THE SUPREME COURT OF APPEALS OF WEST VIRGINIA

No. 21-1004

STATE OF WEST VIRGINIA EX REL. TH EXPLORATION II, LLC and TUG HILL OPERATING, LLC,
Petitioners

vs.

VENABLE ROYALTY, LTD.; V14, LP; VENRO, LTD.; V2, LP; and THE HONORABLE JUDGE JEFFREY KRAMER, Judge of the Circuit Court of Marshall County, West Virginia;
Respondents.

On appeal from the Order of the Circuit Court of Marshall County, West Virginia, on cross-motions for summary judgment, entered on November 10, 2021, in Consolidated Case Numbers 18-C-227 and 18-C-220

PETITION FOR WRIT OF PROHIBITION

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TABLE OF CONTENTS

TABLE OF AUTHORITIES

Page(s)

Cases

Statutes

Other Authorities

I. QUESTIONS PRESENTED

1. Did the Circuit Court commit an error of law by holding that an implied duty to market can override the express terms of an oil and gas lease?

2. Did the Circuit Court commit an error of law on an issue affecting thousands of oil and gas leases in West Virginia by misinterpreting the scope of a lessee's implied duty to market and holding as a matter of law that—

   (i) a lessee must bear all costs to transport oil and gas to a physical location that must have "multiple active sellers and buyers of gas," even if that "market" is downstream from where the oil and gas is first sold; and

   (ii) unprocessed, "wet" gas is not a "marketable product?"

3. Did the Circuit Court commit an error of law by holding that net proceeds leases that provide that a lessee can make "allowances and deductions for a fair and reasonable charge for gathering, compressing, and making the gas merchantable" do not satisfy the requirement in *Estate of Tawney v. Columbia Natural Resources, L.L.C.*, to allow for a lessee to share post-production costs with the lessor?

II. STATEMENT OF THE CASE

A. The Venable Leases

This is a dispute regarding the calculation of royalties paid by TH Exploration II, LLC and Tug Hill Operating, LLC (collectively, "Tug Hill"), to its lessors, Venable Royalty, Ltd, V14, LP, Venro, Ltd. and V2, LP (collectively, "Venable").[1]

In January 2016, Tug Hill acquired Venable's leases in Marshall County from Gastar Exploration USA, Inc. ("Gastar").[2] At all relevant times for the purposes of this writ,[3] Tug Hill operated and produced "wet gas," which means that there are carbon liquids entrained in the unprocessed gas stream.[4] The wet gas is eventually processed and separated into residue gas and natural gas liquids ("NGLs").[5] Tug Hill also produced skim oil, which is separated from water and stored at or near the wellhead.[6]

During production, the unprocessed gas traveled from the wellheads through an approximately 80,500-foot gathering and transportation pipeline system that Tug Hill operates.[7]

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[1] APP0003-0004, ¶ 10; APP0007-0009, ¶ 1. Citations to Tug Hill's Appendix to Petition for Writ of Prohibition are hereinafter referred to by page number with the prefix "APP."

[2] Prior to this acquisition, Gastar conveyed 50% of its interest in the leases to Atinum Marcellus I LLC ("Atinum"), a nonoperating, partial working interest owner. APP0010, ¶¶ 4-7. In 2021, Tug Hill acquired Atinum's 50% interest in the leases such that Tug Hill now owns 100% of the leases.

[3] Since the filing of the parties' cross-motions for summary judgment, Tug Hill's production expanded to include additional wells and third-party purchasers. However, the Circuit Court's order applies only to the Gastar "legacy" production and sales stream. *See* Order of the Circuit Court of Marshall County, West Virginia, granting summary judgment, Consolidated Case Nos. 18-C-227 and 18-C-220 (Nov. 10, 2021).

[4] APP0010-0011, ¶¶ 9, 12.

[5] APP0013, ¶¶ 22-23.

[6] APP0010-0011, ¶ 9; APP0014, ¶ 29. The order does not invalidate Tug Hill's sale of skim oil. In the order, the Circuit Court held that Venable is "entitled to gas-liquids royalties on prices . . . at the field market for field condensate (skim oil)," and found that Tug Hill does "receive proceeds from" the skim oil "at or near the well sites" where purchasers "take possession" and receive title to the skim oil. APP0006-0007, ¶ 22(b); APP0027, ¶ 95; APP0039, ¶ 57. As such, Tug Hill's royalty calculation method for skim oil remains valid and is not addressed herein.

[7] APP0012, ¶ 13; APP0523, at 23:19-25; APP0518, ¶ 4.

Tug Hill's gathering and transportation system separated water and condensate from the gas and compressed the gas so that it is in a condition in which it may enter the Corley and Burch Ridge central delivery points owned by a third party.[8] Tug Hill bore all costs to gather, transport, and compress the gas for delivery to Corley and Burch Ridge.[9]

B. Tug Hill's Sales of Unprocessed Gas

Shortly after acquiring the leases, Tug Hill entered into a contract with an unaffiliated third party, Williams Energy Resources LLC ("WER"), under which WER agreed to purchase the unprocessed gas at Corley and Burch Ridge.[10] Since that time, Tug Hill has continued to revisit and negotiate its contract with WER in order to market the unprocessed gas.[11] For example, Tug Hill conducted an extensive bid process in 2017 in which more than 10 entities submitted competing proposals to purchase the unprocessed gas at Corley and Burch Ridge.[12] After evaluating the proposals, Tug Hill decided to remain with WER, as WER provided the most competitive terms.[13]

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[8] APP0011-0012, ¶¶ 12-13; APP0552, at 219:11-220:10; APP0584, at 74:5-76:24; APP0587, at 111:11-112:25; APP0596-0597, at 273:23-274:17; APP0518, ¶ 7. In Tug Hill's briefing, Corley and Burch Ridge were defined as the "Central Delivery Points." However, Tug Hill uses the terms "Corley and Burch Ridge" throughout this brief to be consistent with the terms used in the order.

[9] APP0535, at 93:7-20; APP0547, at 186:2-16; APP0595, at 259:21-260:9; APP0600, at 304:25-305:19.

[10] APP0012, ¶ 16; APP0018-0019, ¶ 46; APP0020, ¶¶ 57-58; APP0315-0316; APP0518, ¶ 6; APP0617, at 178:19-179:18. When Tug Hill acquired the Gastar working interests, the unprocessed gas stream had been sold to a different third-party buyer, SEI Energy, LLC ("SEI"), at Corley and Burch Ridge. APP0012, ¶ 16; APP0556-0557, at 249:20-250:8; APP0590, at 234:21-235:3. However, in May 2016, SEI filed for bankruptcy and Tug Hill quickly replaced SEI with WER and entered into new, arm's-length sales contracts. APP0590, at 234:21-235:14.

[11] APP0590-0591, at 234:8-15, 236:13-239:6.

[12] APP0312-0313; APP0569, at 426:11-16; APP0598, at 284:2-16.

[13] APP0312-0313; APP0590-0591, at 234:8-15, 236:13-239:6.

C. <u>The Calculation of Royalties</u>

Save for the royalty percentage, the leases contain the following royalty provision:

> "The royalties reserved by Lessor, and which shall be paid by Lessee, are: (a) on oil . . . the same to be delivered at the wells or to the credit of Lessor in the pipeline to which the wells may be connected, provided; . . . (b) on gas, including casing head gas and all other gaseous or vaporous substances, produced from the Land and sold or used off the lease premises or in the manufacture of gasoline or in the extraction of sulphur or any other product, the market value at the wells of [respective royalty rate] of the gas sold or used, *with the market value at the wells in no event to exceed the net proceeds received by Lessee* calculated or allocated back to the wells from which produced, *making allowance and deduction for a fair and reasonable charge for gathering, compressing, and making the gas merchantable*, provided, that on gas sold at the wells, the royalty shall be [respective royalty rate] of the net proceeds received by the Lessee from the sale, all allowances and deductions . . .."[14]

Despite the lease language allowing Tug Hill to calculate royalties by "allocat[ing] back to the wells" the "fair and reasonable charges for gathering, compressing, and making the gas merchantable," Tug Hill does not allocate to Venable any costs Tug Hill incurs before the delivery of unprocessed gas to Corley and Burch Ridge.[15] Rather, Tug Hill pays Venable its royalties for the unprocessed gas based on the same price Tug Hill receives from WER, after adding back in a marketing fee that WER charges and Tug Hill solely bears.[16]

Specifically, after the arm's-length sale at Corley or Burch Ridge, WER incurred costs to process the wet gas stream into residue gas and NGLs.[17] WER then sold the residue gas at an interstate pipeline and either sold the NGLs at the plant tailgate (the outlet of the processing plant)

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[14] APP0009-0010, ¶ 2 (emphasis added).

[15] APP0535, at 93:7-20; APP0547, at 186:2-16; APP0595, at 259:21-260:9; APP0600, at 304:25-305:19; APP0619, at 187:8-20, APP0620, at 196:6-14, 197:11-19.

[16] APP0543, at 152:2-22; APP0575, at 506:10-508:2; APP0595, at 259:24-260:9; APP0602, at 331:20-332:21; APP0620, at 196:6-14, 197:11-19; APP0621, at 198:22-199:3.

