IN THE WEST VIRGINIA SUPREME COURT OF APPEALS
No. 21-0179

SWN PRODUCTION COMPANY, LLC and
EQUINOR USA ONSHORE PROPERTIES INC.,

Petitioners,

v.

CHARLES KELLAM, PHYLLIS KELLAM,
and other persons and entities similarly situated,

Respondents.

AMICUS CURIAE BRIEF ON BEHALF OF WEST VIRGINIA ROYALTY OWNERS' ASSOCIATION, WEST VIRGINIA FARM BUREAU, BOUNTY MINERALS LLC AND SILTSTONE RESOURCES, LLC (IN SUPPORT OF RESPONDENTS CHARLES KELLAM, ET AL.)

Dated: February __, 2022

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(IN SUPPORT OF RESPONDENTS CHARLES KELLAM, ET AL.)

To the Honorable, the Justices
Of the Supreme Court of Appeals of West Virginia:

I. Statements Regarding *Amici Curiae*

Your *Amicus*, West Virginia Royalty Owners' Association ("WVROA"), is an association with 1,162 members, who collectively own tens of thousands of acres in the State of West Virginia, interested in issues affecting the ownership of royalty interests in real property in West Virginia, including, but not limited to, royalty interests in oil and gas estates. WVROA's mission is to inform West Virginia mineral owners about the state of the oil and gas industry, leasing, and their rights as real property owners, as well as promoting legislation that protects the rights of all property owners, whether fee,

surface, or mineral owners, to ensure that oil and gas development in West Virginia is done responsibly and fairly.[1]

Your *Amicus* West Virginia Farm Bureau ("WVFB") represents over 22,721 members who are interested in issues affecting the ownership of mineral interests and real property in West Virginia, including, but not limited to, the computation and payment of royalty interests in oil and gas estates. WVFB's mission is to provide leadership, education, information, training and economic services to members and county farm bureaus to enhance the quality of farming in West Virginia through the betterment of conditions of those engaged in agricultural pursuits, the improvement of the grade of their products, and development of a high degree of efficiency in their agricultural pursuits.

Your *Amicus* Bounty Minerals LLC ("Bounty") is a Texas limited liability company with headquarters located in Fort Worth, Texas. Bounty is interested in issues affecting the ownership of mineral interests and real property in West Virginia, including, but not limited to, royalty interests in oil and gas estates. Bounty owns twenty-six thousand six hundred thirty-seven (26,637) net royalty acres in the West Virginia Counties of Brooke, Doddridge, Harrison, Marion, Marshall, Monongalia, Ohio, Ritchie, Tyler and Wetzel, and paid more than Three Hundred Thirty Thousand Dollars ($330,000.00) in West Virginia for said ten (10) counties in 2021.

Your *Amicus* Siltstone Resources, LLC ("Siltstone"), is a Delaware limited liability company headquartered in Cambridge, Ohio, which owns and leases considerable

[1] In accordance with *West Virginia Rule of Appellate Procedure 30(e)(5)*, no counsel for a party authored this brief in whole or in part and no such counsel or party made a monetary contribution specifically intended to fund the preparation or submission of the brief. No person other than the *amici,* their members, or their counsel made such a monetary contribution. Pursuant to *Rule 30(a),* all parties have consented to the filing of this brief.

acreage in the State of West Virginia. Like its co-*amici*, Siltstone is interested in issues affecting the ownership of mineral interests and real property in West Virginia, including, but not limited to, the fair and equitable treatment of royalty interests in oil and gas estates.

II. Questions Certified By the Court:

1. Is *Estate of Tawney v. Columbia Natural Resources, L.L.C.*, 219 W.Va. 266, 633 S.E.2d 22 (2006) still good law in West Virginia?

2. What is meant by the "method of calculating" the amount of post-production costs to be deducted?

3. Is a simple listing of the types of costs which may be deducted sufficient to satisfy *Tawney*?

4. If postproduction costs are to be deducted, are they limited to direct costs or may indirect costs be deducted as well?

III. Argument

In this Appeal, Petitioners seek to overturn longstanding West Virginia precedent which provides that in the absence of clear lease language to the contrary, the lessee under an oil and gas lease bears all post-production costs associated with processing and transporting the oil and gas and derivative products to the "point of sale." *See Wellman v. Energy Resources, Inc.,* 210 W.Va. 200, 557 S.E.2d 254 syl. pts 4 and 5 (2001), and *Estate of Tawney v. Columbia Natural Resources, L.L.C.*, 219 W.Va. 266, 633 S.E.2d 22, syl. pts 4 and 5 (2006).

Decided in 2001 and beginning with the long-recognized duty of a lessee/producer to market the oil or gas produced, and the related precept that the one-eighth "the landowner's royalty" is inviolable and not chargeable with any of the costs of discovery and production, the *Wellman* Court issued the following syllabus points:

> 4. If an oil and gas lease provides for a royalty based on proceeds received by the lessee, unless the lease provides otherwise, the lessee must bear all costs incurred in exploring for, producing, marketing, and transporting the product to the point of sale."
>
> 5. If an oil and gas lease provides that the lessor shall bear some part of the costs incurred between the wellhead and the point of sale, the lessee shall be entitled to credit for those costs to the extent that they were actually incurred and they were reasonable. Before being entitled to such credit, however, the lessee must prove, by evidence of the type normally developed in legal proceedings requiring an accounting, that he, the lessee, actually incurred such costs and that they were reasonable."

