they are currently prosecuting an oil royalty underpayment class action involving approximately 25,000 leases containing the same oil royalty provision at issue here. *Amicus Curiae Brief of White River Royalties, LLC and Sara Cammack* at ¶ 1. Based on the number of leases involved and the longstanding use of the standard lease language, the Court's answer to the question will have a significant impact.

[¶6] The interpretation of the provision at issue or its equivalent by courts and treatises has consistently allowed deduction of reasonable post-production costs (i.e. applying the "at the well" rule), and there is no valid legal reason to alter that interpretation. Consistency of interpretation based on years of case law and historical interpretation is fundamental for a healthy industry. The NDPC requests the Court answer "Yes" to the certified question because such an interpretation is consistent with the lease language, longstanding prior interpretations by courts and commentators, and the manner in which oil is marketed to obtain the best value.

IV. APPLICABLE LAW AND ARGUMENT

[¶7] Oil is a commodity, and like other commodities, the price per barrel of oil varies depending on where it is sold.[1] See, e.g., *Presentation of Justin J. Kringstad, Geological Engineer, Director, North Dakota Pipeline Authority to House Energy and Natural Resources Committee*, slide 8 (January 7, 2021) (available at https://ndpipelines.files.wordpress.com/2021/01/kringstad-henr-jan-7-2021.pdf). While the WTI crude price may be $50 per barrel, this does not mean every barrel of oil produced

[1] Oil, including oil produced in North Dakota, is sold locally, nationally, and even internationally.

in North Dakota can be sold for $50. In fact, oil sold in North Dakota has historically been priced well below the listed WTI price. See id. at slide 9 (reflecting the historic ND Wellhead Discount to WTI).

[¶8] Consider the following example. An operator may be able to sell oil for $50 per barrel in one market if it transports the oil, whereas the same barrel of oil would sell for $40 per barrel at a well in North Dakota. See id. (indicating various times since 2010 when the North Dakota wellhead discount to WTI is near or more than $10). It may cost $8 per barrel to transport oil from North Dakota to achieve the higher price.[2] For ease of calculation, assume the royalty interest is 20%. In this scenario, the lessor and lessee (or operator)[3] would receive $2.00 more per barrel if the lessee is able to recover the post-production costs of transporting the oil. If the lessee is not able to recover post-production costs, the lessor would receive $10 more per barrel, but the lessee would not receive any additional value for selling the oil in another market because it would be responsible for $8.00 per barrel for each of its barrels plus $8.00 per barrel for each of the lessor's barrels. As a result, there would be no financial incentive for the lessee to transport the oil to another market in order to sell at a higher price. This scenario is summarized in the following table:

[2] See, e.g., *U.S. Rail Transportation of Crude Oil: Background and Issues for Congress*, Congressional Research Service, p. 4 (Dec. 4, 2014) (available at https://fas.org/sgp/crs/misc/R43390.pdf) ("With Bakken crude selling for approximately $4 to $28 per barrel less than West Texas Intermediate (WTI) crude, the U.S. reference price for crude grade, refiners found it profitable to utilize the North Dakota oil delivered by rail even though the rail transportation cost is perhaps $5 to $10 per barrel higher than pipeline costs").

[3] The operator and the lessee are not necessarily the same. But, if the lessee is not the operator, it is a working interest owner in the well that is operated by another lessee in the spacing unit and would receive its proportional share for its working interest from the operator. For purposes of this hypothetical, the lessee is presumed to be the operator as there is no material difference for purposes of the example.

Sale of 100 Barrels of Oil at the Well in North Dakota ($40 per barrel)		Sale of 100 Barrels of Oil in Another Market ($50 per barrel)	
Total received	$4,000	Total received	$5,000
Post-production costs ($0 per barrel)	0	Post-production costs ($8 per barrel)	$800
Lessee's Share	$3,200	Lessee's Share if no post-production costs recovered	$3,200 ($4,000 minus $800)
Lessor's Share	$800	Lessor's Share if no post-production costs recovered	$1,000
		Lessee's Share if post-production costs recovered	$3,360 ($4,000 minus $640*)
		Lessor's Share if post-production costs recovered	$840 ($1,000 minus $160*)
*At a royalty percentage of 20%, the operator's or working interest owner's share of post-production costs would be 80% of $800 ($640) and the royalty owner's share would be 20% of $800 ($160).			