[17] APP0013, ¶¶ 22-23; APP0315; APP0536, at 94:5-95:2; APP0549, at 206:3-9; APP0575, at 507:11-15.

or returned them in-kind to Tug Hill.[18] WER then "netted back" the costs it incurred after the point of sale and paid Tug Hill its proceeds from the sale of the unprocessed gas stream's products.[19] Because WER provides an aggregate monthly statement rather than allocating the price per product when purchasing the unprocessed gas (including the NGLs) at Corley or Burch Ridge, Tug Hill used an internal reconciliation process to allocate the lump sum amount received from WER to each product produced from and traceable to the oil and gas molecules produced from each well drilled on the leases.[20] Thus, Tug Hill calculated Venable's royalties based on the gross proceeds that Tug Hill received from WER's sale of the products of the unprocessed gas stream.[21]

Venable does not dispute that its royalties are based on Tug Hill's gross proceeds from WER or that Venable is charged no deductions for costs that Tug Hill incurred between the wellhead and Corley and Burch Ridge points of sale.[22] Rather, Venable's only objection is that Tug Hill based the royalties on the payment it received from WER for an unprocessed gas stream,

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[18] APP0014, ¶¶ 24, 27-28, APP0318-0320. Beginning in April 2018, Tug Hill determined that it would be more profitable (and therefore more beneficial to Tug Hill and its lessors, including Venable) for Tug Hill to receive a portion of the NGLs in-kind pursuant to the contractual mechanism designed for that purpose rather than have WER sell the NGLs. APP0532-0533, at 73:3-75:9; APP0534, at 80:12-81:2; APP0565, at 365:12-17. Consequently, after WER purchased the NGLs as part of the unprocessed gas stream at Corley and Burch Ridge, WER later transferred title to the NGLs back to Tug Hill, who sold the NGLs to a second third-party purchaser, EQT Energy, LLC ("EQT"), for a "materially higher" price. APP0599, at 296:12-297:2; APP0605-0606, at 57:23-58:10; APP0534, at 80:7-81:2; APP0565, at 363:23-364:18; APP0575, at 508:3-17. Tug Hill sold and transferred title to the NGLs to EQT at the Williams Ohio Valley Midstream LLC ("OVM") plant tailgate, and Tug Hill calculated Venable's royalties based on the price received from EQT without deduction. APP0533, at 76:20-77:2; APP0540, at 124:24-125:7; APP0600, at 303:25-305:19; APP0607, at 65:2-18; APP0619, at 187:8-20; APP0620, at 197:11-19.

[19] APP0318; APP0536, at 94:5-95:2; APP0571, at 442:22-443:8; APP0600, at 303:25-305:19.

[20] APP0578-0582, at 18:7-21, 21:14-22:3, 30:24-31:20, 37:11-39:17; APP0585-0586, at 90:4-94:18; APP0562-0564, at 345:16-346:14, 349:21-351:5.

[21] APP0535, at 93:7-20; APP0575, at 506:10-508:2; APP0600, at 303:25-305:19; APP0602, at 331:20-332:21.

[22] APP0619, at 187:8-20; APP0620-0621, at 196:6-14, 197:11-19, 198:22-199:3.

which nets back costs WER incurred after the Corley and Burch Ridge points of sale, as opposed to an index price based on a second sales point farther downstream.[23]

D. Procedural History

On October 11, 2018, Venable filed its complaint alleging Tug Hill breached the leases by improperly deducting post-production costs from Venable's royalties, seeking monetary damages (Count I) and a declaratory judgment (Count II).[24] Venable filed a motion for summary judgment, seeking a determination that Tug Hill must pay Venable royalties for gas based on the "index prices at the TETCO market."[25] Tug Hill filed a cross-motion for summary judgment seeking a determination that Tug Hill fulfilled its implied duty to market by paying Venable royalties based on the first sale of unprocessed gas to an unaffiliated third-party purchaser.[26]

After argument, the Circuit Court notified the parties that it was granting Venable's motion for summary judgment and denying Tug Hill's cross-motion and requested that Venable prepare a proposed order containing findings of fact and conclusions of law.[27] Tug Hill objected to Venable's submission on October 11, 2021.[28] The Circuit Court adopted wholesale and entered the findings of facts and conclusions of law drafted by Venable on November 10, 2021.[29]

In the order, the Circuit Court held that the oil and gas royalties must be calculated based on index prices for processed gas at the interstate pipeline and for processed NGLs at a plant-

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[23] APP0207-0209.

[24] APP0055-0057, ¶ 72; APP0058, ¶ 76. Venable amended its complaint various times since 2018, with the operative complaint being Venable's Fifth Amended Complaint.

[25] APP0214.

[26] APP0309-0310.

[27] APP0456.

[28] APP0457-APP0502.

[29] *See generally*, APP0001-APP0040.

tailgate market.[30] The Circuit Court further held that no "'point of sale' exists upstream of the foregoing markets to cause Plaintiffs to receive royalties on lower upstream prices" and the "'market value at the wells' phrase in the leases are [*sic*] ambiguous and . . . disallow[] [post-production deductions] occurring or arising before the foregoing markets."[31] Consequently, the Circuit Court concluded that "[t]he 'market value' standard in the Leases, as well as Defendants' implied covenant to market oil and gas from the Leases, may require Defendants to pay royalties on values that do not directly equal Defendants' actual proceeds from sales."[32] In sum, the Circuit Court held that royalties cannot be based on the sale of unprocessed gas, concluding that the only valid markets for oil and gas are the interstate pipeline and plant-tailgate where processed gas and its products are sold, regardless of the language of the parties' leases.

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[30] APP0006-0007, ¶ 22.

[31] *Id.*

[32] APP0030-0031, ¶¶ 14-15.

III. SUMMARY OF THE ARGUMENT

As foreshadowed in *Leggett v. EQT Production Company*,[33] this writ presents the Court "another day" to examine the "faulty legs" of West Virginia's version of the marketable product rule as it pertains to the calculation of oil and gas royalties and to clarify the "continued vitality and scope" of *Wellman v. Energy Resources, Inc.*,[34] and *Tawney v. Columbia Natural Resources, LLC*.[35] Left undisturbed, the order has the potential to perpetuate the "chaos" that currently exists in West Virginia royalty jurisprudence[36] and to cause confusion for all oil and gas producers in the state. Accordingly, for the reasons set forth below, the Court should take the opportunity this writ presents to resolve the questions left unanswered in *Leggett*.

The leases in this case require Tug Hill to pay royalties based on the "market value at the wells . . . with the market value at the wells in no event to exceed the net proceeds received by Lessee calculated or allocated back to the wells from which produced[.]"[37] Since 2016, Tug Hill produces, compresses, gathers, and transports a "wet" gas stream produced from Venable's property to the first point downstream from the wellhead where Tug Hill has identified an unaffiliated, third-party buyer.[38] That is, Tug Hill pays royalties based on the market value received for the arm's-length sale of unprocessed gas.[39] There is no dispute as to the mechanics of Tug Hill's royalty calculation, only whether it complies with West Virginia law.

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[33] 239 W. Va. 264, 276-77, 800 S.E.2d 850, 862-63 (2017).

[34] 210 W. Va. 200, 557 S.E.2d 254 (2001).

[35] 219 W. Va. 266, 633 S.E.2d 22 (2006).

[36] *Leggett*, 239 W. Va. at 277, 800 S.E.2d at 863.

[37] APP0009-0010, ¶ 2.

[38] *Wellman*, 210 W. Va. at 210, 557 S.E.2d at 256; APP0011-0012, ¶¶ 11-14, 16; APP0018-0019, ¶ 46.

[39] APP0600, at 304:3-13; APP0602-0603, at 331:20-332:21, 342:9-21; APP0570-0571, at 431:9-22, 442:3-443:8; APP0575, at 506:16-507:10; APP0619, at 187:8-20; APP0620-0621, at 196:6-14, 197:11-19, 198:22-199:3.

Notwithstanding the foregoing lease language, the Circuit Court held as a matter of law that Tug Hill must pay Venable on a price greater than the proceeds it receives from that first arm's-length sale.[40] In so holding, the Circuit Court disregarded the express language of the leases and adopted an interpretation of the implied duty to market more extreme than that previously endorsed by any West Virginia court. Accordingly, the Court should reverse the Circuit Court's order granting summary judgment in favor of Venable for the following reasons.

First, the Circuit Court disregarded the general tenets of contract interpretation by setting aside the express terms of the leases and applying an implied covenant in their place. This misinterpretation requires Tug Hill to ignore the *actual* sale price of the gas and to instead pay a royalty based on a price that exceeds the proceeds it receives at that point of sale, rendering the plain lease language meaningless. The express terms of the leases must be honored, and such a deviation from West Virginia's contract interpretation law should be reversed.

Second, in setting aside the express language of the leases, the Circuit Court erred by holding contrary to its own prior holding[41] and misapplying West Virginia's interpretation of the implied duty to market, which requires only that the lessee bear costs to the point of sale by "get[ting] the oil or gas in marketable condition and actually transport[ing] it to market."[42] West Virginia courts previously identified a market as the first location where an unaffiliated third-party purchaser is willing to buy oil and gas.[43] In other words, the first willing buyer is the market and

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[40] APP0030-0031, ¶¶ 14-15.

[41] *Huey v. EQT Prod. Co.*, No. 17-C-43, at 17 (W. Va. Cir. Ct. Wetzel Cnty. July 17, 2018) (Cramer, J.) ("[T]he sales price upon which Plaintiffs' royalties should be based is the . . . first sale of natural gas and related products to an unrelated and unaffiliated third-party purchaser.") (provided for reference at APP0623-0639).