Wellman, 557 S.E.2d at 263-264, syl. pts 4 and 5. Under *Wellman,* therefore, unless there is clear lease language to the contrary, the lessee must bear all costs incurred in exploration, production, marketing, and transportation of the product to "the point of sale." *Wellman*, 557 S.E.2d 254, at syl. pt. 4.

Five years after *Wellman* was decided, the Supreme Court of Appeals expanded upon its holding in *Tawney,* issuing the following additional syllabus points:

> 4. Language in an oil and gas lease that is intended to allocate between the lessor and lessee the costs of marketing the product and transporting it to the point of sale must expressly provide that the lessor shall bear some part of the costs incurred between the wellhead and the point of sale, identify with particularity the specific deductions the lessee intends to take from the lessor's royalty (usually 1/8), and indicate the method of calculating the amount to be deducted from the royalty for such post-production costs.
>
> 5. Language in an oil and gas lease that provides that the lessor's 1/8 royalty (as in this case) is to be calculated "at the

> well", "at the wellhead", or similar language, or that the royalty is "an amount equal to 1/8 of the price, net all costs beyond the wellhead," or "less all taxes, assessments, and adjustments" is ambiguous and, accordingly, is not effective to permit the lessee to deduct from the lessor's 1/8 royalty any portion of the costs incurred between the wellhead and the point of sale.

Tawney, 633 S.E.2d at 23-24, Syl. pts 1-11. *Tawney* both reaffirmed Wellman's core holdings and extended them by further holding that "at the wellhead" language commonly found in the royalty clauses, especially in older gas leases, is not sufficiently clear to permit the lessee to calculate and deduct expenses utilizing the so called "net back" method, where the lessee simply deducts a pro-rata portion of all expenses incurred after the gas leaves the ground. *Id.*

In tandem, and for almost two decades, *Tawney* and *Wellman* have provided clear direction to both lessors and lessees regarding their rights and obligations with respect to the taking of deductions in the computation and payment of the landowners' royalty on natural gas produced and sold from their property. However, in the present case, the Petitioner Producer seeks to overturn some, or all of the lodestar syllabus points contained in these two seminal cases in the latest installment of a decades long effort to deprive landowners of their rightful royalty interest through elaborately conceived deduction schemes designed ultimately to fully consume the landowner's royalty through creation of phantom expenses and tricky accounting. The Court should stop this onslaught and reaffirm *Wellman* and *Tawney*.

A. The West Virginia Supreme Court of Appeals' Decisions in Both *Wellman v. Energy Resources, Inc.,* 210 W.Va. 200, 557 S.E.2d 254 (2001) ("*Wellman*"), and *Estate of Tawney v. Columbia Natural Resources, L.L.C.*, 219 W.Va. 266, 633 S.E.2d 22 (2006) ("*Tawney*"), Are Soundly Reasoned and Deeply Rooted in West Virginia Law and Should Not Be Overruled.

The inviolability of the oil and gas lessors' royalty interest, traditionally one-eighth (1/8) of the total amount received without deductions, is a long-standing precept in West Virginia. In discussing the evolution of gas-royalty clauses and the "long-established" expectation of lessors in this State, the *Wellman* Court drew on Professor Robert Donley's seminal 1951 Legal Treatise:

> In Robert Donley, *The Law of Coal, Oil and Gas in West Virginia and Virginia* § 104 (1951), it is stated: "From the very beginning of the oil and gas industry it has been the practice to compensate the landowner by selling the oil by running it to a common carrier and paying him [the landowner] one-eighth of the sale price received. This practice has, in recent years, been extended to the situations where gas is found...." the one-eighth received is commonly referred to as the landowner's royalty. *Wellman*, 557 S.E.2d at 263.

The Wellman Court further relied upon the West Virginia Supreme Court of Appeals' prior holding in *Davis v. Hardman*, 148 W.Va. 82, 133 S.E.2d 77 (1963), wherein the Court held that a distinguishing characteristic of the landowners' royalty interest is that it is "not chargeable with any of the costs of discovery and production." *Davis, supra,* 133 S.E.2d at 81. Moreover, the *Wellman* Court rejected the contention that so-called "post-production" expenses relating to treatment and transportation of the gas to market were somehow deductible, stating:

> The Court believes that such a view has been widely adopted in the United States…[I]n spite of this, there has been an attempt on the part of the oil and gas producers in recent years to charge the landowner with a *pro rata* share of various expenses connected with the operation of an oil and gas lease such as the expense of transporting oil and gas to a point of sale, and the expense of treating or altering the oil and gas so as to put it in a marketable condition. To escape the rule that the lessee must pay

> the costs of discovery and production, these expenses have been referred to as “post-production expenses.”

Wellman, 557 S.E.2d at 263-64.

