

No. 32966

IN THE WEST VIRGINIA SUPREME COURT OF APPEALS

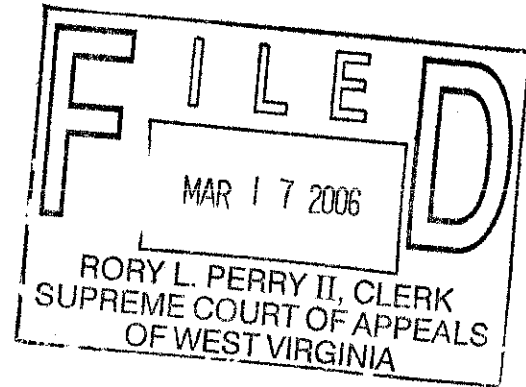
ESTATE OF GARRISON G. TAWNEY, by
LELA ANN GOFF, Executrix,
LELA ANN GOFF and VERNON B. GOFF,
husband and wife, JANICE E. COOPER and
CLIFFORD B. COOPER, husband and wife,
LARRY G. PARKER, JOHN W. PARKER,
RICHARD L. ASHLEY, MYRTLE JONES,
by her Attorney-in-Fact, ORTON A. JONES,

Plaintiffs,

v.

COLUMBIA NATURAL RESOURCES, LLC,
f/k/a COLUMBIA NATURAL RESOURCES, INC.,
a Texas corporation; NISOURCE INC., a
Delaware corporation; and COLUMBIA
ENERGY GROUP, a Delaware corporation,

Defendants



Civil Action No. 03-C-10E
Circuit Court of Roane County

AMICUS CURIAE BRIEF ON BEHALF OF
THE INDEPENDENT OIL AND GAS ASSOCIATION OF WEST VIRGINIA, INC.

Dated: March 17, 2006

Herschel H. Rose III
(WVSB No. 3179)
Steven R. Broadwater
(WVSB# 462)
Rose Law Office
500 Virginia Street, East, Suite 1290
Charleston, West Virginia 25335
(304) 342-5050
(304) 342-0455 FAX

Table of Contents

I.	Introduction.....	1
II.	The Kind of Proceeding and Nature of the Ruling in the Lower Tribunal	2
III.	The Facts of the Case	2
IV.	Assignments of Error	3
V.	Points and Authorities Relied Upon	4
VI.	Discussion of Law.....	5
	A. The Language “at the Well”, “at the Wellhead”, or “Net of All Costs Beyond the Wellhead” Clearly and Unambiguously Permits the Deduction of Post-Production Costs.....	5
	1. Language such as “at the Well” or “at the Wellhead” Has a Specific, Well-Understood Meaning of Long Standing in the Natural Gas Industry.	5
	a. It Was the Wellhead Price of Gas That Was Regulated for Years by the Federal Government.	5
	b. If the Language “at the Well”, “at the Wellhead”, or “Net of All Costs Beyond the Wellhead” Doesn’t Define the Point at which the Value of Gas for Royalty Purposes, It Has No Meaning	8
	2. Under West Virginia Law, Express Terms in Leases Must Be Given Full Force and Effect	9
	a. Court Decisions on W. Va. Law	9
	b. From the Perspective of the Independent Producer, the Disparity in Bargaining Power Between the Lessee and the Lessor Is Reversed	10
	3. Prior to Unbundling, Costs Downstream of the Integrated Pipeline were Invisible to Lessees and Lessors Alike	11
	a. History of Unbundling.....	11
	b. Before Unbundling, the Integrated Pipeline Paid All of the Costs Downstream of the Point of Interconnection.	13
	c. The Effect of Unbundling.....	14
	D. If the Parties Had Intended Something Out of the Ordinary, They Could Have Expressed Their Intent In Express Language.....	16
	4. The Circuit Court’s Rulings on the Certified Questions is Contrary to Both West Virginia Law and The Majority Rule in the United States. ..	17
	a. The Circuit Court’s Finding is Inconsistent with Prior Decisions of the West Virginia Supreme Court of Appeals	17
	b. A Similar Rule in Other Jurisdictions.....	17
	5. Summary	18
	B. Appalachian Gas is Marketable at the Well.....	18
	1. The General Rule in the United States.....	19
	2. Appalachian Gas is Marketable at the Well.....	20
VII.	The Circuit Court’s Decision Would Unsettle An Enormous Number of Leases In West Virginia.....	21