[42] Syl. Pt. 4, *Wellman*, 200 W. Va. at 202, 210-11, 557 S.E.2d at 256, 264-65.

[43] *Huey*, No. 17-C-43, at 17; *W.W. McDonald Land Co. v. EQT Prod. Co.*, 983 F. Supp. 2d 790, 800 (N.D.W. Va. 2014).

point of sale. Instead, the Circuit Court added two unprecedented requirements to West Virginia's "point of sale" approach: (a) it redefined "market" to require that there be "multiple active sellers and buyers" with "common carriers,"[44] triggering a fact-intensive inquiry that will differ for each lease, well, and operator in West Virginia; and (b) it imposed a new "quality standard," holding that unprocessed gas can never be a marketable product in West Virginia.[45] The Court should apply a rule of law that is straightforward, predictable, and applicable to all oil and gas development to prevent interference with the evolving science of oil and gas production and with legitimate commercial relationships between buyers and producers. Even more egregious than its error of law in incorrectly redefining a "market," the Circuit Court further committed an error of law by determining that Tug Hill's actual points of sale are not a market, which, based on its new definition of market, is a question of fact. Under this order, the same error is true for what may constitute a "marketable product."

Third, even if this Court were to accept the Circuit Court's expansion of an operator's obligations pursuant to the implied duty to market, then the Circuit Court still committed an error of law by finding the lease language ambiguous and holding that the royalty provisions did not meet the *Tawney* standard allowing for post-production deductions. Rather, this lease is unambiguous and clearly provides that (i) the lessor will bear some costs incurred after the wellhead, (ii) certain deductions are allowable, and (iii) Tug Hill is to use a specific method for calculating Venable's royalties.

For these reasons, the Court should grant Tug Hill's writ of prohibition and reverse the Circuit Court's summary-judgment holdings.

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[44] APP0023, ¶¶ 72, 74.

[45] APP0029-030, ¶¶ 4, 8-13; APP0036, ¶ 42.

IV. STATEMENT REGARDING ORAL ARGUMENT AND DECISION

Oral argument is appropriate under the criteria of W. Va. R. App. P. 18(a) as it would aid in the decisional process. This case is appropriate for Rule 20 Argument because it involves issues of fundamental public importance and cases involving inconsistencies or conflicts among the decisions of lower tribunals. Additionally, this case is appropriate for an opinion.

V. ARGUMENT

A. <u>The order's unprecedented holdings are contrary to West Virginia law and the attendant industry-wide effects warrant the Court's acceptance of this writ of prohibition to correct the Circuit Court's clear errors of law.</u>

A "writ of prohibition shall lie as a matter of right in all cases of usurpation and abuse of power, when the inferior court . . . exceeds its legitimate powers."[46] As part of that consideration, the Court evaluates five factors (although all five factors need not be satisfied):

> (1) whether the party seeking the writ has no other adequate means, such as direct appeal, to obtain the desired relief; (2) whether the petitioner will be damaged or prejudiced in a way that is not correctable on appeal; (3) whether the lower tribunal's order is clearly erroneous as a matter of law; (4) whether the lower tribunal's order is an oft repeated error or manifests persistent disregard for either procedural or substantive law; and (5) whether the lower tribunal's order raises new and important problems or issues of law of first impression.[47]

Tug Hill satisfies all five of these factors, as discussed below.

First, the order expressly states that it is interlocutory in nature.[48] As a result, Tug Hill has no direct appeal option available to it at this time; rather, a trial or evidentiary hearing on damages would be necessary to obtain a final order. Such a hearing on damages would cause unreasonable delay and expense. This Court has recognized that a writ of prohibition is appropriate where the petitioner "has no plain, speedy, and adequate remedy in the ordinary course of law" and would be "compelled to go through a contested hearing and appeal from a final judgment" in order to

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[46] W. Va. Code § 53-1-1.

[47] *State ex rel. Mass. Mut. Life Ins. Co. v. Sanders*, 228 W. Va. 749, 754, 724 S.E.2d 353, 358 (2012) (internal citations omitted); Syl. Pt. 4, *State ex rel. Hoover v. Berger*, 199 W. Va. 12, 14-15, 483 S.E.2d 12, 14-15 (1996) (noting "[t]hese factors are general guidelines that serve as a useful starting point for determining whether a discretionary writ of prohibition should issue. *Although all five factors need not be satisfied*, it is clear that the third factor, the existence of clear error as a matter of law, should be given substantial weight" (emphasis added)).

[48] APP0040.

prevent unreasonable delay and expense.[49] Similarly, here, the expense and delay caused by conducting a damages hearing would be unreasonable.

Second, if Tug Hill complied with the order immediately, it would be damaged or prejudiced pending the outcome of a direct appeal. If the order stood, Tug Hill would be forced to change its method of calculation of royalties and implement new business practices to comply with the calculation of royalties.[50] The order further places the burden on Tug Hill to calculate damages via an accounting, a process that is likely to involve the additional expense of expert witnesses, and such efforts would be wasted if the findings and conclusions are ultimately overturned on appeal.[51] As discussed above, this Court has allowed writs of prohibition where the allowance has precluded the necessity of addressing issues related to damages.[52]

Third, as discussed at length in the following paragraphs, the order is erroneous as a matter of law because it failed to apply existing West Virginia law or significantly expanded the application of existing West Virginia law. This Court may grant a writ of prohibition "to correct

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[49] *Hoover*, 199 W. Va. at 21, 483 S.E.2d at 21; *State ex rel. Frazier v. Hrko*, 203 W. Va. 652, 658, 510 S.E.2d 486, 492 (1998) (allowing a writ of prohibition where "petitioner has no plain, speedy, and adequate remedy in the ordinary course of law," petitioner "contends that the trial court's ruling is clearly erroneous as a matter of law," and as "a result of the trial court's ruling, both parties would be compelled to go through an expensive, complex trial and appeal from a final judgment, and we determine there is a high likelihood of reversal on appeal," so the "unreasonableness of the delay and expense is apparent"); *see also Ellis v. King*, 184 W. Va. 227, 231, 400 S.E.2d 235, 239 (1990) (granting writ of prohibition to overturn a summary judgment order when "the error on the part of the circuit court [was] clear-cut and substantial . . . alternate remedies to this action for prohibition, particularly an appeal from a partial summary judgment order, are inadequate . . . [and] the writ promotes economy of the lawyers' time, the litigants' efforts, and judicial resources"); *State ex rel. Golden v. Kaufman*, 236 W. Va. 635, 649, 760 S.E.2d 883, 897 (2014) (granting writ to vacate a legally erroneous summary judgment order and instead ordering the circuit court to grant petitioner's motions for summary judgment).

[50] APP0039 (Defendants are hereby ORDERED to "[a]lter their current royalty accounting practices . . .").

[51] *Id.*

[52] *State ex rel. State Auto Ins. Co. v. Risovich*, 204 W. Va. 87, 91, 511 S.E.2d 498, 502 (1998) (finding writ of prohibition proper in part because "our decision to grant a writ in this case precludes the necessity of addressing the issue of punitive damages during the trial in the circuit court").

substantial legal errors where the facts are undisputed and resolution of the errors is critical to the proper disposition of the case, thereby conserving costs to the parties and economizing judicial resources."[53] Specifically, "prohibition will lie where a lower court's denial of a motion for summary judgment is clearly erroneous as a matter of law."[54]

Fourth, the order contradicts the Circuit Court's own, earlier decision, which may confuse oil and gas operators relying on the Circuit Court's interpretation for clarity in determining best practices for royalty payments.[55] As discussed in more detail below (Section B.2.a), in *Huey v. EQT Production Company*, the Circuit Court defined a "market," and in the order in this case, the Circuit Court now provides a definition of "market" that will result in conflicting oil and gas royalty calculations.[56] The Court should consider this writ of prohibition to bring uniformity to this area of law not only in Marshall County, but throughout the entire state.

Fifth, and most significantly, the order raises new and important problems or issues of law. This case involves the calculation of oil and gas royalties and the allegations by a lessor that the lessee is inappropriately deducting post-production costs, implicating this Court's decisions in *Wellman* and *Tawney*.[57] To be sure, the ramifications of the order will ripple through the oil and gas industry. The "quality standard" holding alone has the potential to effectively end wellhead sales in West Virginia, despite express lease language to the contrary and the commonly accepted

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[53] *Id.*, 204 W.Va. at 90, 511 S.E.2d at 501.

[54] *State ex rel. W. Va. Consol. Pub. Ret. Bd. v. Nibert*, 235 W. Va. 203, 210, 772 S.E.2d 609, 616 (W. Va. 2015) (finding petitioner was "entitled to a writ of prohibition" when the circuit court's order denying the motion for summary judgment was "clearly erroneous as a matter of law").

[55] *Huey*, No. 17-C-43, at 17 (Cramer, J.); *Columbia Gas Transmission, LLC v. SWN Prod. Co., LLC*, No. 18-C-265 (Cir. Ct. Marshall Cnty. W. Va. Feb. 15, 2021) (Hummel, J.) (provided for reference at APP0640-0654).

[56] *Huey*, at 17; APP0029-0030, ¶¶ 4-13.