Again, this holding is rooted in the lessee’s implied duty to market oil and gas produced, and to pay the costs associated therewith, which the *Wellman* Court found gives rise to a duty to bear the costs of preparing the oil and gas for market and to pay the cost of transporting them to market.

In arriving at this conclusion, the *Wellman* Court relied not only upon established West Virginia law, but also on authority from other jurisdictions.

> In Kansas and Oklahoma a...rule has developed based on an operator's implied duty to market gas produced under an oil and gas lease. *Wood v. TXO Production Corp.,* 854 P.2d 880, 882 (Okla.1992) (“[T]he implied duty to market means a duty to get the product to the place of sale in marketable form.”); *Gilmore v. Superior Oil Company,* 192 Kan. 388, 388 P.2d 602, 606 (1964) (“Kansas has always recognized the duty of the lessee under an oil and gas lease not only to find if there is oil and gas but to use reasonable diligence in finding a market for the product.”). Wyoming has codified the marketability approach. The Federal government also requires that a lessee “place gas in marketable condition at no cost to the Federal Government....” 30 C.F.R. § 206.153(I) (1993). Arkansas and North Dakota have reached similar conclusions when considering lease royalty clauses which are silent as to allocation of post-production costs. A lease which provides for the lessor to receive “proceeds at the well for all gas” means gross proceeds when the lease is silent as to how post-production costs must be borne. *Hanna Oil & Gas Co. v. Taylor,* 297 Ark. 80, 759 S.W.2d 563, 565 (1988); *see also West v. Alpar Resources, Inc.,* 298 N.W.2d 484, 491 (N.D.1980) (when the lease does not state otherwise lessors are entitled to royalty payments based on percentage **265 *211 of total proceeds received by the lessee, without deduction for costs).” This Court believes that the rationale employed by Colorado, Kansas, and Oklahoma in resolving the question of whether the lessor or the lessee should bear “post-production” costs is persuasive. Like those states, West Virginia holds that a lessee impliedly covenants that he will market oil or gas produced. *See* Robert Tucker Donley, *The Law of Coal, Oil and Gas in West Virginia and Virginia* §§ 70 & 104 (1951). Like the courts of Colorado, Kansas, and Oklahoma, the Court also believes that historically the lessee has had to bear the cost of complying with his covenants under the lease. It, therefore, reasonably should follow that the lessee should bear the costs associated with marketing products produced under a lease. Such a conclusion is also

> consistent with the long-established expectation of lessors in this State, that they would receive one-eighth of the sale price received by the lessor.

Wellman, 210 W.Va. at 210-11, at 264-65 (quoting *Garman v. Conoco, Inc.,* 886 P.2d. 652, 658 (1994)) (emphasis added).

Notably, *Wellman* left open the possibility that lease language "indicating that the 'proceeds' shall be from the 'sale of gas as such at the mouth of the well where gas…is found might be language indicating the parties intended that…lessors…would bear part of the costs of transporting the gas from the wellhead to the point of sale.…" *See Wellman*, *supra,* 557 S.E.2d at 266.

Five years later however, *Tawney* expressly rejected application of this so-called "net back" method of calculating royalties under leases which do not expressly sanction this method but instead merely contain "at the wellhead" type language. In doing so, the *Tawney* Court again made explicit reference to West Virginia's "longstanding" rule that the lessee is to bear all costs prior to the point of sale. In fact, the *Tawney* Court framed the issue presented as "whether the 'at the wellhead'-type language at issue is sufficient to alter West Virginia's general rule that the lessee must bear all costs of marketing and transporting the product to the point of sale," as is evident in the Court's reformulation of the certified question:

> Question: **In light of the fact that West Virginia recognizes that a lessee to an oil and gas lease must bear all costs incurred in marketing and transporting the product to the point of sale unless the oil and gas lease provides otherwise**, is lease language that provides that the lessor's 1/8 royalty is to be calculated "at the well," "at the wellhead" or similar language, or that the royalty is an amount equal to 1/8 of the price, net of all costs beyond the "wellhead," or "less all taxes, assessments, and adjustments" sufficient to indicate that the lessee may deduct post-production expenses from the lessor's 1/8 royalty, presuming that such expenses are reasonable and actually incurred?
> Answer: No.

Tawney, supra, 219 W.Va. at 272. (emphasis added)

Accordingly, in asking the Court to overturn the holdings in *Wellman* and *Tawney*, Petitioners are really asking it to overrule longstanding established West Virginia law which holds that the lessee owes the lessor a duty to market and transport the product from the wellhead to the point of sale and must bear all costs associated with transporting and putting gas into marketable form. The Court should decline this invitation.

1. As Already Recognized by Other Courts, as Well as the West Virginia Legislature, the West Virginia Supreme Court of Appeals' Decision in *Leggett v. EQT Production Company,* 800 S.E.2d 850 (W.Va. 2017) (*Leggett II*"), Did Not Overrule *Wellman* or *Tawney* and Its Criticisms of *Tawney* Constitute Nothing More than Poorly Reasoned *Dicta* Which Should Not *Be* Adopted by This Court.