[¶9] This basic example illustrates the lessor still receives additional value when the post-production costs are proportionally shared ($840 instead of $800). It also reflects the lessee receives no additional value if post-production costs are not shared even though the lessee has additional risk and cost to transport the oil to a more distant market. If the post-production costs per barrel increase by any amount under the example, the lessee actually loses value by selling the oil at a higher price if it is responsible for all of the post-production costs. What this example shows, and what the NDPC would like to make clear, is that reasonable post-production costs are incurred to enhance value, and deducting them from the royalty payment is not simply cost-shifting. Instead, the post-production costs are proportionally borne by the lessee and the lessor. There is a common interest between lessees and lessors to receive the highest value per barrel of oil, and interpreting the royalty provision at issue to require the lessee bear post-production costs for the lessor's in-kind oil diminishes the incentive to obtain the highest value.

[¶10] Under the above example with a 20% royalty, one barrel of every five barrels of oil produced is the lessor's in-kind royalty interest. The lessee's and lessor's barrels are marketed together. The lessee has no reason to incur post-production costs that decrease the value of these barrels because it owns 80% of the barrels. Sharing post-production costs simply recognizes that costs undertaken after the oil is delivered to the lessor in-kind should be shared because they enhance the value of all the oil (including the lessee's). Answering "No" to the certified question would have a negative impact not only on the lessees, but would ultimately have a negative impact on lessors (in the form of lower overall royalty payments and less incentive to receive the highest value for each barrel of oil) and the state and local governments (in the form of lower tax revenue based off the higher value and less investment in/development of the State's resources).

A. This royalty provision has historically been interpreted as valuing the royalty at the well.

[¶11] Oil and gas leases are contracts, and are governed by longstanding contract interpretation principles. The Court is certainly familiar with the longstanding principles of contract interpretation, and the parties will or have addressed them. As a result, it is unnecessary for purposes of the NDPC's brief as *Amicus* to repeat these principles. The NDPC contends the language of the royalty provision is unambiguous and means the royalty is based on the value of the oil "at the well." Further, when interpreting the royalty provision, any interpretation must recognize the basic purpose of an oil and gas lease. While there may be exceptions, an oil and gas lease is typically entered into before drilling and production occurs. Whether oil will be produced, or in what quantities, is unknown.

Similarly, at the time of entering the oil and gas lease, the specific market conditions such as the price in different markets at the time of production, the logistics or cost of marketing any oil produced, and the exact manner the oil will be transported to market are unknown. Of course, the parties to the oil and gas lease desire as much oil production as possible for the best price.

[¶12] Just as courts rely on precedent, the NDPC members also rely upon the historical interpretation of contract language to conduct their business, including how much of a royalty percentage to offer and under what terms (factors directly impacted by the issue in this case). Courts, including this Court, often rely on interpretations from other jurisdictions and commentators when evaluating terms in an oil and gas lease. See, e.g. Wold v. Zavanna, LLC, 2013 WL 6858827, at **10-11 (D.N.D. 2013) (describing this Court's analysis in Bice v. Petro-Hunt, L.L.C., 2009 ND 124, 768 N.W.2d 496).

[¶13] The lease language at issue has been a staple of standard oil and gas leases for over one hundred years. For instance, in Molter v. Lewis, the Supreme Court of Kansas evaluated whether a similar provision allowed the lessee to deduct charges for transporting the landowners' share of oil to a pipeline connection. 134 P.2d 404, 404 (Kan. 1943). The royalty provision in Molter was identical to the language here except the present lease includes additional clarifying language—"on said land"—describing where the royalty is valued. Compare id. at 404-05 with *Order for Certification*, Exhibit A, cl. 3. Even without this clarifying language, the Molter court held the lessor should pay reasonable charges for transporting his share of oil when a pipeline was not available and the oil was transported by truck to the pipeline. Id. at *Syllabus* and p. 406-07.