A.	The Plaintiffs Are Advocating a Profound Change to the Law in West Virginia Concerning Natural Gas Leases	21
B.	That Change Would Affect Leases for All Minerals, Including Coal.	21
VIII.	Prayer For Relief.....	22

No. 32966

IN THE WEST VIRGINIA SUPREME COURT OF APPEALS

ESTATE OF GARRISON G. TAWNEY, by
LELA ANN GOFF, Executrix,
LELA ANN GOFF and VERNON B. GOFF,
husband and wife, JANICE E. COOPER and
CLIFFORD B. COOPER, husband and wife,
LARRY G. PARKER, JOHN W. PARKER,
RICHARD L. ASHLEY, MYRTLE JONES,
by her Attorney-in-Fact, ORTON A. JONES,

Plaintiffs,

v.

Civil Action No. 03-C-10E
Circuit Court of Roane County

COLUMBIA NATURAL RESOURCES, LLC,
f/k/a COLUMBIA NATURAL RESOURCES, INC.,
a Texas corporation; NISOURCE INC., a
Delaware corporation; and COLUMBIA
ENERGY GROUP, a Delaware corporation,

Defendants

AMICUS CURIAE BRIEF ON BEHALF OF
THE INDEPENDENT OIL AND GAS ASSOCIATION OF WEST VIRGINIA, INC.

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

I. Introduction

Your *amicus* the Independent Oil and Gas Association of West Virginia, Inc. ("IOGA") is an association with over 350 members interested in issues affecting the oil and gas producing industry in West Virginia. IOGA's mission focuses on production and marketing issues facing

“independent producers”; that is, those producers who do not control major pipelines or refineries.

This case is a class action in which the plaintiffs claim, inter alia, that the Respondent CNR as the lessee of plaintiffs’ oil and gas interests improperly deducted post-production expenses from royalty payments.

By its brief, IOGA will attempt to provide some insight to this Honorable Court as to the historic background as to the regulatory environment under which the majority of leases for natural gas production in West Virginia were executed. We believe this background sheds light on the expectations and intentions of the parties at the time the leases were executed. By its brief, IOGA also hopes to explain the potential far-reaching adverse impact that the circuit court’s ruling on the questions certified to this honorable Court will have if those rulings are allowed to stand.

II. The Kind of Proceeding and Nature of the Ruling in the Lower Tribunal

Your *amicus* IOGA adopts the description of the kind of proceeding and nature of the ruling in the lower tribunal as stated in the plaintiffs’ “Plaintiff’s Brief in Support of Affirming Trial Court’s Rulings on Certified Questions” submitted to this Court on or about January 27, 2006.

III. The Facts of the Case

The natural gas industry began in West Virginia, Pennsylvania, and Ohio. Like a river’s increasing flow from many streams, gas flows from wells drilled in the field through small-diameter production lines to “gathering” pipelines, then into an interstate transmission line and on to major population centers on the northeast seaboard.

In its Order of Certification, the Circuit Court of Roane County made two findings relevant to the issue of whether the leases in question contain express language concerning the deductibility of post-production expenses:

2. The leases on which the Court is asked to rule are leases under which there is no express language or provision allowing the lessee to deduct transportation, line loss, compression, gas processing fees and other costs or fees from royalty. These types of deductions may be referred to as post-production expenses.
3. Most of these leases have clauses which state that the lessor will be paid royalty at the well or at the wellhead. Attached is a list of the varying language used in the leases to describe the royalty that the lessee was obligated to pay royalty [sic] to the lessor-Plaintiffs (Exhibit A)

Post production expenses are those expenses incurred by the lessee between the wellhead and the point of sale. In short, the court below held that *none* of the leases containing *any* of the language described in Exhibit A attached to the circuit court's Order of Certification contain express language that allows the lessee to deduct post-production costs. Additionally, the circuit court recognized that while most of the leases described in Exhibit A state that the lessor will be paid royalty "at the well" or "at the wellhead", some do not contain this language.

IOGA expects that CNR will argue that its motion for summary judgment was limited to those leases which contained "at the well" or similar language and that, as required by W. Va. Code § 58-5-2, the certified questions should be limited to issues raised in its motion for summary judgment that was denied. IOGA believes CNR to be correct in these positions; accordingly, this brief addresses only issues concerning leases that contain "at the well" or "at the wellhead".