The assertion that the West Virginia Supreme Court of Appeals' second opinion in *Leggett v. EQT Production Company,* 800 S.E.2d 850 (W.Va. 2017) (*Leggett II*"), issued on May 30, 2017,[2] somehow overrules any portion of *Wellman* or *Tawney,* or otherwise sanctions the use by lessees of the so-called "net back" method in computing and paying royalties under leases containing "at the wellhead" type language in their royalty clauses is just plain wrong. Indeed, the analysis contained in *Leggett II* focused on the "at the wellhead" language contained in West Virginia's "flat rate well" statute, *W.Va. Code §22-6-8(e)*, and the *Leggett II* Court specifically noted that its statutory construction of this language was inapposite to any correlative analysis involving interpretation of "at the wellhead" as used in the context of freely negotiated private leases. Specifically, the *Leggett II* Court noted that such statutory analysis does not, by

[2] The West Virginia Supreme Court of Appeals initially ruled in accordance with both *Wellman* and *Tawney* in *Leggett I,* No. 16-0136, 2016 W.Va. Lexis 890 (Nov. 17, 2016), that mineral owners receiving royalties under West Virginia's "flat rate" statute *W.Va. Code §22-6-8,* cannot be charged for post-production expenses. The Court later reheard the case and reversed itself in *Leggett II,* holding that such expenses may be deducted.

definition, involve common law rules of contractual construction, notably including both the "implied covenant to market" and the well-known rule of construction which holds that contractual language must be construed against its drafter, both of which were central to the decisions in *Wellman* and *Tawney*. *See Leggett II, supra,* 800 S.E.2d., at 860, 863. ("[T]he issue presently before the court does not permit intrusion into these issues [regarding private gas leases]."

Moreover, numerous federal courts have since confirmed that *Wellman* and *Tawney* were not overruled by *Leggett II*. For instance, in 2020, the United States Court of Appeals for the Fourth Circuit held in *Young v. Equinor US Onshore Properties, Inc.,* 982 F.3d 201 (4th Cir. 2020)*,* that "a West Virginia oil and gas lease must satisfy *Tawney's* three-pronged test to rebut the *Wellman* presumption that the lessee will bear all post-production costs," and further explicitly noted that "*Leggett* didn't overrule *Wellman* and *Tawney*." *Young,* 982 F.3d at 207.

Instead, the *Young* Court reaffirmed and applied the three-pronged standard from the *Tawney* decision:

> … an oil and gas lease that intends to allocate post-production costs between the lessor and lessee must: (1) "expressly provide that the lessor shall bear some part of the costs incurred between the wellhead and the point of sale"; (2) "identify with particularity the specific deductions the lessee intends to take from the lessor's royalty"; and (3) "indicate the method of calculating the amount to be deducted from the royalty for such post-production costs." 633 S.E.2d at 30. Applying this test, *Tawney* held that lease language that provides for the lessor's royalty to be calculated "at the wellhead" is ambiguous, and therefore fails to rebut the *Wellman* presumption [that the lessee is presumptively responsible for all post-production costs until the product is sold]. *Id.*

Young, 982 F.3d at 206.[3]

In addition, several U.S. District Court opinions from within the State of West Virginia have similarly concluded that *Leggett II* did not (and should not) be read as overruling *Wellman* and *Tawney. See* e.g., *Sandra Goodno, et al. v. Antero Resources Corp.*, Case No. 5:20-CV-00100-JPB, U.S. Dist. Ct. N.D. W.Va., at pp. 4-5 (Doc. 23, July 21, 2020); *Cather v. EQT Prod. Co.*, 2019 WL 3806629, at p. 14 (N.D. W.Va. August 13, 2019); *Romeo v. Antero Res. Corp.*, Civil Action No. 1:17CV88 Doc. 38, at p. 15 (N.D. W.Va. July 12, 2021).

Most notably, the West Virginia legislature, in direct response to the *Leggett II* Court's express request, has rejected the arguments advanced by Petitioners and their *Amici* regarding and reaffirmed the core legal principles underlying *Wellman* and *Tawney.* In its opinion, the *Leggett II* Court explicitly recognized "the inherent tension between holders of leases subject to our interpretation of *West Virginia Code §22-6-8* and those freely-negotiated leases which remain subject to the holdings of *Wellman* and *Tawney*" and it "therefore implore[d] the West Virginia Legislature to resolve the tensions" as it saw fit. *Leggett,* 800 S.E.2d at 869.

Taking the Court up on its invitation, in its very next session, the West Virginia Legislature answered this call, amending *W.Va. Code §22-6-8(e)* effective May 31, 2018, requiring the owner of the working interest in a well to tender to the owner of oil and gas in place" not less than one eighth of the gross proceeds, and "**free from any deductions from post-production expenses**." *W.Va. Code §22-6-8(e) (2018).*

The legislature's action should be read as wholly negating *Leggett II's* Syllabus Point 8, which ostensibly endorsed the so-called "net back method" as a

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[3] It does not appear that the parties in *Young v. Equinor US Onshore Properties, Inc.,* 982 F.3d 201 (4th Cir. 2020), advised this Court of *W.Va. Code §22-6-8*'s amendment.

method of calculating royalty due under the statute, which previously contained the "at the wellhead" language. *See* previous version of the statute *W.Va. Code §22-6-8(e) (1982)*. Moreover, this clarification is also properly construed as a wholesale rebuke to the fallacious notion that *Wellman* and *Tawney* are poorly reasoned and/or that the "net back method" of calculating royalty is an acceptable method of calculating royalty due under the leases with "at the wellhead type language" that was inherent in West Virginia law prior to the advent of both *Wellman* and *Tawney*.

