IN THE SUPREME COURT OF APPEALS OF WEST VIRGINIA

DOCKET NO. 21-0729

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

Petitioners,

v.

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

Respondents.

BRIEF OF AMERICAN PETROLEUM INSTITUTE, GAS AND OIL ASSOCIATION OF WV, INC., AND WEST VIRGINIA CHAMBER OF COMMERCE AMICI CURIAE IN SUPPORT OF PETITIONERS

W. Henry Lawrence (WV Bar # 2156)
Amy M. Smith (WV Bar # 6454)
STEPTOE & JOHNSON PLLC
400 White Oaks Boulevard
Bridgeport, WV 26330
(304) 933-8000
hank.lawrence@steptoe-johnson.com
amy.smith@steptoe-johnson.com

Counsel for American Petroleum Institute,
Gas and Oil Association of WV, Inc., and
West Virginia Chamber of Commerce
Amici Curiae

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I. STATEMENT OF IDENTITY OF AMICI CURIAE, THEIR INTERESTS IN THIS CASE, AND SOURCE OF AUTHORITY TO FILE

The American Petroleum Institute ("API") is a nationwide non-profit trade association that represents approximately 600 member companies involved in all aspects of the petroleum and natural gas industry. Its members range from the largest integrated companies to the smallest independent operators. API's members include producers, refiners, suppliers, marketers, pipeline operators, and marine transporters, as well as service and supply companies. API is also the worldwide leading body for establishing standards that govern the oil and gas industry.

The Gas and Oil Association of WV, Inc. ("GO-WV") is a non-profit trade association formed in 2020 when the Independent Oil and Gas Association of West Virginia and the West Virginia Oil and Gas Association merged. GO-WV supports and advocates for its 600 member companies and their thousands of employees as they contribute to the growth and prosperity of West Virginia. GO-WV works to promote and protect all aspects of the oil and gas industry in West Virginia, including the exploration, drilling, production, gathering, processing, interstate transportation, local distribution, marketing and sale of oil, gas, and natural gas liquids ("NGLs"). GO-WV also helps advance and grow the oil and gas industry and protects fair-market prices.

The West Virginia Chamber of Commerce ("Chamber") is the voice of business in West Virginia. The Chamber encourages public policies that attract new businesses and foster the growth of existing businesses within the state so that all West Virginians enjoy the benefits of a robust economy. The Chamber is a consistent advocate for a legal system with predictable outcomes in the mainstream of jurisprudence to ensure that businesses in West Virginia operate under the same general ground rules as their competitors elsewhere in the country.[1]

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[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

II. ARGUMENT

A. The Court Should Overrule *Wellman* and *Tawney*.

The Court should reformulate the first certified question and overrule *Wellman v. Energy Resources, Inc.*, 557 S.E.2d 254 (W. Va. 2001), and *Tawney v. Columbia Natural Resources, L.L.C.*, 633 S.E.3d 22 (W. Va. 2006). Specifically, the Court should overrule *Wellman*'s Syllabus Points 4 and 5 and *Tawney*'s Syllabus Points 1, 2, 10, and 11, which collectively hold:

> 1. "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." Syllabus Point 4, *Wellman v. Energy Resources, Inc.*, 210 W. Va. 200, 557 S.E.2d 254 (2001).
>
> 2. "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." Syllabus Point 5, *Wellman v. Energy Resources, Inc.*, 210 W. Va. 200, 557 S.E.2d 254 (2001).
>
> ...
>
> 10. 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.
>
> 11. 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.

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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.

Tawney, 633 S.E.2d 22, at Syl. Pts. 1, 2, 10, and 11.

These holdings in *Wellman* and *Tawney* are based on flawed legal analyses. Initially, *Wellman* and *Tawney* misread one section on an implied covenant to sell minerals in an antiquated treatise, Robert Donley, *The Law of Coal, Oil and Gas in West Virginia and Virginia* (1951). Next, *Wellman* and *Tawney* conflated production and post-production costs and concluded generally that the implied duty to market requires the lessee to get the oil or gas in marketable condition and transport it to market. *Tawney* then further erroneously concluded that "at the wellhead" language in a lease was ambiguous and insufficient to alter *Wellman*'s holding that the lessee must bear all costs of marketing and transportation to the point of sale.

Wellman and *Tawney* failed to consider relevant caselaw, statutory law, and regulatory authority. The Court ignored persuasive authority from the Fourth Circuit that applied West Virginia contract law and illustrated how royalties should be paid on wellhead value. In addition, the Court ignored West Virginia statutes and regulations that have taxed gas based on wellhead value since the 1920's. Moreover, although the Court in *Tawney* found it significant that the defendant did not begin taking post-production deductions until 1993, *Tawney* failed to recognize the impact of deregulation of the oil and gas market. Finally, the Court contravened West Virginia's conservation statutes and the public policy against waste.

The holdings in *Wellman* and *Tawney* lack any meaningful connection to basic principles of contract law. Moreover, *Wellman* and *Tawney* put West Virginia lessees at a competitive disadvantage by creating a legal climate that ignores the economic realities of the oil and gas industry and disincentivizes production, especially where the value of gas can be enhanced.