[¶14] More recently, the Supreme Court of Texas evaluated a similar provision to determine "whether the parties agreed to an 'at the well' valuation point or its equivalent." Burlington Resources Oil & Gas Company LP v. Texas Crude Energy, LLC, 573 S.W.3d 198, 205 (Tex. 2019). The Burlington court evaluated treatises from several authors, recognizing they agree such a provision contemplates valuation "at the well" and authorizes deduction of post-production costs. Id. at 207-08. The court held Burlington's "view that the 'into the pipeline' provision creates an 'at the well' valuation point gives the provision the broad effect it seems intended to have and allows the provision to be applied to the actual transactions that occurred among these parties." Id. at 210.

[¶15] As recognized in the above cases, the major treatises analyzing oil and gas law recognize lessors are responsible for post-production costs under provisions such as the one at issue. Williams & Meyers indicates:

> By the weight of authority in cases involving language such as that first quoted above, providing for delivery "free of cost *in the pipe line* to which Operator may connect his wells," the expense of transportation or of treating oil or gas or of compressing gas to make it deliverable must be shared by the owner of the nonoperating interest. The language employed suggests that the parties assumed that a pipe line connection at the well would be available. Although the operator may have a duty to market a nonoperator's share of production, this duty will not include the burden of bearing the expense of treating, compressing or transporting such share of production.

3 Williams & Meyers, Oil and Gas Law § 646 (2019). Kuntz provides, "[i]f the royalty clause provides for delivery of royalty gas to the lessor's credit free of cost in the pipeline to which the well is connected, the parties contemplate a delivery of royalty gas at the well, and the lessee is not required to construct the lessee's own expense a feeder line in order to deliver lessor's royalty gas to a distant pipeline." 3 Eugene Kuntz, Treatise on the Law of Oil and Gas § 40.5(a) (2019).

[¶16] Other commentators have similarly evaluated such provisions.

> The typical oil royalty clause requires that the lessee deliver to the lessor its royalty share of production "to the credit of the lessor, free of cost, in the pipe line to which the lessee may connect its well" or words of like import. For a royalty clause that, as many do, specifically identifies a pipe line connected by the lessee *on the lease premises*, there would seem to be no question but that the lessor would be responsible for its share of any trucking or other cost to get the royalty oil to the pipe line or other place of market.

James C.T. Hardwick, *Private Landowner Royalties on Oil—Theory and Reality*, 2003-1 Rocky Mtn. Min. L. Special Inst. 10, §10.9 (Sept. 2003) (emphasis added). It has also been explained:

> A royalty was traditionally a portion of production at the place of production. The lessee accepted the risk of drilling, and producing any oil (and later, gas) that could be discovered and delivered it free of cost to the point at which it could be divided in-kind. Thus, the lessor's share of production taken in-kind was "free of cost" to that point. A lessor taking its portion in-kind incurred whatever costs were necessary to market its share. Royalties "in value" evolved as a substitute for in-kind division of production, especially in relation to gas which was not so susceptible of being taken in-kind by a lessor, but did not change the fundamental obligation of the lessee to produce the production free of cost, nor of the lessor to incur its own marketing costs. Modern definitions of royalty have not departed from this basic concept of an interest in production at the surface free of the costs of production. In the absence of specific lease provisions, issues concerning the propriety of deductions for costs incurred or value added to production by the lessee can all be traced to the fundamental concept that a lessor is entitled to a portion of production in its natural condition when it is produced.

Jack D. Palm, II & Stephen York, *Current Royalty Valuation Issues on State Lands*, 20A Rocky Mtn. Min. L. Special Inst. 16, pt. V.B.1 (Mar. 1988) (emphasis added).

[¶17] The NDPC requests the Court adopt the reasoning from the above cases and other authorities. The plaintiffs' argument regarding the lease language ignores the longstanding, consistent manner in which these types of clauses have been interpreted, the valuation point identified in the lease language for the in-kind royalty, and the realities of marketing oil to obtain the best value for both the lessor and lessee. An oil and gas lease is not obtained in a vacuum or with perfect foresight, and the lease language used here means the royalty is based on the value of the oil "at the well."