IV. Assignments of Error

1. The circuit court erred when it casually lumped all of the lease language found in Exhibit A attached to the circuit court's Order of Certification into a single

category of “leases under which there is no express language or provision allowing the lessee to deduct” post-production expenses.

2. The circuit court erred when it ruled that leases that contain “at the well” or “at the wellhead” language does not clearly and unambiguously contemplate the deduction of post production expenses.

3. The circuit court erred when it adopted the extreme minority rule from Colorado that gas is not marketable until it is delivered to a market location.

4. The circuit court erred when it failed to rule that Appalachian gas is in marketable condition at the well.

V. Points and Authorities Relied Upon

Cases

Barn-Chestnut, Inc., v. CFM Dev. Corp., 193 W. Va. 565, 457 S.E.2d 502 (1995)9
Cotiga Dev. Co. v. United Fuel Gas Co., 147 W.Va. 484, 128 S.E.2d 626 (1963).....9, 15, 16
Creson v. Amoco Production Co., 129 N.M. 529, 10 P.3d. 853 (2000)17
Garman v. Conoco, Inc., 886 P.2d 652 (Col. 1994)18, 19
Imperial Colliery Co. v. Oxy USA, Inc., 912 F.2d 696 (1990)10
Maryland v. Louisiana, 451 U.S. 725 (1981)5
Mittelstaedt v. Santa Fe Minerals, Inc., 954 P.2d 1203 (1998).....19
Peoples Natural Gas Co. v. Public Service Commission of Pennsylvania, 270 U.S. 550
(1926).....6
Permian Basin Area Rate Cases, 390 U.S. 747 (1968)5
Phillips Petroleum Co. v. Wisconsin, 347 U.S. 672 (1954).....6, 7
Public Service Commission of the State of New York v. Mid-Louisiana Gas Co. et al., 433
U.S. 319 (1983).....6
Rogers v. Westerman Farm Co., 29 P.3d 887 (Col. 2001)10, 11, 18, 20
Schroeder v. Terra Energy, Ltd., 223 Mich. App. 176, 565 N.W.2d 887 (1997).....18
TXO Production Corp. v. Commissioner of Land Office, 903 P.2d 259, 263 (Okla. 1994)18, 19
Wellman v. Energy Resources, Inc., 210 W. Va. 200, 557 S.E.2d 254 (2001).....10, 17, 19, 21

Statutes

The Natural Gas Act 5, 6, 14
The Natural Gas Policy Act (“NGPA”) 7, 8, 10, 12
The Natural Gas Wellhead Decontrol Act (“Wellhead Decontrol Act”)..... 8, 12
W. Va. Code § 24-3-3a 14
W. Va. Code § 58-5-2 3

Administrative Decisions

Order 436	8
Order 500	8
Order 636, 57 FR 13267 (1982).....	6, 7, 8, 12

Treatises

Lansdown, Scott, <u>The Marketable Condition Rule</u> , 44 S. Tex. L. Rev. 667 (2003).....	19, 21
Stewart, Jefferson D. and Maron, David F., <u>Post-Production Charges to Royalty Interests: What Does the Contract Say and When Is It Ignored?</u> , 70 Miss. L.J. 625 (2000)	18

VI. Discussion of Law

A. The Language “at the Well”, “at the Wellhead”, or “Net of All Costs Beyond the Wellhead” Clearly and Unambiguously Permits the Deduction of Post-Production Costs.

1. Language such as “at the Well” or “at the Wellhead” Has a Specific, Well-Understood Meaning of Long Standing in the Natural Gas Industry.

a. *It Was the Wellhead Price of Gas That Was Regulated for Years by the Federal Government.*

It is impossible to understand the history of the natural gas industry without understanding the pervasive influence of governmental regulation of the industry and how that regulation has evolved over the years. As the United States Supreme Court observed, “[i]n 1938, Congress enacted the [Natural] Gas Act to assure that consumers of natural gas receive a fair price and also to protect against the economic power of the interstate pipelines” in *Maryland v. Louisiana*, 451 U.S. 725 at 747-48 (1981). Congress vested the authority to regulate the natural gas industry originally with the Federal Power Commission (“FPC”); that authority is now vested in the Federal Energy Regulatory Commission (“FERC”). However, the NGA didn’t specifically extend to producers, and as that Court observed in *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968), “the [Federal Power] Commission declined until 1954 to regulate sales by independent producers¹ to interstate pipelines. Its efforts to regulate such sales began only after

¹ The Court defined “independent producers” as those that do “not engage in the interstate transmission of gas from producing fields to consumer markets and [are] not affiliated with any interstate pipeline

this Court held in 1954 that independent producers are “natural gas compan[ies] within the meaning . . . of the Act [in] *Phillips Petroleum Co. v. Wisconsin*, 347 U.S. 672”, *Id.*, 390 U.S. at 755-56.