The Court signaled the demise of *Wellman* and *Tawney* in *Leggett v. EQT Production Co.*, 800 S.E.2d 850, 862 (W. Va. 2017), but left their continued vitality for another day when the issue was presented. The issue is presented, and the time to overrule *Wellman* and *Tawney* is now.

1. The holdings in *Wellman* and *Tawney* are based on flawed legal analyses.

a. *Wellman* and *Tawney* misread Professor Donley's treatise.

Initially, *Wellman* and *Tawney* misread one section in Professor Donley's 1951 treatise. Specifically, *Wellman* and *Tawney* quoted the first two sentences of § 104 titled "The Implied Covenant to Sell the Minerals," which states:

> 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 to him [the landowner] one-eighth of the sale price received. This practice has, in recent years, been extended to situations where gas is found[.]

Wellman, 557 S.E.2d at 263 (citing Donley, *supra* p. 3 at § 104) (alterations in *Wellman*); *Tawney*, 633 S.E.2d at 27 (same).

Even Professor Donley's treatise, however, recognizes that it is permissible to value gas at the wellhead for royalty purposes where gas is sold away from the well without regard to the implied covenant to sell the minerals. Professor Donley's treatise § 159 titled "Gas Royalties" quotes the following example of a typical gas royalty provision in a modern lease of that time:

> "Should a well be found producing gas only, the full consideration to Lessor for such gas well and its products shall be a rental [royalty] payable within 30 days after the expiration of each quarter beginning with the date when gas is marketed therefrom and continuing so long as gas is produced and marketed or used off the premises, equal to one-eighth (1/8) of the proceeds received by the Lessee from the sale of the gas if measured and sold at the well, *but if not sold at the well but after transmission or commingling with gas from other properties, then equal to one-eighth (1/8) of the average prevailing price currently paid at the well in the same field by public utility companies ....*"

Donley, *supra* p. 3 at § 159 (emphasis added). *See id.* at Form Nos. 16–17 (additional examples of leases providing for gas royalty valuation at the well).

Thus, *Wellman* and *Tawney* began with a false premise based on a misreading of Professor Donley's treatise. *See* 3 Williams & Meyers, *Oil and Gas Law*, § 645.2 (discussing *Tawney*'s "false premise" caused by reliance on treatise from 1951 when most gas was sold at the wellhead).

b. ***Wellman* and *Tawney* conflated production and post-production costs and concluded that the implied duty to market requires the lessee to get the oil or gas in marketable condition and transport it to market.**

Next, *Wellman* and *Tawney* cited *Davis v. Hardman*, 133 S.E.2d 77 (W. Va. 1963), for the proposition that royalties are not chargeable with any of the costs of discovery and production but conflated production and post-production costs and concluded that the implied duty to market requires the lessee to get the oil and gas in a marketable condition and transport it to market. *Wellman*, 557 S.E.2d at 264; *Tawney*, 663 S.E.2d at 27. *Davis* simply does not support the Court's conflation of production and post-production costs or the Court's further conclusion.

The impact of this unsupported conclusion was lessened at least in *Wellman*, which expressly excluded market value leases. Specifically, *Wellman* stated: "Where leases call for the payment of royalties based on the value of oil or gas produced, and sold directly, the Court perceives that there are possibly different issues, and they are excluded from this discussion." *Wellman*, 557 S.E.2d at 264 n.3. Thus, *Wellman* recognized the distinction between proceeds leases and market value leases and excluded market value leases from its discussion and holdings. *Wellman*'s Syllabus Point 4 and *Tawney*'s Syllabus Point 1 by their terms apply only to royalties based on proceeds.[2]

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[2] This Court recognized *Wellman*'s limited application to proceeds leases in *Cabot Oil & Gas Corp. v. Beaver Coal Co., Ltd.*, No. 16-0904, 2017 WL 5192490 (W. Va. Nov. 9, 2017). In *Cabot Oil & Gas*, the plaintiff argued that a 2004 arbitration award should not have a preclusive effect because the panel improperly relied on *Wellman*. *Id.* at *7. The Court rejected this argument and reasoned:

> While the panel discussed *Wellman*, as well as other cases, it clearly stated that *Wellman* was "expressly limited to 'proceeds' leases, excluded 'value' leases from the discussion and, even as to 'proceeds' leases, failed to resolve the issue of the deductibility of 'post-production' expenses, at least with respect to 'mouth of the well' leases." Because the 1929 Lease is not a proceeds lease, the panel ultimately found there was no "controlling West Virginia decision" and that it was reaching its decision on the deduction of postproduction expenses from royalties by applying "the language of the lease[ ] as written." Further, *Wellman* has never been reversed and continues to be the basis for the law in this state on the deduction of post-production costs.

c. ***Tawney* erroneously concluded that "at the wellhead" language was ambiguous and insufficient to alter *Wellman*'s holding that the lessee must bear all costs of marketing and transportation to the point of sale.**

Tawney erroneously concluded that "at the wellhead" language was ambiguous and insufficient to alter *Wellman*'s holding that the lessee must bear all costs of marketing and transportation to the point of sale. *Tawney*, 633 S.E.2d at 28. *Tawney* improperly rejected the following finding in *Wellman*:

> "[T]he language of the leases in [*Wellman*] 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 that the parties intended that the Wellmans, as lessors, would bear part of the costs of transporting the gas from the wellhead to the point of sale[.]"