[57] *Wellman*, 210 W. Va. at 202, 557 S.E.2d at 256; *Tawney*, 219 W. Va. at 267-68, 633 S.E.2d at 23-24.

industry practice, particularly by smaller producers. Also, the order's expansive interpretation of *Tawney* to render this entire royalty provision ambiguous creates uncertainty, and, arguably, impossibility that any lease satisfies West Virginia's version of the marketable product rule. By the Court's own forecast in *Leggett*, this issue is ripe for adjudication. Finally, the issues decided by the Circuit Court will have a direct impact on other pending litigation, including a currently pending class action, addressing similar lease language and similar issues.[58] Therefore, the Court's speedy resolution of this appeal will promote judicial efficiency and certainty as to the status of oil and gas royalty law in West Virginia and any further delays would be a distinct disadvantage to all participants in the oil and gas industry.

In evaluating these factors to determine whether a writ is proper, the Court need not find that all factors are present; rather, it may use a single factor or a combination of the factors to grant the writ.[59] As discussed, however, this case satisfies all five factors.

B. Points of Legal Error

1. The Circuit Court erred by holding that the implied duty to market supersedes the leases' express language.

The Circuit Court committed an error of law by disregarding the express lease language and replacing it with an implied duty, a clear violation of the most basic tenets of contract interpretation. The entire order is premised on the improper legal conclusion that, regardless of the actual lease language, the implied duty to market "may require [Tug Hill] to pay royalties on values that exceed [Tug Hill's] actual proceeds from sales."[60] This holding plainly ignores the royalty provision, which states the "market value" is "*in no event to exceed the net proceeds*

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[58] *S. Country Farms, Inc. v. TH Expl., LLC*, No. 5:21-cv-84 (N.D.W. Va.) (Bailey, J.).

[59] Syl. Pt. 4, *Hoover*, 199 W. Va. at 14-15, 483 S.E.2d at 14-15.

[60] APP0030-0031, ¶¶ 12-15.

received by Lessee calculated or allocated back to the wells from which produced . . .."[61] The Circuit Court's clear error ignores binding black-letter law, which does not allow it to ignore express lease language, and this alone warrants reversal.

It is true that West Virginia law allows courts to imply covenants, but not in the place of express and unambiguous language of a lease.[62] Rather, "[a] valid written instrument which expresses the intent of the parties in plain and unambiguous language is not subject to judicial construction or interpretation but will be applied and enforced according to such intent."[63] The language of a lease agreement "must be considered as an integrated whole, giving effect, if possible, to all parts of the instrument."[64] Accordingly, "specific words or clauses of an agreement are not to be treated as meaningless, or to be discarded, if any reasonable meaning can be given them consistent with the whole contract."[65]

In fact, "[b]ecause the implied covenants are derived from the presumed intentions of the parties to the lease, they will not be imposed if doing so would be inconsistent with the express provisions of the lease."[66] As a result, an implied duty to market, specifically, cannot be interpreted

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[61] APP0009-0010, ¶ 2 (emphasis added).

[62] George Bibikos, *A Review of the Implied Covenant of Development in the Shale Gas Era*, 115 W. VA. L. REV. 949, 957 (2013) ("Over time, *absent express language in the agreement*, courts have, under certain circumstances, implied certain covenants into the lease." (emphasis added)).

[63] Syl. Pt. 1, *Cotiga Dev. Co. v. United Fuel Gas Co.*, 147 W. Va. 484, 484-85,128 S.E.2d 626, 628 (1962); *see also Barn-Chestnut, Inc. v. CFM Dev. Corp.*, 193 W. Va. 565, 572, 457 S.E.2d 502, 509 (1995) ("*[W]here the express intention of the contracting parties is clear, a contrary intent will not be created by implication.* The implied covenant of good faith and fair dealing cannot give contracting parties rights which are inconsistent with those set out in the contract." (emphasis added)); Syl. Pt. 1, *Adkins v. Huntington Dev. & Gas Co.*, 113 W. Va. 490, 168 S.E. 366, 366 (1932) ("*In the absence of an express provision* requiring the lessee to protect the leased premises from drainage by oil and gas wells on adjacent property, an implied obligation will be read into the lease to give such protection."(emphasis added)).

[64] *Moore v. Johnson Service Co.*, 158 W. Va. 808, 815, 219 S.E.2d 315, 320 (W. Va. 1975).

[65] *Dunbar Fraternal Order of Police, Lodge No. 119 v. City of Dunbar*, 218 W. Va. 239, 244, 624 S.E.2d 586, 591 (W. Va. 2005) (quoting Syl. Pt. 3, *Moore*, 158 W. Va. at 808, 219 S.E.2d at 317).

[66] Scott Lansdown, *The Implied Marketing Covenant in Oil and Gas Leases: The Producer's Perspective*, 31 ST. MARY'S L.J. 297, 304-35 (2000); *see also* 5-8 Patrick H. Martin and Bruce M. Kramer, WILLIAMS

to "extend beyond the boundaries of the lease."[67] In other words, a party cannot be held in breach of an implied duty where there is an express provision in the contract that the party satisfied.[68]

This Court in *Leggett* recognized that an implied duty to market is not a license to rewrite a contract: "in addition to making express provisions for costs, freely negotiating parties to a lease may limit the implied covenants which may append to such leases."[69] Specifically, *Leggett* held that while an implied covenant to market "is a tool utilized to resolve contractual ambiguities," it is only a "'gap-filler[]' utilized to implement the parties intentions where not otherwise stated[.]"[70]

Here, the Circuit Court erred in its application of the implied duty to market as a "gap filler." The royalty provisions state that the royalties to be paid are the "market value at the wells . . ., *with the market value at the wells in no event to exceed the net proceeds received by Lessee calculated or allocated back to the wells from which produced* . . . ."[71] Yet, despite this language, the Circuit Court held the exact opposite, that the leases may require Tug Hill to "pay royalties on

& MYERS OIL & GAS LAW § 858, at 423 (2021) ("implied covenants are displaced by inconsistent express lease provisions and . . . the chief difficulty in applying this rule is in determining whether an express provision conflicts with an implied obligation").

[67] Brian S. Wheeler, *Deducting Post–Production Costs When Calculating Royalty: What Does The Lease Provide?*, 8 APPALACHIAN J.L. 1, 10 (2008); *see also* Lansdown, *supra* note 66, at 306 ("[W]here parties have agreed in the lease to the marketing of production, the implied covenant to market should not be used to alter the agreement.").

[68] *Games v. Chesapeake Appalachia, LLC*, No. 5:17CV101, 2017 WL 5297948, at *4 (N.D.W. Va. 2017) ("Chesapeake is also correct that the implied duty to market claim would likewise fail even if sufficiently pled under *Twombly* because there is an express provision in the leases regarding any delay in marketing . . . *This Court cannot find that Chesapeake breached an implied duty to market when there is an express provision as to the duty to market in the parties' agreement, which Chesapeake satisfied.*" (emphasis added)).

[69] 239 W. Va. at 275, 800 S.E.2d at 861.

[70] *Id.*

[71] APP0009-0010, ¶ 2; Scott Lansdown, *The Marketable Condition Rule*, 44 S. TEX. L. REV. 667, 670 (Summer 2003) ("Proceeds" is the "amount actually received by the lessee for the gas.").

values that exceed [its] actual proceeds from sales,"[72] which "would be inconsistent with the express provisions of the lease."[73]

To circumvent the express provisions of the leases and "gap fill" with the implied duty to market, the Circuit Court relied upon the Fourth Circuit's decision in *Imperial Colliery Co. v. OXY USA, Inc.*[74] to redefine "market value" to "require [Tug Hill] to pay royalties on values that do not directly equal [Tug Hill's] actual proceeds from the sales."[75] The order is actually inapposite to *Imperial Colliery's* definition, which holds that "market value is computed by ascertaining the price that a willing buyer would pay a willing seller in a free market."[76] That is, the order requires Tug Hill, a willing seller, to disregard the price received from WER, a willing buyer, and rather pay royalties on downstream index prices.[77] This holding is precisely the opposite of the Fourth Circuit's definition of a "market value."

Rather, following basic principles of contract interpretation, the leases must be read in their entirety, as they "must be considered as an integrated whole, giving effect, if possible, to all parts

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[72] APP0030-0031, ¶¶ 14-15.

[73] Lansdown, *supra* note 66, at 304-05; *see also* 5-8 WILLIAMS & MEYERS, *supra* note 66, at 423.

[74] 912 F.2d 696, 699-701 (4th Cir. 1990).

[75] APP0030-0031, ¶¶ 14-15.

[76] *Imperial Colliery*, 912 F.2d at 701; Lansdown, *supra* note 71, at 670; *see also Heritage Res. Inc. v. NationsBank*, 939 S.W.2d 118, 122 (Tex. 1996) ("Market value is the price a willing seller obtains from a willing buyer."); *Rogers v. Westerman Farm Co.*, 29 P.3d 887, 906 (Colo. 2001) (stating that gas is marketable when it is in the condition and location "such that it is commercially saleable in the oil and gas marketplace," but holding that the "determination of whether gas is marketable is a question of fact," not that unprocessed gas sold upstream of the interstate pipeline is not marketable as a matter of law). Notably, the Circuit Court's reliance on the Kuntz Treatise is also wholly inapposite, as the cited section applies to sales that are "not at arm's length," while here, it is undisputed that the royalties are based on an arm's-length sale to an unaffiliated purchaser. APP0030-0031, ¶ 14 (citing Eugene Kuntz, LAW OF OIL AND GAS § 40.4, 347 (rev. ed. 1989)).