However, the FPC found the task of regulating wellhead prices to be quite a challenge. See, for example the discussion by the United States Supreme Court in *Public Service Commission of the State of New York v. Mid-Louisiana Gas Co. et al.*, 433 U.S. 319 (1983). As therein described, the FPC first attempted to regulate each producer individually, but soon realized that that task was hopelessly large. The Commission then shifted to an “area rate” approach, under which it attempted to establish a single rate schedule for each of several producing regions in the country.

Order 636² summarizes the pervasive regulation of the gas industry by the federal government beginning in 1938:

“...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 gasSee, e.g., *Peoples Natural Gas Co. v. Public Service Commission of Pennsylvania*, 270 U.S. 550 (1926). [When the NGA became law] 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 [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

company.” *Permian Basin Area Rate Cases*, 390 U.S.747 at 755 (1968), citing *Phillips Petroleum Co. v. Wisconsin*, 347 U.S. 672, 675 (1954).

² In the narrative of that history that follows, we quote parts of the Federal Energy Regulatory Commission’s gas industry restructuring Order 636, 57 FR 13267 (1982), Pipeline Service Obligations and Revisions to Regulations Governing Self-Implementing Transportation; and Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol. When quoting from Order 636, we have included footnotes as text and omitted footnote references for easier reading.

[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 [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....(emphasis added)

However, the regulation of the price of gas and transportation in the interstate market did not stimulate adequate investment for interstate supply. In contrast, an abundance of supply existed on local intrastate markets, where regulation was less severe. In Order 636, FERC noted this phenomenon as follows:

The interstate natural gas shortages of the 1970s were the catalyst for reform of the regulation of the natural gas industry. ... [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, [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 NGPA to increase the flow of gas into the interstate market....(emphasis added)

The Natural Gas Policy Act ("NGPA") followed the Arab oil embargo of the early 1970s, and as FERC noted in Order 636, slowly decontrolled prices at the wellhead, and signaled a major change in the way natural gas was purchased and sold across our nation:

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

From the background provided by Order 636, it is apparent that beginning in 1954 (after the *Phillips* decision) the federal government directly controlled the wellhead price of gas, and that direct regulation by the FPC and FERC extended for forty years until Congress took the first step to deregulation in 1978. The entire process of fully deregulating the price producers could

charge at the wellhead only began in 1978; a succession of Orders by FERC (Orders 436 in 1985, Order 500 in 1987, and Order 636 in 1992) and acts of Congress (the Natural Gas Wellhead Decontrol Act ("Wellhead Decontrol Act") in 1989) was required to complete the process of deregulating the price producers could charge at the wellhead. Under the Wellhead Decontrol Act, the NGPA was amended and all remaining regulated prices on wellhead sales were repealed. As of January 1, 1993, all remaining NGPA price regulations were eliminated, allowing the market to completely determine the price of natural gas at the wellhead.

b. If the Language "at the Well", "at the Wellhead", or "Net of All Costs Beyond the Wellhead" Doesn't Define the Point at which the Value of Gas for Royalty Purposes, It Has No Meaning

If the language "at the well" or "at the wellhead" doesn't define the point at which the value of the royalty interest is determined, that language simply has no meaning. Rather, throughout the discussion above, it is crystal clear that the term "wellhead" is a term used pervasively by the natural gas industry. Moreover, a wellhead is a physical entity easily recognized for what it is by everyone. It is where gas is brought to the surface and begins its journey to the ultimate end user; logically, it demarks where production ends and transportation begins. It comes as no surprise, then, that the vast majority of the leases in this case contain language such as "at the wellhead" or "at the well". The FPC, FERC, Congress, and the United States Supreme Court have all been interpreting and thus giving meaning to the term "wellhead" for over 50 years. It is simply erroneous for the circuit court to ascribe no meaning to those words.