Tawney, 633 S.E.2d at 29 (citing *Wellman*, 557 S.E.2d at 265).[3]

Tawney further improperly refused to heed *Cotiga Development Co. v. United Fuel Gas Co.*, 128 S.E.2d 626, 633 (W. Va. 1962), which computed royalties based on the price received, as specified in the lease, but stated that parties could easily have said that royalties were to be computed on the wellhead price. *Tawney* found that *Cotiga Development* was unhelpful since it did not define wellhead price or determine how it is calculated. *Tawney*, 633 S.E.2d at 29.

One treatise has indicated that *Tawney*'s conclusion is a head scratcher. *See* Williams & Meyers, *supra* p. 4 at § 645.2 (reasoning that "the court's conclusion that use of 'wellhead' language was ambiguous leaves one scratching one's head as to whether the court was really looking at a bargain struck between the parties or just imposing what it perceived to be a 'fair' and/or 'equitable' result.... If anything, the term 'wellhead' is very precise and definite ....")

Id. at *7 n.16. *See* R. Cordell Pierce, Note, *Making A Statement Without Saying a Word: What Implied Covenants "Say" When the Lease Is "Silent" on Post-Production Costs*, 107 W. Va. L. Rev. 295, 236 (2004) ("The court's holding in *Wellman*, as stated, pertains only to a proceeds lease.... The court correctly realizes that value or market value leases present different issues and limited the decision to deal only with the proceeds lease.").

[3] As discussed in footnote 2, *supra*, in *Cabot Oil & Gas* this Court quoted with approval an arbitration panel's decision that relied on this passage from *Wellman*.

2. *Wellman* and *Tawney* failed to consider relevant caselaw, statutory law, and regulatory authority.

a. The Court ignored persuasive authority from the Fourth Circuit that applied West Virginia contract law and illustrated how royalties should be paid on wellhead value.

The Court in *Wellman* and *Tawney* ignored *Imperial Colliery Co. v. Oxy USA Inc.*, 912 F.2d 696 (4th Cir. 1990), which applied West Virginia contract law and illustrated how royalties should be paid on wellhead value. In *Imperial Colliery*, the Fourth Circuit recognized the difference between leases that provide for royalties on market value or prevailing price at the well and those that provide for royalties on proceeds upon a sale and held that the plain language of the lease at issue obligated the defendant to pay royalties on market value. The court explained:

> In oil and gas practice, there are two generally used lease clauses dictating the amount of royalties due under a lease: the "market value" clause and the "proceeds" clause. Under a market value clause, royalties are paid based upon the market value of the gas; under a proceeds royalty clause, upon the amount of money received by the lessee upon its sales of gas.
>
> The 1944 lease required Oxy to pay Imperial
>
>> One eighth (1/8) of the current *wholesale market value at the well* for all gas produced . . . which *wholesale market value is hereby defined to mean the prevailing purchase price currently paid at the well* by purchasers of gas at wholesale in the field in which the well is located.

Id. at 700 (emphasis added).

In arriving at the "prevailing purchase price currently paid at the well," *Imperial Colliery* recognized the fact "that there was no available wellhead price does not necessarily preclude computation of the gas' wellhead price." *Id.* at 701. The court explained that, generally, computation of the gas' value at the wellhead could simply be made by taking the price paid by the purchaser and deducting compression and gathering expenses. *Id.* In *Imperial Colliery*, however, because the contract price was below market value, the court ultimately held that the district court properly applied a "willing buyer-willing seller" analysis, which computes market value by ascertaining the price that a willing buyer would pay a willing seller in a free market without regard to federal gas-price regulations. *Id.* (citation omitted). The court rejected the defendant's argument that the district court erred in its choice of comparable wells. *Id.*

Imperial Colliery's application of the unambiguous market value royalty provision placed West Virginia in the majority position on this issue. The majority of courts have recognized the unambiguous nature of market value royalty provisions like the one at issue in *Imperial Colliery*. *See* John S. Lowe, *Defining the Royalty Obligation*, 49 SMU L. Rev. 223, 233 (1996) (recognizing that the majority view is that the term market value is a "plain term").[4]

Thus, in 1990 the Fourth Circuit recognized that West Virginia contract law requires royalties on market value leases to be computed based on wellhead prices, which generally can be achieved by deducting post-production costs from the price received.