[77] APP0036, ¶ 42 (holding Plaintiffs are entitled to receive "residue-gas royalties on index prices at the TETCO M2-region market" and "liquids royalties on index prices, such as 'OPIS' index prices, at the Williams OVM plant-tailgate markets for NGLs").

of the instrument."[78] Because there is no ambiguity to construe,[79] the Circuit Court should have applied the plain language of the leases. Instead, the Circuit Court erred by disregarding the express language of the remaining, unambiguous clauses of the royalty provision.

In summary, Tug Hill urges the Court to reverse the order because the Circuit Court's interpretation invalidates an unambiguous agreement between two parties. Venable's royalties are based on the proceeds Tug Hill received from a willing third-party buyer.[80] The leases state that the royalties cannot be based on net proceeds exceeding that which Tug Hill received.[81] Thus, by calculating its lessors' royalties based on the same proceeds it receives from its third-party purchasers without deduction, Tug Hill adhered to the leases' language.[82] Despite this express and unambiguous language, the Circuit Court held that the Tug Hill may be required "to pay royalties on values that exceed Defendants' actual proceeds from sales."[83] The Circuit Court's interpretation, which sets aside the express language of the leases, is an error of law that should be reversed, because West Virginia law does not allow imposition of the implied duty to market to alter the leases' express terms.

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[78] *Moore*, 158 W. Va. at 815, 219 S.E.2d at 320.

[79] Although the Circuit Court held the leases' "market value at the well" language is ambiguous pursuant to *Tawney*, APP0033, ¶ 28, that is not relevant to this argument and discussed at greater length in Section B.3, *infra*. Regardless, it is undisputed that Tug Hill does not pay royalties based on the value "at the well."

[80] APP0012, ¶ 16; APP0018-0019, ¶ 46; APP0600, at 304:3-13; APP0602-0603, at 331:20-332:21, 342:9-21; APP0570-0571, at 431:9-22, 442:3-443:8; APP0575, at 506:16-507:10; APP0619, at 187:8-20.

[81] APP0009-0010, ¶ 2.

[82] APP0571, at 442:3-443:8; APP0574-0575, at 503:23-508:2; APP0600, at 304:20-305:19; APP0602, at 331:20-332:21; APP0619, at 187:8-20.

[83] APP0030-0031, ¶ 14.

2. **The Circuit Court erred in its application of the implied duty to market by adopting unprecedented legal standards for what constitutes a "market" and the condition of gas to be considered "marketable."**

When it comes to allocating oil and gas production costs, West Virginia adopted a version of the "marketable product rule" in *Wellman*, stating that "the lessee must bear all costs incurred in exploring for, producing, marketing, and transporting the product to the point of sale," that includes "get[ting] the oil or gas in marketable condition and actually transport[ing] it to market."[84] Both the majority "at the well" and the minority "marketable product rule" jurisdictions recognize an implied duty to market obligating a lessee to diligently seek a market in which to sell oil and gas at the best price reasonably obtainable.[85] However, this order underscores that West Virginia is an untenable "minority of one" in the application of this implied duty. It is important, as a threshold matter, for a brief discussion of the evolution of West Virginia's implied duty to market, and its "point of sale" corollary, to appreciate just how unsupportable the order's holding is.

Historically, oil and gas were typically sold at the wellhead, with royalties paid on that wellhead sales price and with no obligation on the lessee to transport the natural gas further downstream.[86] Rather, the pipeline company that transported the gas from the well was responsible for gathering, dehydrating, compressing, and processing.[87] However, the calculation of royalties on modern oil and gas production changed dramatically subsequent to Federal Energy

[84] 200 W. Va. at 202, 210, 557 S.E.2d at 256, 264.

[85] WILLIAMS & MEYERS, *supra* note 66, at § 853, 390-96.3.

[86] Joyce Colson, *Upstream, Midstream, Downstream – The Valuation of Royalties on Federal Oil and Gas Leases*, 70 U. COLO. L. REV. 563, 568 (Spring 1999); *see also Leggett*, 239 W. Va. at 272, 800 S.E.2d at 858; Owen L. Anderson, *Royalty Valuation: Should Royalty Obligations Be Determined Intrinsically, Theoretically, or Realistically?* (Part 1), 37 NAT. RESOURCES J. 547, 561-63 (Summer 1997) ("Anderson Part 1") ("[I]n calculating gross income from a property, any value attributable to post-production processing and transportation is excluded.").

[87] Colson, *supra* note 86, at 593.

Regulatory Commission ("FERC") Order No. 436 in 1985 and No. 636 in 1992. Those orders required pipeline companies to "unbundle" their transportation services from their own natural gas sales efforts and, in effect, to provide common-carrier services to others who wished to transport natural gas.[88] The effect of these orders, referred to as "deregulation," is significant because lessees were "now faced with the sudden need to meet all the costs which the interstate pipeline firms had previously met after purchasing gas at the wellhead – transportation costs, processing costs, and so forth."[89]

This deregulation impacted the interpretation of oil and gas leases. Absent express language to the contrary, every jurisdiction recognizes an implied duty to market oil and gas produced pursuant to an oil and gas lease.[90] "In general, early cases dealing with the covenant to market dealt with the complete failure of a lessee to produce and market gas."[91] That is, the implied duty to market historically was not determinative of responsibility for post-production expenses. However, since deregulation, and the points of sale for gas moving downstream, lessors, like Venable, now invoke the implied duty to market to prevent lessees from allocating post-production expenses to them in their royalty calculations, significantly expanding it beyond its original purpose.[92]

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[88] Wheeler, *supra* note 67, at 29.

[89] *Id.*

[90] *Id.* at 11.

[91] Lansdown, *supra* note 66, at 304.

[92] Owen L. Anderson, *Royalty Valuation: Should Royalty Obligations Be Determined Intrinsically, Theoretically, or Realistically?* (Part 2), 37 NAT. RESOURCES J. 611, 630 n.89 (1997) ("Anderson Part 2") ("I will be the first to concede that the implied covenant to market has grown like Topsy. Arguably, it should be confined to its original purpose: to require the lessee to diligently seek a market for gas reserves that are shut-in.").

Jurisdictions are divided regarding whether these post-production costs associated with marketing gas should be deducted prior to calculating royalties owed to the lessor. As noted above, while most states adopted an "at the wellhead" approach, allowing lessees to allocate post-production costs to the lessor and value the oil and gas as it exists when it is produced from the ground, a minority of jurisdictions, including West Virginia, adopted a variation on what is referred to as the "marketable product doctrine" for the calculation of royalties.[93] Under this doctrine, *in the absence of express language to the contrary*, the lessee is responsible for all post-production expenses until the natural gas is a "marketable product" unless the lease expressly provides for the allocation of the post-production expenses.[94] In other words, a "lessor's royalty is not based upon the value of the gas when the lease is signed (*i.e.*, the value of the gas in its raw natural state), but the value of the gas after it has been enhanced exclusively by the lessee."[95]

West Virginia has interpreted the implied duty to market and the marketable-product rule even more broadly than other jurisdictions and has "expand[ed] the duty to market to require a lessee to bear all costs to the point of sale and not just to the point where a marketable product is created" to the extent those locations are different.[96] This "point-of-sale" approach has been met with criticism by scholars and industry professionals,[97] as well as by this Court, which has recently recognized that this approach stands on "faulty legs."[98] In *Leggett*, the Court held that the issues

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[93] *Wellman*, 210 W. Va. at 210-11, 557 S.E.2d at 265.

[94] Wheeler, *supra* note 67, at 8-9.

[95] *Id.* at 26.

[96] *Id.* at 22.

[97] Anderson Part 2, *supra* note 92, at 682-83; Lansdown, *supra* note 66, at 337 ("the marketable condition rule is illogical because it bases the allocation of marketing costs on factors wholly irrelevant to such allocation.").

[98] *Leggett*, 239 W. Va. at 276-77, 800 S.E.2d at 862-63 (referring to the *Tawney* Court's interpretation of the implied duty to market as a "complete misunderstanding of the industry").

of statutory interpretation "presently before the Court simply do[] not permit intrusion into" the issue regarding the interpretation of a lessee's obligations and rights under an oil and gas lease.[99] However, in this case, those issues are now squarely before the Court.

Despite the criticism of West Virginia's approach to the marketable product by this Court, the Circuit Court not only relied on this approach, it added additional, unprecedented restrictions in applying it to Tug Hill's royalty calculations. The Circuit Court erred in adopting Venable's proposal as a matter of law for the reasons set forth below.

a. <u>The Circuit Court ignored West Virginia law, including its own prior ruling, and erred by holding that a "market" requires more than the purchase by the first unaffiliated, third-party purchaser downstream in an arm's-length transaction.</u>

The Circuit Court first erred in application of West Virginia's version of the implied duty to market in defining what constitutes a "market" for purposes of Tug Hill's royalty calculation. On this point, expanding on West Virginia's "point-of-sale" approach to defining the market, the Circuit Court concluded that a "market" also requires "multiple active sellers and buyers" or "common carriers."[100] However, as discussed below, no West Virginia courts, or any other courts, have imposed this unprecedented standard on the definition of "market."

Contrary to the Circuit Court's holding, West Virginia courts have defined a market simply as where an unaffiliated, third-party purchaser is willing to purchase oil and gas.[101] As recognized by the same Circuit Court almost three years prior to this case in *Huey*, "the sales price upon which Plaintiffs' royalties should be based is the . . . *first sale of natural gas and related products to an*

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[99] *Id.* at 277.