Other leases contain either the terms "gross" or "net", which, if they shed no light on the point at which the value of the royalty interest is determined, also have no meaning. "It is a basic tenet of contract construction that each and every word is to be given meaning, and that the

court cannot create or impose an implied covenant or construction that is inconsistent with the express terms of the contract". *Barn-Chestnut, Inc., v. CFM Dev. Corp.*, 193 W. Va. 565, 572, 457 S.E.2d 502, 509 (1995). Again, it is simply erroneous for the circuit court to ascribe no meaning to those words.

As Exhibit A attached to the circuit court's Order of Certification shows, some of the leases in question contain the language "1/8 of price, net of all costs beyond the well, received." It is difficult to imagine express language that would more explicitly permit the deduction of post-production expenses incurred beyond the well. As a result, it defies comprehension that the circuit court would casually lump all of the lease language found in Exhibit A into a single category of "leases under which there is no express language or provision allowing the lessee to deduct" post-production expenses.

2. Under West Virginia Law, Express Terms in Leases Must Be Given Full Force and Effect

a. Court Decisions on W. Va. Law

Under West Virginia law, express terms in a natural gas lease must be applied and enforced according to the intent of the parties. "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". Syl. Pt. 1, *Cotiga Dev. Co. v. United Fuel Gas Co.*, 147 W.Va. 484, 128 S.E.2d 626 (1963). In that case, the lease terms which provided for royalty to be paid "at the rate received by the Lessee for such gas" at the downstream point where the lessee sold the gas were strictly construed against the lessee, despite its contention that it should be paid based on the market price of gas "at the wellhead in the area covered by the lease".

Also, in *Imperial Colliery Co. v. Oxy USA, Inc.*, 912 F.2d 696 (1990), the Court of Appeals for the Fourth Circuit strictly applied West Virginia law to interpret the express language “wholesale market price at the well...defined as the prevailing price currently paid at the well by wholesale purchasers in the field where the well is located” as meaning a price higher than the price actually received by the lessee, even though the Lessee argued that the price he received was the maximum price the lessee could charge under the NGPA. The Court could have decided that it would be reasonable to infer that “market price” meant the maximum price the regulatory agency had approved, but it declined to read this inference into the lease; rather, it interpreted the lease language exactly as written.

Both of these cases stand for the proposition that terms and conditions bargained for and agreed to by two parties should never be second guessed by the courts when a simple interpretation of the covenant is clear.

b. From the Perspective of the Independent Producer, the Disparity in Bargaining Power Between the Lessee and the Lessor Is Reversed

When interpreting natural gas leases, some courts have based their analysis of the language in part on a perceived disparity in the sophistication of the typical lessor as compared to the typical lessee. In *Wellman v. Energy Resources, Inc.*, 210 W. Va. 200, 557 S.E.2d 254 (2001), the West Virginia Supreme Court of Appeals observed that:

often in the oil and gas lease situation, the landowner is a relatively small operator with limited resources and the lessee often has substantially greater resources.

Id., 210 W. Va. at 206, 557 S.E.2d at 260. In similar fashion, the Colorado Supreme Court observed in *Rogers v. Westerman Farm Co.*, 29 P.3d 887 (Col. 2001):

Finally, in interpreting leases like those in this case, we are mindful of the generally accepted rule that oil and gas leases are strictly construed against the lessee in favor of the lessor. . . This rule is generally based on the recognition that the bargaining power between a lessor and lessee is similar to that historically

found between an insurance company and its customers. Thus, the parties are in similar unequal positions. For example, lessors are not usually familiar with the law related to oil and gas leases, while lessees, through experience drafting and litigating leases, generally are. . . Accordingly, based on our interpretation of the "at the well" and "at the mouth of the well" language common to the four lease types at issue, we conclude that the leases in this case are silent with respect to allocation of costs

Id., 29 P.3d at 901-02.

It is critical for this Court to understand that from the perspective of the independent producer in West Virginia, the perceived disparity may well be reversed. An independent producer may well be a very small entity, while the royalty owner may well be a sophisticated large corporate landowner that manages thousands of acres and leases. Accordingly, it would be unreasonable to assume that, as a general rule, all royalty owners are unfamiliar with the meaning of terms commonly used in the industry and are incapable of understanding the express terms of the leases into which they enter.