[4] *Corpus Juris Secundum* has explained that "[u]nder some leases, royalties are based upon the 'market value' of the product," or "the prevailing market price for gas in the vicinity at the time of the sale, irrespective of the actual sale price." 58 C.J.S. *Mines and Minerals* § 377 (June 2018 Update). Conversely, "[u]nder some leases, royalties are based upon 'proceeds,' meaning the amount of money received by the lessee upon its sale of the product." *Id.* (footnotes omitted).

In addition, *American Jurisprudence Second* has defined market value leases and proceeds leases as follows:

> "Market value" is the prevailing market price at the time of delivery and is not affected by a price set at the time the lessee enters into a long-term sales contract with the buyer. A "market value" or a "market price" clause in oil and gas leases requires payment of royalties based on the prevailing market price for gas in the vicinity at the time of sale, irrespective of the actual sale price. "Market value," for purposes of a market value royalty called for under an oil and gas lease, is the price oil or gas would bring when it is offered for sale by one who desires but is not obligated to sell and bought by one who is under no obligation of buying it. Under an oil and gas lease providing for a royalty consisting of a percentage of gross proceeds at the prevailing market rate, "market value" is the price negotiated by a willing buyer not obligated to buy and a willing seller not obligated to sell in a free and open market.
>
> Unless something in the context of an oil and gas lease provides otherwise, "proceeds" generally means total proceeds. "Proceeds" or "amount realized" clauses in oil and gas leases require measurement of the royalty based on the amount the lessee in fact receives under its sales contract for the gas.

38 *Am. Jur. 2d* Gas & Oil § 99 (Feb. 2019). *Cf.* 8 Williams & Meyers, *Manual of Oil and Gas Terms* (2020) (noting that the term "net proceeds" implies that the parties intended to "make deductions to account for costs").

b. The Court ignored West Virginia statutes and regulations that have taxed gas based on wellhead value since the 1920's.

In addition, the Court in *Wellman* and *Tawney* ignored West Virginia statutes and regulations that have taxed gas based on wellhead value since the 1920's. In 1927, the Supreme Court affirmed a decision of this Court that held that West Virginia's gross receipts tax could not include the portion of the value of the gas attributable to the value added by transportation. *Hope Nat. Gas Co. v. Hall*, 135 S.E. 582 (W. Va. 1926), *aff'd*, 274 U.S. 284 (1927).

In 1985, the West Virginia Legislature radically changed how most businesses in this State were taxed. Beginning July 1, 1987, producers of natural resources pay the severance tax on natural resource production, in lieu of the Business and Occupation tax which was effectively repealed. It is obvious, however, that the current severance tax on natural gas still bears many of the same features as did the former tax. West Virginia Code § 11-13A-3a imposes a 5% tax on the "gross value" of natural gas produced. The legislative rules promulgated by the State Tax Commissioner and approved by the Legislature define the term "gross value" as meaning "the market value of the natural resource product, in the immediate vicinity, where severed." W. Va. Code R. § 110-13A-2.7. Specifically for natural gas, West Virginia Code of State Regulations § 110-13A-2a.10 also provides that "gross value" is "the value of the natural gas at the well head immediately preceding transportation and transmission."

West Virginia Code of State Regulations § 110-13A-4.8 specifies how a producer is to calculate the appropriate "transportation allowance." Section 110-13A-4.8 provides:

> The severance and production of natural gas shall be valued at the well-mouth immediately preceding transportation and transmission. In order to arrive at the well-mouth value of such severance and production, transportation or transmission expenses incurred by producers of natural gas before its sale shall be allowed as a deduction from the gross proceeds of the sale of such gas.

This section goes on to specify four alternative methods that the taxpayer may select to obtain the "well-mouth value." One of these four methods is simply "by a deduction of transportation and transmission costs in the amount of 15% of the gross proceeds of the natural gas severed and produced." *Id.* § 110-13A-4.8.4.

As to the cost of processing for the gas, West Virginia Code § 11-13A-4(c), titled "Treatment processes considered part of production of oil, natural gas and natural gas liquids," provides that "[t]he privileges of severing and producing oil and natural gas shall not include any conversion or refining process." The legislative rules also provide that "[t]he terms 'severing' or 'severed' shall not include any separation process for natural gas or oil commonly employed to obtain marketable natural resource products after the gas or oil is produced *at the well-head.*" W. Va. Code R. § 110-13A-2.17.2 (emphasis added).[5]

Thus, since the 1920's, West Virginia has taxed only the value of gas in its natural state as it comes out of the ground and the terms "at the well," "at the wellhead," and "at the mouth of the well" define both the location (before transportation begins) and condition (before processing) of the gas at which the tax is imposed.

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[5] Regulations for federal gas royalties provide similar definitions as follows:

> Gross proceeds (for royalty payment purposes) means the total monies and other consideration accruing to an oil and gas lessee for the disposition of the gas, residue gas, and gas plant products produced. Gross proceeds includes, but is not limited to, payments to the lessee for certain services such as dehydration, measurement, and/or gathering to the extent that the lessee is obligated to perform them at no cost to the Federal Government. Tax reimbursements are part of the gross proceeds accruing to a lessee even though the Federal royalty interest may be exempt from taxation ....
>
> Net-back method (or work-back method) means a method for calculating market value of gas at the lease. Under this method, costs of transportation, processing, or manufacturing are deducted from the proceeds received for the gas, residue gas or gas plant products, and any extracted, processed, or manufactured products, or from the value of the gas, residue gas or gas plant products, and any extracted, processed, or manufactured products, at the first point at which reasonable values for any such products may be determined by a sale pursuant to an arm's-length contract or comparison to other sales of such products, to ascertain value at the lease.