B. The oil royalty provision means the royalty is based on the value at the well.

[¶18] The oil royalty provision at issue provides that the Lessee agrees "[t]o deliver to the credit of the lessor, free of cost, in the pipeline to which lessee may connect wells on said land, the equal [fractional] part of all oil produced and saved from the leased premises." *Order for Certification*. As an in-kind royalty, this means the lessor is entitled to its share of the oil produced at the well on said land. Historically, this lease language or its equivalent has been consistently interpreted as allowing the lessee to deduct post-production costs from the royalty payment. In fact, the plaintiffs have not identified any case interpreting such a provision as precluding the deduction of post-production costs from royalty payments to the lessor under similar circumstances. In addition, the major treatises and other sources have recognized this provision allows deductions of post-production costs, i.e. treating it as an "at the well" provision. The reason for this is clear based on the language of the provision and the in-kind nature of the royalty.

[¶19] The certified question addresses who is responsible for post-production costs after the oil is produced free of cost to the lessor. Based on its language, the royalty provision simply cannot be interpreted as requiring lessors to be wholly responsible for post-production costs. Under the plaintiffs' and *Amicus* White River's position, the point at which post-production costs are shared by the lessor could change depending on whether a pipeline is constructed to the well. However, this ignores the in-kind nature of the oil royalty and ignores that the best value may not be obtained via a pipeline at the well.

Instead, the lease recognizes the lessee "may connect wells on said land" to a pipeline. The operative and dispositive language to answer the certified question is "on said land." This language places the location where the oil is "free of cost" to the lessor, and cannot simply be ignored. After this point—"on said land"—the lessee has delivered the royalty in-kind and the lessor must share in the post-production costs to market its oil.

[¶20] Interpreting the language like past courts and commentators is consistent with the in-kind nature of the royalty provision. The royalty is valued when it can be delivered in-kind, which is at the well "on said land." The royalty provision does not include any language that could support a different meaning. For instance, it does not say "free of any and all costs." Rather, it says "free of cost, <u>in the pipeline to which Lessee</u> <u>**may connect wells on said land.**</u>" Given this language, the location where the oil is "free of cost" is clear. It is at the wells on said land where the lessors' oil is delivered.

[¶21] In <u>Bice</u>, this Court joined the majority of states adopting the "at the well" rule and affirmed the district court's order allowing deduction of post-production costs prior to calculating royalty. 2009 ND 124, ¶ 21, 768 N.W.2d 496. Of course, parties can contract around the general rule, but the standard oil royalty provision at issue does not have any language supporting such an interpretation. <u>See</u> <u>Newfield Exploration Co. v. State of N.D.</u>, 2019 ND 193, ¶ 6, 931 N.W.2d 478. When dealing with oil and gas leases, which are often entered into many years earlier by predecessors in interest, applying the historically accepted and common interpretation of the lease language is vital. Such language has a clear, established meaning that the valuation point is "at the well" and reasonable post-production costs must be proportionately borne by the lessor. Consistent and uniform interpretation is essential for the parties involved to avoid unnecessary disputes, provide meaning to all provisions of the lease, and recognize the manner in which oil is marketed.

V. CONCLUSION

[¶22] For the foregoing reasons, the North Dakota Petroleum Council requests the Court answer "Yes" to the certified question.

Dated this 22nd day of February, 2021.

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CERTIFICATE OF COMPLIANCE

[¶23] Consistent with N.D.R.App. P. 32(e), I certify this 16 page brief complies with the 19-page length limitation as provided by N.D.R.App. P. 29(a)(5), establishing an amicus brief page limitation of one-half the maximum length of a principal party brief.

Dated this 22nd day of February, 2021.

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I, Tiffany Knopik, hereby state that I am of legal age and that on February 22, 2021, I served the following documents:

1. **MOTION FOR LEAVE TO FILE BRIEF OF AMICUS CURIAE; AND**

2. **AMICUS CURIAE BRIEF OF THE NORTH DAKOTA PETROLEUM COUNCIL IN SUPPORT OF DEFENDANTS' INTERPRETATION OF THE LEASE LANGUAGE**

by sending a true and correct copy thereof by e-mail and electronically through the North Dakota e-filing portal to the parties' counsel listed below:

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Dated this 22nd day of February, 2021.

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