3. Prior to Unbundling, Costs Downstream of the Integrated Pipeline were Invisible to Lessees and Lessors Alike

a. History of Unbundling

Natural gas has been produced in West Virginia for more than a century. Producers have always been in the business of obtaining leases for natural gas, drilling for and producing the gas, and finding the best market for the gas, and have always paid royalties based on what they receive for the gas. For the vast majority of that time, however, producers really only had one market for their gas: the nearest integrated natural gas pipeline company. The integrated pipeline company owned the gathering systems and processing facilities similar to those at issue in this case. It also owned large volume interstate transmission pipelines and local distribution systems that delivered gas to the ultimate end user. Thus, these integrated pipeline companies handled the gas literally from the wellhead to the burner tip.

While essentially the same physical pipelines and processing facilities exist today, there have been major changes over the past decade or so in how the natural gas industry is regulated. In conjunction with the deregulation of the wellhead price of gas discussed above, FERC's Order 636 also restructured the interstate pipeline industry. As FERC explained in that Order:

[Under Order 636, FERC] is changing its regulations to restructure the services provided by interstate natural gas pipelines. The changes are intended to ensure that transportation service is equal in quality for all gas supplies, whether the customer purchases the gas from the pipeline or from another supplier. This should maximize the consumer benefits of the competitive wellhead gas market by allowing buyers of natural gas to reach as many sellers as possible, thereby ensuring that the most efficient and beneficial transactions take place....

[T]his [Order 636] requires significant alterations in the structure of interstate natural gas pipeline services in light of the changes in the natural gas industry brought about by the Natural Gas Policy Act of 1978 (NGPA), the [FERC's] open access transportation program, and the Natural Gas Wellhead Decontrol Act of 1989 (Decontrol Act). . . . This rule will, therefore, reflect and finally complete the evolution to competition in the natural gas industry initiated by those changes so that all natural gas suppliers, including the pipeline as merchant, will compete for gas purchasers on an equal footing. ...[T]his promotion of competition among gas suppliers will benefit all gas consumers and the nation by "ensur[ing] an adequate and reliable supply of [clean and abundant] natural gas at the lowest reasonable price." ...[end quotes].

As a result of Order 636 and subsequent Orders, the integrated pipelines could no longer engage in merchant gas sales or sell any product as a bundled service. Rather, all customers of the pipeline were to have a choice in selecting their gas sales, transportation, and storage services from any provider. The production and marketing arms of the pipeline companies were required to be restructured as arms-length affiliates, and these affiliates could in no way have an advantage (in terms of price, volume, or timing of gas transportation) over any other potential user of the pipeline.

FERC unbundled and restructured both main trunk pipelines for interstate transportation of large volumes of gas and, in gas producing areas like Appalachia, also included many other gathering lines that connect to the main trunk lines. Originally, the main trunk lines and many of

the other lines were constructed together as a unit in the producing areas of Appalachia so that the pipelines would have gas available to transport to the populous northeastern states. Later, as the demand for gas increased in the Northeast, pipelines from the southwest and Gulf of Mexico were constructed to interconnect with the pipelines systems that were originally constructed in Appalachia.

b. Before Unbundling, the Integrated Pipeline Paid All of the Costs Downstream of the Point of Interconnection.

Before unbundling, the costs of operating the smaller gathering lines were combined with the costs of operating the main trunk lines, and the cost for transportation on the overall system made up part of the cost of service that determined the rate for which the integrated pipeline could charge for the gas as part of its merchant function. As a result, there were a minimal number of entities involved in moving the gas from the wellhead to the burner tip: the lessee sold the gas to the integrated pipeline, and the integrated pipeline absorbed all the cost of all of the gathering, processing, compression, transportation, and storage services necessary to deliver the gas to the end user. The integrated pipeline sold the gas at the burner tip at a regulated price designed to be sufficient to recoup its costs and earn an approved rate of return. The integrated pipeline paid the lessee essentially a "take it or leave it" price for the gas, and that price already had the costs of gathering, processing, compression, and line loss deducted from it, because those costs were borne by the pipeline.

Most of the natural gas leases in West Virginia were executed long before unbundling was mandated beginning in 1992. The price that the integrated pipeline company paid lessees for the gas was reduced because it reflected the fact that the integrated pipeline alone bore the expenses for gathering, compression, line loss, and processing.

c. *The Effect of Unbundling*

As part of its regulatory restructuring process, however, FERC decided to price transportation on the other lines (designated "gathering lines" under the Natural Gas Act) separately from the cost to use the main transmission lines. IOGA, among others, objected to the inclusion of allocating costs to gathering lines, and establishing separate fees for the use of those lines. Nevertheless, FERC continued on its course and, acting in response to FERC's direction, the major pipelines spun-off or spun-down portions of their gathering pipelines, often to separate companies that were not subject to FERC jurisdiction since they were no longer owned by an interstate pipeline. These gathering systems provide access to market for IOGA producers, and those gathering systems are now regulated by the West Virginia Public Service Commission under W. Va. Code § 24-3-3a on an open-access basis.