30 C.F.R. § 1206.151.

c. **The Court failed to recognize the impact of deregulation of the oil and gas market.**

Although the Court in *Tawney* found it significant that the defendant did not begin taking post-production deductions until 1993, *see Tawney*, 633 S.E.2d at 28, *Tawney* failed to recognize the impact of deregulation of the oil and gas market and specifically the impact of Federal Energy Regulatory Commission ("FERC") Order No. 636, 57 Fed. Reg. 13,267 (Apr. 16, 1992) (codified at 18 C.F.R. pt. 284). The defendant in *Tawney* likely would not have incurred post-production costs prior to 1993 because prior to deregulation the pipeline company would have been purchasing gas at the wellhead for a price that reflected the post-production costs. *See* David E. Pierce, *Royalty Jurisprudence: A Tale of Two States*, 49 Washburn L.J. 347, 368 (2010).

Order No. 636 summarizes the history of federal regulation of the gas industry as follows:

> In 1938, Congress enacted the [Natural Gas Act "NGA"] to regulate the sale for resale in interstate commerce of natural gas. Congress' action stemmed from the Supreme Court's barring of state regulation of wholesales of natural gas ....
>
> ...
>
> ... Congress, therefore, regulated the interstate chain of distribution of natural gas *from the wellhead* to market under a public utility model. The "heart of the new regulatory system" was the "fixing of 'just and reasonable' rates" for natural gas companies (both producers and pipelines) engaging in the sale for resale in interstate commerce of natural gas. The structure of the natural gas industry regulated by the NGA was simple. The producers would sell their natural gas in the production area to the interstate pipelines at [the FERC]-determined just and reasonable rates. The pipelines would transport their purchased gas and their own production to the city gate for sale to local distribution companies (LDCs) at [the FERC]-determined just and reasonable rates which recovered both the pipelines' cost of gas and cost of transmission.... The central features of the NGA-regulated natural gas industry were [the FERC]-determined just and reasonable prices and interstate pipeline sales of gas for resale to LDCs at the city gate at those prices in transactions that combined or bundled into one package the pipelines' gas supply and transmission costs.

FERC Order No. 636, 57 Fed. Reg. at 13,270 (emphasis added) (footnotes omitted).

However, the regulation of the price of gas and transportation in the interstate market did not stimulate adequate investment for interstate supply. Because the regulated rates for natural gas were below the market value of that gas, demand surged. At the same time, there was little incentive for natural gas producers to devote the money required to explore for and produce new natural gas reserves. Severe shortages of natural gas resulted. In contrast, an abundance of supply existed on local intrastate markets, where regulation was less pervasive. Order No. 636 explains:

> The interstate natural gas shortages of the 1970s were the catalyst for reform of the regulation of the natural gas industry.... [The FERC] established prices for gas in the interstate market could not compete with prices available in the intrastate markets where the prices were not regulated.... Simply put, [the FERC's] struggles ... did not prove adequate to the task of ensuring an adequate supply of interstate gas. Hence, Congress responded to the natural gas shortages by enacting the [Natural Gas Policy Act of 1978, 92 Stat. 3350, 15 U.S.C. § 3301 *et seq.* ("NGPA")] to increase the flow of gas into the interstate market.

Id. at 13,270 (footnotes omitted).

The Natural Gas Policy Act of 1978 ("NGPA"), 15 U.S.C. § 3301, *et seq.*, followed the Arab oil embargo of the early 1970s, and, as the FERC noted in Order No. 636, slowly decontrolled prices at the wellhead and signaled a major change in the way natural gas was purchased and sold:

> The [FERC] has recognized the movement to competition set in motion by the NGPA in 1978. From the special marketing programs in 1984, to the elimination of pipeline minimum bills, to Order Nos. 436 and 500, the [FERC] has sought to promote and expand access to *the wellhead market.* Now, the complete deregulation of *the wellhead market* is on the horizon. The [FERC] must, therefore, take further steps to ensure that the public can realize the full benefits of the competition *at the wellhead.*

FERC Order No. 636, 57 Fed. Reg. 13269 (emphasis added).

The Natural Gas Wellhead Decontrol Act of 1989, 15 U.S.C. § 3301, *et seq.*, amended the NGPA and repealed wellhead price controls beginning January 1, 1993. Since then, lessees often sell gas at distant markets at enhanced prices that are not reduced by post-production costs.

Thus, although deregulation was designed to increase wellhead competition for the public good, sales have moved from the wellhead and lessees incur higher post-production costs.

d. The Court contravened West Virginia's conservation statutes and the public policy against waste.