[100] APP0005-0006, ¶¶ 18-19; APP0023, ¶¶ 72, 74.

[101] *W.W. McDonald,* 983 F. Supp. 2d at 800; *Huey*, No. 17-C-43, at 17.

unrelated and unaffiliated third-party purchaser."[102] Similarly, the U.S. District Court for the Northern District of West Virginia held in *W.W. McDonald* that "[t]he market . . . is the *first place downstream of the well where the gas can be sold to any willing buyer and title passed to that buyer.*"[103] Finally, that court further held in *Richards v. EQT Production Company* that the fact "that a downstream market exists, however, does not mean that 'markets' do not also exist at other potential points of sale."[104] This line of cases clearly demonstrate that, for the purposes of interpreting West Virginia's implied duty to market, the "point of sale" and the "market" are synonymous as applied to Tug Hill's operations: the lessee fulfills its duty once the gas is delivered and sold to the first willing, third-party buyer as a result of an arm's-length sale.[105]

Contrary to this established West Virginia law, the Circuit Court went a step further, holding that the "implied marketing covenant ensures that Defendants are selling in an actual market, one containing active sellers and buyers and responsive product prices, and not into a closed or limited selling location."[106] Based on this definition, the Circuit Court held that Corley and Burch Ridge are not markets because they "lack multiple active sellers and buyers to create competitive and market-sensitive prices."[107] In effect, this order would overturn *W.W. McDonald*, *Richards,* and *Huey* (the Circuit Court's own order). Taken to its logical conclusion, no producer in West Virginia could base a royalty on the sale of wellhead gas.

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[102] *Huey*, No. 17-C-43, at 17 (emphasis added).

[103] *W.W. McDonald*, 983 F. Supp. 2d at 800 (emphasis added).

[104] 1:17-cv-50, 2018 WL 3321441, at *4-5 (N.D.W. Va. Jul. 5, 2018).

[105] Syl. Pt. 1 *Wellman*, 200 W. Va. at 202, 210, 557 S.E.2d at 256, 264.

[106] APP0005, ¶ 16. However, the order itself states that both WER *and* SEI sold the unprocessed gas at Corley and Burch Ridge, demonstrating that it is not a "closed or limited selling location." APP0012, ¶ 16.

[107] APP0023, ¶ 74.

Setting aside that the Circuit Court committed an error of law in determining that Corley and Burch Ridge are not markets, which required it to decide issues of disputed facts,[108] the definition proposed by the Circuit Court is incorrect. There is simply no legal authority for the Circuit Court's expanded requirements to meet the standard of a "market."

It is undisputed that Tug Hill based its royalty calculations on the net proceeds it received from the first unaffiliated, third-party purchaser (WER) without deducting any costs Tug Hill incurred between the wellhead and the market (Corley and Burch Ridge).[109] Further, Venable conceded that WER is an unaffiliated marketing company.[110] Therefore, applying the correct legal definition of a "market," Corley and Burch Ridge are markets because the gas is sold to an unaffiliated third-party purchaser. Because Tug Hill made no deductions prior to that sale, it satisfied any implied duty to market.[111]

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[108] Tug Hill submitted evidence that there were in fact multiple active potential buyers who submitted bids for the gas at Corley and Burch Ridge. APP0312-0313; APP0567, at 415:23-417:19; APP0569, at 426:11-16; APP0590-0591, at 234:8-15, 239:12-23; APP0594, at 250:5-252:17; APP0598, at 284:2-16. Even if the Circuit Court's definition of "market" is correct (and it is not), the fact that Tug Hill conducted a competitive bid process to find a single buyer and renew its contract with that buyer does not mean that there were not multiple active buyers willing to purchase Tug Hill's gas. By applying these disputed facts to its definition of "market," the Circuit Court committed an error of law.

[109] APP0600, at 304:3-13; APP0602-0603, at 331:20-332:21, 342:9-21; APP0570-0571, at 431:9-22, 442:3-443:8; APP0575, at 506:16-507:10; APP0619, at 187:8-20; APP0620-0621, at 196:6-14, 197:11-19, 198:22-199:3; *see also Wellman*, 200 W. Va. at 211, 557 S.E.2d at 265 (noting there is a "long-established expectation of lessors in this State, that they would receive one-eighth of the sale price received by the lessor").

[110] APP0617, at 178:19-179:18. To the extent that Venable argues that a title transfer is dispositive of whether or not a "market" exists, the Circuit Court committed an error of law in concluding that title did not transfer from Tug Hill to WER. APP0004, ¶ 14; APP0006, ¶ 21; APP0015-0021, ¶¶ 30-63. Venable produced no evidence to dispute Tug Hill's evidence that title did transfer, and, therefore, the only other possible conclusion by the trial court could be that a question of fact exists, not that the title of the gas failed to transfer to WER. APP0574-0576, at 503:7-510:14 ("Q. . . . you testified that . . . title transfers from the navy blue arrow that is entitled wells gathered to OVM – inlet of OVM system at the point it touches the circle called plant inlet volumes. Is that correct? A. It transfers at the Corley and Burch Ridge CDPs. . . . and from there downstream, WER has title.")

[111] *Wellman*, 200 W. Va. at 211, 557 S.E.2d at 265. The order also states that Tug Hill is not paying Venable on the full amount of the constituents produced because OVM retains ten percent of the NGLs per the processing contract with WER. APP0018, ¶ 44; APP0027, ¶ 97. This argument is wrong. First, the parties

Thus, the Court should reverse the Circuit Court's summary judgment decision because it committed an error of law in redefining "market" in its application of the implied duty to market.

b. The Circuit Court erred by imposing an unprecedented "quality standard," holding the unprocessed gas meeting the specifications of a third-party buyer was not in a "marketable condition."

As discussed above, West Virginia's version of the marketable product rule precludes a lessee from deducting costs it incurs between the well and the point of sale or market.[112] However, the Circuit Court, *for the first time in West Virginia*, imposed a quality standard on the condition of the gas and determined that standard as a matter of law. The Circuit Court held that royalties can never be based on gas in any condition but that which meets an interstate pipeline standard.

In adopting this quality standard, the Circuit Court does not cite to a single West Virginia case or law but instead to Colorado law for the position that unprocessed gas is not marketable.[113] However, no jurisdiction's highest court, including Colorado, has ever held that royalties must be paid on the sale of processed gas in order for a producer to fulfill its duty to market. In *Rogers*, the Colorado court considered the definition of "marketability," noting that it "includes both a reference to the physical condition of the gas, as well as the ability for the gas to be sold in a

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do not dispute that Tug Hill pays royalties on the full amount of the price received from WER. APP0600, at 304:3-13; APP0602-0603, at 331:20-332:21, 342:9-21; APP0570-0571, at 431:9-22, 442:3-443:8; APP0575, at 506:16-507:10; APP0619, at 187:8-20; APP0620-0621, at 196:6-14, 197:11-19, 198:22-199:3. Second, where a lessee pays "100% of the money it actually received," any proceeds that were not remitted to the lessee pursuant to the third-party contract do not constitute deductions in breach of the lease. *Tana Oil & Gas Corp. v. Cernosek*, 188 S.W.3d 354, 360-61 (Tex. App. 2006) (holding because lessee "never received all of the proceeds from the sales of" liquids, by paying plaintiffs' royalties "based on 100% of the money it actually received, [lessee] did in fact pay royalties on 100% of the total volume of raw gas that it sold," and did not breach the leases).

[112] Wheeler, *supra* note 67, at 76-79.

[113] APP0029, ¶¶ 4-5 (citing *Rogers*, 29 P.3d at 905-06). Though the Circuit Court also cites to *Leggett*, it is incorrect in noting that *Leggett* cites to *Rogers* "with approval." *Id.* Rather, the Court in *Leggett* cites *Rogers* merely to examine the various jurisprudence of other jurisdictions, and does not, in any way, adopt or endorse the holding in *Rogers*. *Leggett*, 239 W. Va. at 273 n.13, 800 S.E.2d at 859 n.13.

commercial marketplace."[114] The court ultimately defined "marketability" as "when [the gas] is in the physical condition such that it is acceptable to be bought and sold in a commercial marketplace, and in the location of a commercial marketplace, such that it is commercially saleable in the oil and gas marketplace."[115] It agreed that "a single purchaser, in a good faith purchase of gas, is evidence that there is a market for that gas" but did not agree that "such a purchase conclusively establishes a market."[116] Even if the *Rogers* case was dispositive of West Virginia law, the *Rogers*' definition of "marketability" only requires that the gas be in such a condition that it is acceptable at a commercial marketplace and does not stand for a rule of law that unprocessed gas cannot be marketable, as the Circuit Court purports to represent.

Most significantly, the *Rogers* court held that marketability is a question of fact.[117] Although the Circuit Court appears to rely on *Rogers* for its definition of marketability, it departed from *Rogers* significantly by holding that "[m]erely selling gas and condensate in an unprocessed, unusable form to an unaffiliated buyer ... does not satisfy West Virginia law requiring a lessee to bear all costs necessary to render marketable products and to bring those marketable products to a market."[118] In other words, unlike Colorado, the Circuit Court not only imposed a quality standard requirement on the gas, it then determined, as a matter of law, what that condition must be.[119]

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[114] *Rogers*, 29 P.3d at 903.

[115] *Id.* at 906.

[116] *Id.* at 910.