2. Despite ***Leggett II's Dicta***, the Phrase "At the Wellhead" Was Rendered Latently Ambiguous by Deregulation Changes in the Way Oil and Gas are Transported and Sold

The *Tawney* Court found the "at the wellhead" language as used in the leases at issue to be ambiguous and not sufficient, by itself, to alter the default rule that the lessee must bear all post-production expenses necessary to put the gas in marketable form.

> [T]he present dispute boils down to whether the "at the wellhead"-type language at issue is sufficient to alter our generally recognized rule that the lessee must bear all costs of marketing and transporting the product to the point of sale. We conclude that it is not…We believe that the "wellhead"-type language at issue is ambiguous. First, the language lacks definiteness. In other words, it is imprecise. While the language arguably indicates that the royalty is to be calculated at the well or the gas is to be valued at the well, the language does not indicate *how* or *by what method* the royalty is to be calculated or the gas is to be valued. For example, notably absent are any specific provisions pertaining to the marketing, transportation, or processing of the gas. In addition, in light of our traditional rule that lessors are to receive a royalty of the sale price of gas, the general language at issue simply is inadequate to indicate an intent by the parties to agree to a contrary rule-that the lessors are not to receive 1/8 of the sale price but rather 1/8 of the sale price less a proportionate share of deductions for transporting and processing the gas.

Tawney, supra at 272.

The *Leggett II* Court, in construing "at the wellhead" language as used in the prior version of *W.Va. Code §22-6-8,* rejected this conclusion and held that the phrase was "not ambiguous in its face" but had a "very precise and definite meaning, i.e. "oil and gas … valued in its unprocessed state as it comes to the surface at the mouth of the well …" *Leggett II,* 800 S.E.2d at 865 (quoting *Atl. Richfield Co. v. State of California,* 214 Cal. App. 3d 533, 262 Cal. Rprt. 683, 688 (1989)).

Besides the obvious fact that the *Leggett II* analysis occurred in a statutory, as opposed to contractual context, no consideration was given as to latent as opposed to facial ambiguity. The "at the wellhead" language at issue in *Tawney* constitutes a technical industry term of art that developed as a trade usage over many decades in various private lease agreements. Accordingly, over time, it developed a meaning that was consistent with its prior use in lease agreements, which was, for all intents and purposes, the point of sale for the produced gas. This Court has been clear that technical terms of art, when used in contracts, must be given their meaning as of the date of the contract. *See e.g., Tide Water Oil Sales Corporation v. Don Harper*, 113 W.Va. 643, 169 S.E. 454 (1933) ("technical terms of art must be given their meaning at the time of contract until such time as that meaning is changed by the parties").

However, this technical meaning was later rendered ambiguous in practice once deregulation changed the way in which gas was sold and valued beginning in the 1980's. *See Tawney*, 633 S.E.2d at 28. Indeed, as recognized by Petitioners' *Amici* in their brief, "at the wellhead," as used in leases developed in an age in which the final sale of the gas usually occurred very near to the wellhead. (*Amici* API and WV Go Brief at p. 10.) However, the manner in which natural gas was sold and the point of that sale began to change radically in 1986 with the coming of Federal Energy Regulation

Commission, “FERC,” Order No. 436, wherein the FERC initiated a program to introduce greater competition into the market for transportation of gas.

The FERC’s reforms necessitated a massive reform in the way pipeline companies conducted virtually all their business.

> Underlying the FERC’s action in Order No. 436 was its premise that for purposes of analysis and regulation, the natural gas industry can be split into parts: sales and transportation. In this model, the market consisting of sales and purchases of the commodity, natural gas, is the quintessential perfectly competitive market. On one side, selling gas, stands thousands of producers, pipeline companies, LDC’s, and marketers; on the other side, buying gas, stands thousands of consumers. Standing between the multitudes is the other side of the commissions paradigm, the pipeline through which the natural gas must flow. A sizeable proportion of the thousands of sellers and buyers of natural gas, FERC believed, have no or few options with regard to which pipeline to use. Accordingly, FERC had reasoned, the natural gas industry as a whole can be made to mimic a perfectly competitive industry only if monopoly pipeline portion can be made to act like a competitive industry. Thus, Order No. 436 proposed a voluntary self-implementing transportation program wherein pipelines would provide “equal access to anyone who requests transportation of gas, regardless of type or quantity of gas, usage, or alternate fuel capability.”… The Commission’s virtual mandate to pipelines to provide open access to transportation…fundamentally changed the way all components of the gas industry do business…The major role of the interstate pipelines now [was that of] transporters rather than merchants of gas. More than any of the other changes resulting from the FERC’s new policy initiatives, this change in the pipelines’ role, brought about in large part by Order No. 436, has had the greatest effect on the conduct of business in the natural gas industry.