Through its holdings in *Wellman* and *Tawney*, the Court contravened West Virginia's conservation statutes, W. Va. Code §§ 22C-8-1, 22C-9-1(a), 22C-9-6, and the public policy against waste. For example, § 22C-9-1(a) provides in relevant part:

> (a) It is hereby declared to be the public policy of this state and in the public interest to:
>
> (1) Foster, encourage and promote exploration for and development, production, utilization and conservation of oil and gas resources;
>
> (2) Prohibit waste of oil and gas resources . . .; [and]
>
> (3) Encourage the maximum recovery of oil and gas[.]

One author has explained that the marketable product rule contravenes conservation statutes, quoting § 22C-9-1(a) as an example and reasoning as follows:

> When gas is sold off the leased premises, the lessee's revenue stream is also reduced by the post-production costs incurred to gather, treat, and transport the gas to the point of sale. In non-Marketable Product Rule jurisdictions, the lessor bears its proportionate share of those postproduction costs. However, in Marketable Product Rule states, the lessee's share of production revenue is further burdened with the lessor's share of post-production costs from the wellhead to the point where the gas is placed in marketable condition, or even further to a marketable location (for Colorado) or the ultimate point of sale (for West Virginia). Since this shifting of post-production costs is not accompanied by any increase in the lessee's production revenue, in most cases the unavoidable result is that the underlying lease will terminate due to cessation of production in paying quantities at an earlier point in time, and with less overall recovery of natural gas, than if the lessor had been required to bear its share of post-production costs.

John W. Broomes, *Waste Not, Want Not: The Marketable Prod. Rule Violates Pub. Pol'y Against Waste of Nat. Gas Res.*, 63 U. Kan. L. Rev. 149, 182–83 (2014) (footnotes omitted).[6]

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[6] It should be noted that *Wellman* cited § 22C-9-1 and held that when an oil and gas lease remains capable of producing at the termination of a lease, the lessee must afford the lessors an opportunity to continue the well. *Wellman* did not indicate why the defendant had abandoned a well that the Court found was still capable of producing oil and gas. Moreover, the Court noted that there was no evidence that the lessors could or wished to qualify to operate the well. *See Wellman*, 557 S.E.2d at 266–67.

The Marcellus Shale boom has exacerbated the negative impact on the public policy against waste expressed in West Virginia's conservation statutes. *Tawney* involved only deductions for processing the gas to make it satisfactory for delivery and transportation to the Columbia Gas Transmission line located in West Virginia. 633 S.E.2d at 25. Although the holdings in *Wellman* and *Tawney* reference only two post-production costs – marketing and transportation (the costs of exploring and producing being production costs) – courts have construed the holdings broadly to prohibit costs that were never at issue in *Wellman* or *Tawney* and never contemplated by this Court.

The oil and gas industry has come a long way since *Wellman* and *Tawney*. Gas production from Marcellus Shale wells surpassed production from all other gas wells in West Virginia for the first time in 2011, and Marcellus Shale wells accounted for more than three-fourths of the state's production in 2016.[7] By 2019, only ten percent of the gas produced in West Virginia was consumed in this state.[8] The characteristics of gas may vary from dry to wet, and the gas is sold in different markets.

Today, post-production costs often include processing plant and fractionation charges associated with the manufacture of NGLs that were not at issue in *Wellman* and *Tawney*. In addition, transportation frequently entails costs to distant but more lucrative markets. These post-production costs enhance the value of the gas, but unless the lessee can allocate a proportionate share of post-production costs to the lessor there is an even greater disincentive to the lessee to continue production.

Thus, as the West Virginia oil and gas industry improves its technology and reach, the holdings in *Wellman* and *Tawney* increasingly contravene the public policy against waste.

[7] *See WV Energy Profile: Natural Gas/Marcellus Shale*, W. Va. Off. Energy, http://www.energywv.org/wv-energy-profile/natural-gas-marcellus-shale (last visited Dec. 21, 2021).

[8] *See Natural Gas Production Far Exceeded Consumption in West Virginia in 2019*, U.S. Energy Info. Admin. (Feb. 1, 2021), http://www.eia.gov/todayinenergy/detail.php?id=46616.

3. ***Leggett* signaled the demise of *Wellman* and *Tawney*.**

This Court's decision in *Leggett* signaled the demise of both *Wellman* and *Tawney*, describing them as "inadequately reasoned" and resting on "faulty legs," but leaving "for another day" whether to formerly overrule them. *Leggett*, 800 S.E.2d at 862–63. *Leggett* recounted "stinging" criticism from scholars complaining that *Wellman* and *Tawney* adopted a version of the first marketable product doctrine which has "created 'chaos' and 'foster[s] the belief—perhaps the reality—that the [marketable product] doctrine lacks any cornerstone principles[.]'" *Id.* at 863 (alteration in original) (citation omitted). *Leggett* found it important that commentators have observed that "'West Virginia has actually achieved a ... result that seems to arise more from an unwillingness to accept the realities of deregulation in the natural gas market than from implied covenant law'" and is "'nothing more than a re-writing of the parties' contract to take money from the lessee and give it to the lessor.'" *Id.* (citations omitted).