[117] *Id.* at 896, 906, 910; *see also* Wheeler, *supra* note 67, at 24 ("This is highlighted by the fact that even the states which follow the 'marketable product' rule have failed to articulate a clear standard of determining when a marketable product has been created."); Kuntz, *supra* note 76, at § 40.5 ("It is not always easy to determine, however, when the first marketable product has been obtained"); *Bice v. Petro-Hunt, LLC*, 768 N.W.2d 496, 502 (N.D. 2009) ("The problem that has emerged with the first marketable product doctrine is the difficulty in determining when the gas has become a marketable product.").

[118] APP0029, ¶ 8.

[119] In fact, Kansas, a marketable product doctrine states, does not limit marketable condition as a matter of law to a specific physical condition, but instead, the Kansas Supreme Court held that marketable condition

Even though royalties were based on the condition of gas at the wellhead (i.e., unprocessed, raw gas) for decades until FERC's deregulation, the Circuit Court decided, *as a matter of law*, that the condition of the gas at the wellhead, and even the condition of the gas after gathering and compression by Tug Hill, is not marketable. In fact, the Circuit Court appears to decide *as a matter of law* that gas is not marketable until it meets some indeterminate interstate pipeline specifications.[120] With respect to Tug Hill's gas specifically, the Circuit Court held as a matter of law that any gas sold at Corley and Burch Ridge "would have involved un-marketable gas at points that are not markets" and that the gas is not marketable until it "can be burned on a stovetop, used to generate electricity in a utility plan, on consumed in industrial plants."[121] In other words, despite the undisputed fact that Tug Hill *actually sold* its unprocessed gas to a willing third-party buyer, the Circuit Court curiously decided as a matter of law that not only was there no market, that the gas was not in a saleable condition.

Based on these vast deviations from existing West Virginia law, this Court should reverse the Circuit Court. West Virginia courts have never defined (and should not define) the scope of the implied duty to market by requiring a specified quality or condition of gas. This creates an untenable rule of law that cannot take into account the ever-changing landscape of oil and gas

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is a condition in which a willing buyer will purchase the gas, even if it is raw gas at the wellhead. *See, e.g. Fawcett v. Oil Producers, Inc. of Kan.*, 352 P. 3d 1032, 1042 (Kan. 2015) (holding that gas is marketable when it is "in a condition acceptable to the purchaser in a good faith transaction"). Even Oklahoma, also a marketable product doctrine state, leaves the question of whether gas is marketable as a question of fact for the jury. *See, e.g., Slatten v. Range Res. Corp.*, No. 118,171, at 9 (Okla. Civ. App. Mar. 3, 2021) (affirming the judgment on the jury verdict where the jury found unprocessed gas was marketable because "a market exists were someone is willing to buy the gas," and the gas met the buyers' specifications) (provided for reference at APP0655-0669).

[120] APP0030, ¶ 13.

[121] APP0025, ¶ 88, APP0030, ¶¶ 11-12.

development.[122] Indeed, taken to its logical conclusion, the order would be placing a burden on operators to "add back in all 'costs' incurred by non-party purchasers after the point of sale, which would include all the costs of delivering natural gas to kitchen stoves in retail customers' homes."[123] As another judge from this Circuit Court recognized recently, "[t]his is an absurd result and is not the law in any state."[124]

To the extent it remains in the minority of the minority of states who follow the marketable product rule, West Virginia would be better served to rely on its existing definition of "market" or to follow the straightforward, predictable Kansas approach: "the duty to make gas marketable is satisfied when the operator delivers the gas to the purchaser in a condition acceptable to the purchaser in a good faith transaction."[125] It is simply not the place of the Court to determine whether or not a specific condition of gas is marketable. A buyer willing to pay money in exchange for a seller's gas determines whether it is marketable.

Because the Circuit Court deviated from settled West Virginia law, Tug Hill seeks reversal of its summary judgment holding.

3. If the Circuit Court correctly interpreted the implied duty to market, the Circuit Court still erred by applying *Tawney* to determine that the leases did not allow for post-production deductions.

Under current West Virginia law, as set forth in *Tawney*, a lessee may not deduct from a lessor's royalty any of the costs incurred in exploring for, producing, marketing, and transporting

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[122] Significantly, *Wellman* and *Tawney* were decided in 2001 and 2006, respectively, before the nuances of the production of and markets for rich gas from the Marcellus shale were fully developed, as Marcellus Shale production began in West Virginia in 2003. *See* eia.gov/todayinenergy/detail.php?id=33972 (last accessed on Dec. 2, 2021).

[123] *Columbia*, No. 18-C-265, at 11 (Hummel, J.).

[124] *Id.*

[125] *Fawcett*, 352 P. 3d at 1042.

oil and gas to the point of sale unless the lease provides with particularity "that the lessor shall bear some part of the costs." [126] *Tawney* further held that lease language that the royalty is to be calculated "at the well" or "at the wellhead" does not provide the specificity necessary to enable deductions.[127]

Importantly, as argued by Tug Hill at summary judgment,[128] this is not a *Tawney* case, which addresses the lease language required to shift to a lessor a share of post-production deductions incurred by the lessee "between the wellhead and the point of sale" following a finding that the royalty provision is ambiguous as a matter of law.[129] That is because, in this case, it is uncontested that Tug Hill bases its royalty calculations on net proceeds received without deduction. Because Tug Hill takes no deductions "between the wellhead and the point of sale," *Tawney* should not apply at all. However, if the Circuit Court was correct to (1) ignore the express "in no event" language of the leases (Section B.1, above) and (2) disregard Tug Hill's legitimate point of sale under the auspices of an expanding the definition of the implied duty to market (Section B.2, above), the Circuit Court still erred in its application of *Tawney*.

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[126] Syl. Pts. 1, 2, 10, 11, *Tawney*, 219 W. Va. at 267-68, 633 S.E.2d at 23-24.

[127] *Id.*

[128] The Circuit Court erroneously concluded that Tug Hill somehow conceded the inapplicability of *Tawney* to its leases. APP0035-0036, ¶¶ 40-41. That is not correct, and Tug Hill submitted objections to the Circuit Court regarding this very point. APP0279 ("Even if the Court entirely invalidated the third-party sales at issue here . . . [the] calculations would still be correct under the Leases because the royalty provision complies with all three prongs necessary to allow for deductions under *Tawney*."); APP0336 (recognizing that a *Tawney* analysis is necessary if a court were to determine that Tug Hill deducted post-production costs, but not conceding that fact); APP0365-0367. Regardless, as noted above, Tug Hill filed a supplemental notice of authority following the Fourth Circuit's opinion in *Young v. Equinor USA Onshore Prop., Inc.*, 982 F.3d 201, 208 (4th Cir. 2020), specifically arguing that the lease language satisfied *Tawney*. APP0438-0449.

[129] Syl. Pts. 10, 11, *Tawney*, 219 W. Va. at 267-68, 633 S.E.2d at 24.

a. *Tawney does not apply because the leases' royalty provisions are not ambiguous.*

The *Tawney* Court held that the lessee could not allocate any share of the post-production costs to the lessor *after* finding that the underlying lease language was ambiguous.[130] In *Tawney*, the leases all contained the language "at the well," "at the wellhead," or "net all costs beyond the wellhead" as the basis for the royalty calculation, but the language was not qualified in any further way.[131] The *Tawney* Court held that this "at the well" language in its various forms was ambiguous and construed it against the lessee.[132] Tug Hill's leases contain different language, with the "in no event" qualifying language: "market value at the wells of [respective royalty rate] of the gas sold or used, with the market value at the wells *in no event to exceed the net proceeds received by Lessee calculated or allocated back to the wells from which produced . . ..*"[133] *Tawney* is not applicable to Tug Hill's leases for the following reasons.

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[130] *Id.* at 272-73.

[131] *Id.* at 269-70.

[132] *Id.* at 272. Although not squarely raised because the lease language in this case is distinguished, Tug Hill would urge this Court to revisit the fundamental holding of *Tawney* that found ambiguity in the standard "at the well" language. That holding is but one of the "faulty legs" upon which West Virginia's so-called marketable product rule stands, and a driving force for the state's stature as an outlier to its legal approach to oil and gas royalty calculations. *Leggett*, 239 W. Va. at 276-77, 800 S.E.2d at 862-63 ("West Virginia has actually achieved a Marketable Product Rule 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") (quoting John W. Broomes, *Waste Not, Want Not: The Marketable Product Rule Violates Public Policy Against Waste of Natural Gas Resources*, 63 U. Kan. L. Rev. 179, 170-71 (2014)); *see also* Byron C. Keeling & Karolyn King Gillespie, *The First Marketable Product Doctrine: Just What Is the "Product"?*, 37 ST. MARY'S L.J. 1, 77, 79 (2005) (explaining the *Wellman* Court did not "recognize the variations in the first marketable product doctrine from state to state," "took the first marketable product doctrine even a step beyond *Rogers*," and "adopted yet another version of the" doctrine); Wheeler, *supra* note 67, at 27-28 (the "'point of sale' approach results in an even bigger windfall for lessors than the 'marketable product' approach. Under the 'point of sale' approach, a lessor will not only receive a royalty valued upon the gas in its natural state at the wellhead or when the gas becomes marketable, but will receive a royalty valued upon the gas in its processed state at the point of sale after the gas has had value added to it solely at the lessee's expense").