Hollis, Sheila S., “The Changing Framework of Natural Gas Business and Law,” 35 *Rocky Mountain Mineral Law Institute*, §1402, 14-5 through 14-8 (1989).

Accordingly, these changes in the natural gas business prior to both the *Wellman* and *Tawney* decisions fundamentally altered the relationship between buyer and seller such that the term “at the wellhead,” which previously connoted a single point both a physical point and a figurative point of sale, took on multiple connotations and was no longer a reasonable corollary to the business relationship that exists between

lessors and lessees. This is a classic "latent" ambiguity of the type recognized by the Court in *Energy Development Corp. v. Moss*, 214 W.Va. 577, 591 S.E.2d 135, 143-144 (2004) (*quoting Kopf v. Lacey*, 208 W.Va. 302, 307, 540 S.E.2d 170, 175 (2000) (*per curium*) (citing *Black's Law Dictionary* 794 (5th ed. 1979)). ("A latent ambiguity, which does not appear upon the face of the document…may be created by intrinsic facts or extraneous evidence.")[4]

Moreover, and as noted in *Tawney's* Syllabus Point 7, to the extent the "at the wellhead" language contained in leases renders their meaning ambiguous, the ambiguity must be resolved in favor of the lessee. *See Tawney*, 633 S.E.2d at Syl. pt. 7.

B. ***Wellman* and *Tawney* Apply to Both "Proceeds" and "Market Value" Type Royalty Clauses.**

Petitioners' *Amici* WV Go, American Petroleum Institute, and the West Virginia Chamber of Commerce argue that should the Court not overrule *Wellman* and *Tawney* outright, it should restrict their holdings to so called "Proceeds" leases, wherein royalty is computed on the "proceeds" received by the lessee in an arm's length transaction as opposed to leases which compute royalty on the "market value" of the gas produced. (*See Amici* API and WV Go Brief at pp. 7-8.) However, in its opinion, the *Tawney* Court specifically rejected the notion that its ruling does not apply to so-called "market value leases," stating:

> [The lessee] asserts, however, that when read with accompanying language such as "gross proceeds," "market price," and "net of all costs,"

[4] Your *amici* humbly posit that the most efficient remedy for such a situation is for producers/lessors and lessees to renegotiate and modernize the terms of the subject leases to bring them more clearly in line with the practices of the modern gas business by delineating specifically which costs may be deducted from the computation of royalty. *See Tawney, supra,* 633 S.E.2d at 30. Until they do so, however, despite Petitioners' sophisticated rationalizations, the latent ambiguity created by "at the wellhead" valuations will persist, and it is only fair that the producers/lessees, who are explicitly understood to be the bearers of such "business risk" in this relationship, should absorb the costs associated with that risk.

> the wellhead-type language clearly calls for allocation of post-production expenses. We disagree. First, we note that the word "gross" implies, contrary to CNR's interpretation, that there will be no deductions taken. Hence, the phrase" gross proceeds at the wellhead" could be construed to mean the gross price for the gas received by the lessee. On the other hand, the words "gross proceeds" when coupled with the phrase "at the well head" could be read to create an inherent conflict due to the fact that the lessees generally do not receive proceeds for the gas at the wellhead. Such an internal conflict results in an ambiguity. <u>Likewise, the phrase "market price at the wellhead" is unclear since it contemplates the actual sale of gas at the physical location of the wellhead, although the gas generally is not sold at the wellhead.</u>

Tawney, 633 S.E.2d at 28-29 (emphasis added). Thus, *Wellman's* and *Tawney's* holdings clearly encompass co-called "market value" lessees as opposed to only those leases which contain the words "gross proceeds."

Moreover, Footnote 2 of *Tawney* reveals that the original questions that had been certified by the trial court, arose from the defendant lessee/producer's motion for summary judgment which requested summary judgment only as to leases with the language "at the well," "at the wellhead" (or similar language), or that the royalty is to be "one-eighth of the price, net all costs beyond the wellhead," or "less all taxes, assessments, and adjustments." *Tawney,* 633 S.E.2d at 25, n. 2. However, this Court then found that these certified questions went

> beyond the scope of CNR's motion for summary judgment in that the questions include lease language never placed in issue by CNR's motion for summary judgment.

Tawney, 633 S.E.2d at 25, n. 2. The Court therefore declined to answer the original certified questions formulated by the trial court, and instead reformulated the certified question to conform to the motion for summary judgment.

Instead, the reformulated certified question was:

> In light of the fact that West Virginia recognizes that a lessee to an oil and gas lease must bear all costs incurred in marketing and transporting the product to the point of sale unless the oil and gas lease provides

> otherwise, <u>is lease language that provides that the lessor's 1/8 royalty is to be calculated "at the well</u>," "at the wellhead" or similar language, or that the royalty is "an amount equal to 1/8 of the price, net of all costs beyond the wellhead," or "less all taxes, assessments, and adjustments" sufficient to indicate that the lessee may deduct post-production expenses from the lessor's 1/8 royalty, presuming that such expenses are reasonable and actually incurred.

Tawney, 633 S.E.2d at 24-25 (emphasis added). Thus, *Tawney's* holding is clearly not limited to "proceeds" type leases but applies equally to the "market value" type leases employing the "at the wellhead" language as well.