In addition, *Leggett* disagreed fully with *Tawney*'s conclusion that "at the wellhead" is ambiguous simply because it fails to fully outline allocation of post-production costs. *Id.* at 864–65. *Leggett* cited to several authorities, including *Cotiga Development* and cases from other jurisdictions construing royalty provisions in leases that have found the phrase "at the wellhead" to be unambiguous, easily definable and with a precise meaning. *Id.*

Although *Leggett* explained that neither *Wellman* nor *Tawney* was applicable to an analysis of the "at the wellhead" language in West Virginia Code § 22-6-8(e), the reasoning in *Leggett* applies with equal force to the royalty language contained in leases. *Leggett*'s general criticism of *Wellman* and *Tawney* was directly on point. Moreover, *Leggett*'s holding that "at the wellhead" was not ambiguous in § 22-6-8(e) relied on authorities that found the same language unambiguous in royalty language contained in leases.

Just last year, in *Young v. Equinor USA Onshore Properties, Inc.*, 982 F.3d 201 (4th Cir. 2020), the Fourth Circuit clearly instructed that federal courts evaluating oil and gas leases under West Virginia law should heed the strong criticism of *Wellman* and *Tawney* in *Leggett*. In *Young*, the court confronted whether a particular proceeds lease satisfied *Tawney*'s third prong—i.e., whether the lease adequately "indicate[d] the method of calculating the amount to be deducted from the royalty for such post-production costs." *Id.* at 207 (citation omitted). The court began by emphasizing that "although *Leggett* didn't overrule *Wellman* and *Tawney*, its criticism of those cases and its endorsement of the work-back method inform our analysis here." *Id.* The court then rejected the district court's over-rigorous application of *Tawney*'s three-prong test, finding that *Tawney* does not require a "'mathematical formula'" or "demand that an oil and gas lease set out an Einsteinian proof for calculating post-production costs." *Id.* at 208. The proceeds lease in question needed only to set forth "a simple formula" identifying "*which* costs and *how much* of those costs will be deducted from the [mineral owner's] royalties." *Id.* "Especially in light of *Leggett*," *Young* reiterated in closing, "West Virginia law demands nothing more." *Id.* at 209.

Nonetheless, in its Order of Certification the District Court expresses its view that the *Tawney* requirements should remain the law in West Virginia and "require a clearly spelled out mathematical method for deducting post-production costs." *Kellam v. SWN Prod. Co.*, LLC, No. 5:20cv85 (N.D. W. Va.), ECF No. 21 at 25. The District Court recites a four-paragraph royalty provision without directing this Court's attention to any particular language that the District Court seeks to have construed although one paragraph lists allowed charges against the royalty for transportation, dehydration, and compression, and another paragraph authorizes royalties to be paid on the basis of a field market price at the wellhead. *Id.* at 3–4. The time is now ripe to overrule *Wellman* and *Tawney*.

B. The Court Should Extend *Leggett*'s Net-Back Method as One Way to Calculate Royalties Owed to a Lessor under Oil and Gas Leases.

The Court should reformulate the remaining certified questions regarding deductions and, upon overruling Syllabus Point 10 in *Tawney*, extend Syllabus Point 8 in *Leggett* to recognize the net-back or work-back method as one method by which lessees may calculate royalties owed to a lessor under oil and gas leases wherever deductions are listed and also wherever wellhead valuation is indicated by the language of the royalty provision at issue.[9] *Leggett*'s Syllabus Point 8 holds:

> 8. Royalty payments pursuant to an oil or gas lease governed by West Virginia Code § 22-6-8(e) (1994) may be subject to pro-rata deduction or allocation of all reasonable post-production expenses actually incurred by the lessee. Therefore, an oil or gas lessee may utilize the "net-back" or "work-back" method to calculate royalties owned to a lessor pursuant to a lease governed by West Virginia Code § 22-6-8(e). The reasonableness of the post-production expenses is a question for the fact-finder.

Leggett, 800 S.E.2d 850, at Syl. Pt. 8.

The District Court's concerns about deductions expressed in its Order of Certification are not well founded. *Leggett* made it clear that the language of Syllabus Point 8 was designed to prevent lessees from *carte blanche* allocating post-production costs. To be allocated, post-production costs must be both actually incurred and reasonable as determined by the fact finder. *Id.* at 868. The "actually incurred and reasonable" requirements can apply equally to prevent *carte blanche* allocation of post-production costs in the context of royalties paid under oil and gas leases.