[133] APP0009-0010, ¶ 2 (emphasis added). "Proceeds" is the "amount actually received by the lessee for the gas." Lansdown, *supra* note 71, at 670. "'Market value' is the price that a willing buyer would pay to a

First, both parties agree that Tug Hill is not paying royalties "at the well," but rather based on the gross proceeds received in the sale to WER downstream from the well.[134]

Second, the leases contain the "in no event" unambiguous qualifying language expressly limiting the definition of "market value" to the proceeds Tug Hill receives from selling the gas. Unlike the "at the well" language at-issue in *Tawney*, the "in no event" lease language is readily distinguishable because it is clear and unambiguous. No courts have held that the "in no event" qualifying language of "market value" is ambiguous. A lease term is only ambiguous if the language is "reasonably susceptible of two different meanings" or language "of such doubtful meaning that reasonable minds might be uncertain or disagree as to its meaning."[135] Simply stated, while scholars have offered "stinging criticism" of *Tawney*, there was at least some basis to examine the "at the well" language as a result of the changing deregulation of the oil and gas market.[136] In this case, the Circuit Court's tortured reading to find ambiguity in the "in no event" qualifying language has no such basis and "extend[s] [Tug Hill's royalty obligations] beyond the boundaries of the lease."[137]

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willing seller." *Id.; see also Heritage Res. Inc.*, 939 S.W.3d at 122 ("Market value is the price a willing seller obtains from a willing buyer.").

134 APP0021 ("FINDING: Defendants' royalty-calculation mechanics are undisputed."). As both parties agree, Tug Hill does not calculate royalties based on a hypothetical value "at the well," thus avoiding the *Tawney* ambiguity issue altogether.

135 *Payne v. Weston*, 195 W. Va. 502, 507, 466 S.E.2d 161, 166 (1995) (quoting Syl. Pt. 1, *Shamblin v. Nationwide Mut. Ins. Co.*, 175 W. Va. 337, 332 S.E.2d 639 (1985)); *Tawney*, 219 W. Va. at 272, 633 S.E.2d at 28.

136 *Leggett*, 239 W. Va. at 276-77, 800 S.E.2d at 862-63.

137 Wheeler, *supra* note 67, at 7; *see also* Lansdown, *supra* note 66, at 305 ("[W]here parties have agreed in the lease to the marketing of production, the implied covenant to market should not be used to alter the agreement.").

Therefore, the Circuit Court erred in finding the leases contained any ambiguities and interpreting them contrary to their express language. Because there is no ambiguity, *Tawney* should not be applied to the leases.

b. *Tawney* is not applicable because the leases allow Tug Hill to make allowances and deductions to make the "gas merchantable."

The Circuit Court further erred in holding that the leases do not allow Tug Hill to allocate post-production costs to Venable.[138]

In addition to evaluating whether lease language was ambiguous, the *Tawney* Court then considered what lease language would be sufficient for an oil and gas lease to allocate a share of post-production costs to the lessors.[139] The Court explained that the lease must contain specific language "which clearly informed the lessors exactly how their royalties were to be calculated and what deductions were to be taken from the royalty amounts for post-production expenses."[140]

Simply put, since that 2007 case, West Virginia has been recognized as an outlier state in the area of oil and gas royalty law, in that before a lessee can allocate a share of any post-productions costs it incurs "between the wellhead and the point of sale," a lease must (1) expressly provide that the lessors shall bear some part of the costs incurred between the wellhead and the point of sale, (2) identify with particularity the specific deductions that lessee would take, and (3) indicate the method of calculating the amount of post-production costs to be deducted. [141] As noted in *Leggett*, this unprecedented approach to the marketable product rule has resulted in "chaos,"

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[138] APP0021-0023, ¶¶ 65-70; APP0032, ¶ 21.

[139] *Tawney*, 219 W. Va. at 274, 633 S.E.2d at 30.

[140] *Id.*

[141] *Id.*; *see also* Keeling, *supra* note 132, at 79.

leading one scholar to describe the *Tawney* ruling as "nothing more than a re-writing of the parties' contract to take money from the lessee and give it to the lessor."[142]

The Fourth Circuit recently clarified *Tawney*'s requirements and provided a reasonable application of the rule.[143] In *Young*, the Fourth Circuit held that

> *Tawney* doesn't demand that an oil and gas lease set out an Einsteinian proof for calculating post-production costs. By its plain language, the case merely requires that an oil and gas lease that expressly allocates some post-production costs to the lessor identify *which* costs and *how much* of those costs will be deducted from the lessor's royalties. These conditions may be satisfied by a simple formula, like the one here.[144]

Yet, even with the benefit of the Fourth Circuit's clarification of the "faulty legs" upon which *Tawney* stands, the Circuit Court still erred as a matter of law because the leases do, in fact, satisfy the standard. That is, if WER's costs incurred after Corley and Burch Ridge are considered "post-production costs," the leases:

> (i) expressly provide that the lessors shall bear some part of the costs incurred between the wellhead and the point of sale, by providing for "*net proceeds received by Lessee*" and "*making allowance for fair and reasonable charge*;"
>
> (ii) identify with particularity the specific deductions that the lessee would take, including "*gathering, compressing, and making the gas merchantable*;"[145] and
>
> (iii) indicate the method of calculating the amount of post-production costs to be deducted, by identifying a method of "*calculated or allocated back to the wells.*"[146]

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[142] *Leggett*, 239 W. Va. at 277, 800 S.E.2d at 863 (internal citations omitted).

[143] *Young*, 982 F.3d at 208.

[144] *Id.* at 208-09 (holding that lease language providing for payment based on gross proceeds minus identified, reasonable post-production costs satisfied *Tawney*'s specificity requirements).

[145] Importantly, by the very nature of Venable's "marketable product" argument, the order implicitly acknowledges that all of the costs incurred by WER and netted back against the unprocessed gas sales price must be incurred to make the "gas merchantable," which is unequivocally allowed under the Lease.

[146] APP0009-0010, ¶ 2 (emphasis added); *Young*, 982 F.3d at 206-09 (dismissing *Tawney's* "at the well" analysis, under *Leggett*, and holding the "work back" method was specific enough and appropriate in West Virginia).

Consistent with the holding of *Young*, the lease language satisfies *Tawney,* and Tug Hill urges the Court to reverse the order's holding to the contrary.

Moreover, whether the leases satisfy *Tawney* overlaps with a case presently before this Court: *Kellam v. SWN Production Company, LLC*, No. 5:20-CV-85, 2021 WL 4621067 (N.D.W. Va. Sept. 13, 2021). At the request of the Northern District of West Virginia, the Court has taken up a series of certified questions considering the viability of *Tawney*, what constitutes the "method of calculating" the amount of post-production costs, the sufficiency of the identification of the types of costs that may be deducted, and whether the costs are limited to direct or indirect costs.[147] These four issues are directly relevant to and overlap with this final error of law. Therefore, if, and only if, the Court upholds the Circuit Court's ruling in the first two assignments of error such that it must consider this third issue, Tug Hill believes that the consideration of this issue should be stayed pending the outcome in *Kellam*.

[147] *Kellam*, 2021 WL 4621067, at *3.

VI. CONCLUSION

This Court has already recognized that *Wellman* and *Tawney* stand on a "faulty leg." This case demonstrates that the leg is still wobbling and needs to be steadied.

If affirmed, this order represents a deviation from long-standing law regarding the interpretation of contracts and an unsupported and unprecedented interpretation of the implied duty to market, creating legal standards for the calculation of oil and gas royalties at odds with even the minority of states who follow the marketable product rule. The holdings have the potential to dramatically change how natural gas is produced and sold in West Virginia, impacting all types of production wells and producers big and small.

Tug Hill respectfully requests that this Court (a) grant this writ, (b) direct the Circuit Court to reverse the grant of Venable's Motion for Summary Judgment, (c) direct the Circuit Court to reverse the denial of Tug Hill's Cross-Motion for Summary Judgment, and (d) remand to the Circuit Court to award any additional relief that the Court deems appropriate in accordance with this Court's opinion.

Respectfully submitted this 13th day of December, 2021

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THE SUPREME COURT OF APPEALS OF WEST VIRGINIA

No. _______

STATE OF WEST VIRGINIA EX REL. TH EXPLORATION II, LLC and TUG HILL OPERATING, LLC,
Petitioners

vs.

VENABLE ROYALTY, LTD.; V14, LP; VENRO, LTD.; V2, LP; and THE HONORABLE JUDGE JEFFREY KRAMER, Judge of the Circuit Court of Marshall County, West Virginia;
Respondents.

On appeal from the Order of the Circuit Court of Marshall County, West Virginia, on cross-motions for summary judgment, entered on November 10, 2021, in Consolidated Case Numbers 18-C-227 and 18-C-220

PETITION FOR WRIT OF PROHIBITION

VERIFICATION

I, Thomas C. Ryan, counsel for Petitioner, being first duly sworn upon oath, state that I have read the foregoing **"Petition For Writ of Prohibition"** along with the attached **"Appendix To Petition For Writ of Prohibition,"** and believe that the factual information contained therein are true and accurate to the best of my belief and knowledge.

Thomas C. Ryan (WV Bar No. 9883)

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PETITION FOR WRIT OF PROHIBITION

CERTIFICATE OF SERVICE

I, Thomas C. Ryan, counsel for Petitioners TH Exploration II, LLC and Tug Hill Operating, LLC, hereby certify that on this day, December 13, 2021, I served a true and correct copy of the foregoing ***"Petition For Writ of Prohibition"*** upon those listed below via overnight FedEx, postage prepaid:

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