Tawney's reformulated certified question emphasizes "the fact that West Virginia recognizes that a lessee to an oil gas lease must bear all costs incurred in marketing and transporting the product to the point of sale unless the oil and gas lease provides otherwise, …" *Id.* at 24. In doing so the *Tawney* Court signaled clearly that the lessee's obligation to bear all costs in transporting the product to the point of sale is not limited to either "proceeds" leases or "market value" leases (or any other particular type of lease language) but instead applies to any lease which does not clearly provide otherwise, including leases with "market value" royalty provisions.[5]

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[5] Recent district court decisions from the U.S. District Court for the Northern District of West Virginia have adopted this reasoning holding that *Tawney* applies to both "proceeds" and market value type leases. *See Sandra Goodno, et al. v. Antero Resources Corp.*, Case No. 5:20-CV-00100-JPB, U.S. Dist. Ct. N.D. W.Va., pp. 4-5 (Doc. 23, July 21, 2020). (District Court "agree[d] with the other courts that have addressed the issue that the holdings of *Tawney* are not limited to any specific type of royalty provision."); *Cather v. EQT Prod. Co.*, 2019 WL 3806629 (N.D. W.Va. August 13, 2019) (Court held lease which requires the gas producer to pay that "*Tawney* [does not] limit its own application to any particular lease language."). Moreover, neither *Cabot Oil & Gas Corp. v. Beaver Coal Co., Ltd.,* No. 16-0904, 2017 WL 5192490 (W.Va. November 19, 2017) nor *Imperial Colliery Co. v. Oxy USA, Inc.*, 912 F.2d 696 (4th Cir. 1990) alters this conclusion. In *Cabot*, the Court considered a 2004 arbitration award which was issued two years before *Tawney* was ever decided. The Court merely applied the doctrine of *res judicata* to the 2004 arbitration award and held that such award could not be vacated based upon *Tawney's* change in the applicable law since the award was issued before *Tawney* was decided. *Id.* at *3. *Imperial Colliery, supra,* was decided in 1990, some eleven years before the *Wellman* decision was issued, under the *Erie R.R. Co. v. Tompkins,* 204 U.S. 64 (1938) standard. *See Volvo Const. Equipment North America Inc. v. CLM Equipment Co., Inc.,* 386 F.2d 581, 599-600 (4th Cir. 2004) ("A federal court exercising diversity jurisdiction is obliged to apply the substantive law of the state in which it sits.") Thus, to the extent *Imperial Colliery's* holding conflicts with *Wellman* and *Tawney*, it was effectively overruled thereby.

C. *Wellman* and *Tawney* Represent the Only Effective Protection West Virginia Landowners/Lessors Have Against Lessees' Predatory Accounting Practices Which Seek to Diminish and Ultimately Negate the Entire Royalty and the Court Should Continue to Require Express Authorization Via Clear Lease Language in Order for a Lessee to Utilize the "Net-Back" Method to Deduct Any and All Expenses Incurred Between the Wellhead and the Point of Sale.

A recent article in the West Virginia Law Review, Adam H. Wilson, Without a *Leggett* to Stand On: Arguing for Retroactive Application of West Virginia's Amended Flat-Rate Well Statute, 124, W.Va.L.R. 259 (2021), provides an apt description of the various, sundry and deeply conceived strategies which the producers and, in particular, the large national producers regularly deploy against their lessors in a decades long effort to completely consume the entire landowner's royalty through a "death by one thousand cuts" type strategy deployed through accounting-based chicanery.

> At first blush, the net-back method may sound like an equitable way to allocate costs between lessor and lessees; however, lessees use the net-back method to fleece lessors of their valuable minerals. Gas companies–EQT in particular–best effectuate this by creating wholly-owned subsidiary companies that charge the mineral owner with what would be otherwise impermissible deductions.
>
> EQT Corporation, the parent company, utilizes three main subsidiaries while producing natural gas. First, EQT Production Company ("Production") is responsible for leasing property and, as lessee, drilling for and producing natural gas. Production then sells the gas to EQT Energy, L.L.C., ("Energy") at the wellhead. Energy relies on EQT Gathering, L.L.C., ("Gathering") to gather and transport the gas until Energy sells it to a downstream buyer.
>
> These relationships become even more convoluted, and at times intertwined, once payments are due. The best way to fully appreciate these intricacies is to work backwards, beginning downstream, and finishing at the wellhead. Energy ultimately sells the gas to an unaffiliated third-party buyer, where it receives the gross proceeds. Gathering then charges Energy for its transportation services, based on an annual rate that Gathering sets; Energy pays Gathering by deducting the gathering and transportation costs from the gross proceeds and is left with the net proceeds. Energy pays the net proceeds to Production, which it claims to be the "wellhead price." Production uses the net proceeds–instead of the gross proceeds–to calculate the mineral owner's royalty.
>
> Interestingly, EQT Corporation ("EQT") appears absent from the entire process, from well to sale. This is not because EQT is uninvolved

> with its subsidiaries, but quite the opposite. EQT uses these subsidiaries as alter egos to avoid paying the full royalties owed to mineral owners. EQT restructured its business–forming these subsidiaries–following *Wellman*'s holding that the mineral owner's royalty must be based on the first point of sale. EQT relies on the fallacy that these intra-company sales are arm's-length transaction among independent entities, allowing it to base royalties on the wellhead sale between Production and Energy. This position is indefensible because these entities are one and the same. EQT and its subsidiaries act in unison and assign profits to each group. The entities then agree to a consolidated business plan with the aim of doing what is best for EQT. Any profits the subsidiaries accrue ultimately make their way back to EQT Corporation, as the parent company controls what capital each subsidiary may own….