Again, the reasoning in *Leggett* applies with equal force to the royalty language contained in leases that list or otherwise allow for allocation of post-production deductions. *Leggett*'s adoption of the net-back method relied on authorities that adopted the same method for royalty

[9] What the District Court has called deductions in its Order of Certification, *see Kellam*, ECF No. 21, this Court explained in *Leggett* is really use of the net-back method as follows: "Although the issue is commonly referred to as a 'deduction of costs'" issue, it is more accurately a 'work-back' issue to adjust a downstream price to reflect an upstream value by subtracting (deducting) from the downstream price what it cost to put the wellhead gas in the position to fetch the downstream price." *Leggett*, 800 S.E.2d. at 856 n.8.

language contained in leases. For example, *Leggett* relied on *Baker v. Magnum Hunter Production, Inc.*, 473 S.W.3d 588 (Ky. 2015), which concluded that refusal to allow all post-production deductions would result in the lessor receiving more than the agreed-upon royalty. *Id.* at 866–67. *Leggett* concluded that the industry-recognized net-back method of royalty calculation is equally just to both parties. *Id.* at 867.

Overruling *Wellman* and *Tawney* and extending Syllabus Point 8 in Leggett to recognize the net-back method as one method to calculate royalties owed to a lessor under an oil and gas lease would bring West Virginia in line with the standards that govern the oil and gas industry. As the Sixth Circuit explained in the context of "produced and marketed from the leasehold" royalty language "it is standard practice in the industry to calculate the wellhead sales price using the netback method and to use the netback price to calculate landowners' royalties. Why? A netback royalty base avoids a windfall to landowners." *Henceroth v. Chesapeake Exploration, LLC*, 814 F. App'x 67, 69–70 (6th Cir. 2020).

In addition, recognizing that the net-back method may be used to calculate royalties under an oil and gas lease would advance and grow the oil and gas industry in West Virginia and protect fair-market prices. The Kentucky Supreme Court recognized this in *Baker*, which as mentioned above was discussed in *Leggett*. *Baker* reasoned in the context of "market price at the well" royalty clauses that "[a]s for the landowners' 'fairness' argument, it seems abundantly clear that the market value at the well approach employed by Kentucky and the majority of states is not only long-standing but also fair in every sense." *Baker*, 473 S.W.3d at 595.

Finally, recognizing the net-back method in this context would ensure that businesses in West Virginia operate under the same general ground rules as their competitors elsewhere in the country and in particular their neighbors operating in similar shale plays. Ohio and Kentucky have both adopted the netback method as reflected in *Henceroth* and *Baker*, respectively. Pennsylvania has also adopted the net-back method in *Kilmer v. Elexo Land Services, Inc.*, 990 A.2d 1147 (Pa. 2010), which was also discussed in *Leggett*. *See Leggett*, 800 S.E.2d at 860, 863, 865–66. Similar to *Leggett* the issue in *Kilmer* involved statutory construction. Nonetheless, *Kilmer* has been construed broadly and applied to royalty lease language without regard to Pennsylvania's minimum royalty statute. *See Aker v. Keeton Grp., LLC*, No. 3:2009-101, 2011 WL 13235036 (Mar. 15, 2011).

Likewise, this Court should extend Syllabus Point 8 in *Leggett* to recognize the net-back method as one method to calculate royalties wherever indicated by the royalty language at issue, including here where the Kellams' royalty provision has one paragraph that lists allowed charges against the royalty for transportation, dehydration, and compression, and another paragraph that authorizes royalties to be paid on the basis of a field market price at the wellhead.

III. CONCLUSION

For all of the foregoing reasons, the Court should reformulate the first certified question and overrule Syllabus Points 4 and 5 in *Wellman* and Syllabus Points 1, 2, 10 and 11 in *Tawney*. The Court should further reformulate the remaining certified questions and extend Syllabus Point 8 in *Leggett* to recognize the net-back method as one method to calculate royalties owed to a lessor under an oil and gas lease in this action and wherever indicated by the royalty language at issue.

Respectfully submitted this 27th day of December 2021.

W. Henry Lawrence (WV Bar # 2156)
Amy M. Smith (WV Bar # 6454)
STEPTOE & JOHNSON PLLC
400 White Oaks Boulevard
Bridgeport, WV 26330
(304) 933-8000
hank.lawrence@steptoe-johnson.com
amy.smith@steptoe-johnson.com

Counsel for American Petroleum Institute,
Gas and Oil Association of WV, Inc., and
West Virginia Chamber of Commerce
Amici Curiae

CERTIFICATE OF SERVICE

I hereby certify that on this 27th day of December 2021, I caused this Brief of American Petroleum Institute, Gas and Oil Association of WV, Inc., and West Virginia Chamber of Commerce Amici Curiae in Support of Petitioners to be served by first class mail postage prepaid in envelopes addressed to counsel of record as follows:

James G. Bordas III, Esquire
Bordas & Bordas, PLLC
1358 National Road
Wheeling, WV 26003

Jennifer Jo Hicks, Esquire
Katrina N. Bowers, Esquire
Timothy M. Miller, Esquire
Babst, Calland, Clements & Zomnir, P.C.
BB&T Square
300 Summers Street, Suite 1000
Charleston, WV 25301

Elbert Lin, Esquire
Hunton Andrews Kurth LLP
Riverfront Plaza, East Tower
951 East Byrd St., 18th Floor
Richmond, VA 23219-4074

Amy M. S