Wilson, supra, 124 W.Va.L.R. at 282-283 (citations omitted). The article goes on to expose the fallacy of allowing producers to utilize the "net back" method of gas valuation in the absence of clear lease language authorizing the same.

> Gas companies claim the net-back method is a fair way of allocating to mineral owners their *pro rata* share of expenses, but this pays mere lip service to the idea of equity. Instead, lessees carefully structure their businesses–by forming alter egos–in order to maximize the amount of deductions that can be taken, thereby diluting the mineral owner's royalty payment. Such a scheme enables the lessee to dictate how much the lessor's royalty will be, to the point he receives wholly inadequate compensation for his valuable minerals.
>
> Proponents of the net-back method argue that mineral owners should not fret about gas companies inflating costs because the latter is responsible for the remaining seven-eighths. This position is incorrect because it fundamentally misunderstands how the net-back method works in practice. While the total costs are in fact a zero-sum game, which costs are deductible remains in flux. Each subsidiary, Production, Energy, and Gathering, are best thought of as departments, amongst which EQT's total costs must be distributed. Because Production's costs are not deductible, EQT has no incentive to allocate expenses to Production. On the other hand, every expense Gathering accounts for can be charged to the mineral owner as a post-production expense, thereby incentivizing EQT to assign Gathering as many expenses as possible. Unsurprisingly, EQT does exactly that. The rate that Gathering charges includes not only the costs of gathering and transporting the gas but also meals and entertainment, uniforms, meter operations and repair, personal property taxes, salaries, retirement, medical insurance, and office supplies.

Wilson, supra, 124 WVCLR at 284-285 (citations omitted).

Although Petitioners and their *Amici* refer to recent Court decisions which have recognized and precluded the use of the tactics employed by the producer as described above, the great disparity in resources between the lessors and lessees virtually insures that any financial motivation provided them by this Court in fully or partially overruling *Tawney* and *Wellman* will almost certainly give rise to new and even more difficult to attack accounting strategies to continuously and exert ably degrade the integrity of the lessor's royalty.

Accordingly, the Court should continue to require that leases contain <u>clear</u> language authorizing the taking of deductions via the "net back" method. Both *Tawney* and *Wellman*, repeatedly provide that the lessee "must bear all costs incurred in marketing and transporting the product to the <u>point of sale</u> unless the oil and gas lease provides otherwise." *Tawney*, 633 S.E.2d at 30, syl. pts. 10 and 11 (emphasis added); *Wellman*, 557 S.E.2d at 256 ("If an oil and gas lease provides for a royalty based on proceeds received by the lessee, unless the lease provides otherwise, the lessee must bear all costs incurred in exploring for, producing, marketing, and transporting the product to <u>the point of sale</u>") (emphasis added).

In *W.W. McDonald v. EQT Production Co.,* 983 F.Supp.2d, 790 (S.D. W.Va. 2013), U.S. District Judge Goodwin explicitly rejected a producer's attempted employment of the so-called "work back method" in deducting costs incurred between the wellhead and the point of sale in order to arrive at its fictional "at the well" price stating plainly that "absent lease language to the contrary, *Tawney* requires lessees to pay royalties free of all [post-production costs which enhance the value of the gas from the interstate connection price]," holding in essence that in the absence of clear language to the contrary, the "market" and the "point of sale" are one in the same.

W.W. McDonald, 983 F.Supp.2d, at 804. The Court should reject Petitioners' arguments and reaffirm these holdings.

IV. Prayer for Relief

For all the reasons set forth herein your *Amici* West Virginia Royalty Owners' Association, West Virginia Farm Bureau, Bounty Minerals LLC and Siltstone Resources, LLC, respectfully request the Court whole heartedly reaffirm the holdings in *Wellman* and *Tawney*, syllabus points 4, 5 and 7.

Respectfully Submitted,

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Dated: February __, 2022

CERTIFICATE OF SERVICE

I, Howard M. Persinger, III, hereby certify that on the ___ day of February, 2022, the foregoing, "***AMICUS CURIAE* BRIEF ON BEHALF OF WEST VIRGINIA ROYALTY OWNERS' ASSOCIATION, WEST VIRGINIA FARM BUREAU, BOUNTY MINERALS LLC AND SILTSTONE RESOURCES, LLC (IN SUPPORT OF RESPONDENTS CHARLES KELLAM, ET AL.)**" was served upon the following counsel to Petitioners, Respondents and other *Amici Curiae* by email and by depositing a true copy thereof in the United States mail, first class, postage prepaid, and addressed as follows:

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