One result of the FERC mandated unbundling of services is that there is no longer a simple number that can be used to depict the price of gas paid to producers. Rather, what has evolved is a "price mechanism" that contains a myriad of elements in the restructured contracts between the lessees and marketers. Typically, the price mechanism specifies a price based on a published index price of natural gas at some location that fluctuates over time and specifies the downstream costs that will be deducted from that index price. These costs also fluctuate over time. Many of these gas purchase contracts also specify the point of sale and/or custody transfer meter, and it is common to define the point of sale as the meter where the gas enters the third party gathering pipeline as opposed to the interstate pipeline interconnect or at TCO pool.

As a result, the lessee now contracts with a marketer for the sale of the gas, and the marketer finds a buyer and arranges *separately* for all of the required services: gathering, processing, transportation, storage, and distribution. In fact, it is only because of unbundling by

FERC that CNR now exists as a separate entity with separately identifiable charges for gathering, compression, line loss, etc. and that MarkWest now exists as a separate entity with separately identifiable charges for processing.

It was only after unbundling that the true cost of these services was determined through a process overseen by FERC and published for all to see. There are no new services now being provided and no new fees now being assessed against lessees or royalty owners. In fact, the whole purpose of FERC's deregulation and unbundling was to better match the supply of gas to the demand and to spur lower prices through competition wherever feasible. As a result, FERC would argue that the total cost to get the gas to the end user is less today than it would have been absent deregulation and unbundling.

At the time the leases were signed, prior to unbundling, costs for services downstream of the interconnect with the integrated pipeline were borne by the pipeline. Neither the royalty owner nor the producer could have contemplated the changes that occurred as a result of deregulation and unbundling over the last decade, and neither should benefit over the other as a result of this government-mandated change in accounting procedure. The circuit court's finding would result in an entirely unwarranted and unjustified benefit to royalty owners at the expense of the lessees contrary to the rational expectations of both. "It is not the right or province of a court to alter, pervert or destroy the clear meaning and intent of the parties as expressed in unambiguous language in their written contract or to make a new or different contract for them". Syl. Pt. 3, *Cotiga Dev. Co. v. United Fuel Gas Co.*, *supra*. Given this history, the intent of the parties could not have been other than that the cost of gathering, compression, line loss, and processing is deductible, because those costs always have been deducted.

As an illustration of just how absurd the result is of the circuit court's rulings on the certified questions, consider what would happen if the royalty owner elected to take his royalty payment "in kind"; that is, in the form of gas rather than money. If the lessor wanted then to sell his share, he would have to get his gas to market by entering a gas sales contract with a marketer, just as lessees do currently. As is now the rule, that contract would specify a price based on a published index price and would specify that downstream costs would be deducted from that index price, just as is now true for the lessees. The lessors wouldn't be any better off if the lessees were entirely eliminated; therefore, it is ridiculous for the plaintiffs to assert that the lessees should not now be allowed to deduct the same expenses as have historically been deducted by the integrated pipelines.

D. If the Parties Had Intended Something Out of the Ordinary, They Could Have Expressed Their Intent In Express Language

Finally, if parties intended to define how the value of the royalty interest was to be determined in some different and unusual manner, they could easily have done so with express language. See, for example, *Cotiga Dev. Co. v. United Fuel Gas Co.*, *supra*, in which the express language in the lease "at the rate received by the Lessee for such gas" was given full force and effect and was interpreted as requiring royalty payments greater than would be required had the leases contained language requiring royalties to be computed on the basis of "the market price of gas at the wellhead in the area covered by the lease".

Generally speaking, however, it simply makes sense that costs that benefit both the lessee and the lessor should be shared by both. Undeniably, the costs at issue do benefit both parties. Compression artificially lowers line pressure, thus allowing for more production over the years to the benefit of both the producer and royalty owner. Extraction renders the gas suitable for use in more markets, thus providing competitive prices to the benefit of both the producer and

royalty owner. Gathering provides market access on pipelines that otherwise may have been taken out of service based on economic considerations. Having access to these pipelines benefits both the producer and royalty owner.

Therefore, in the absence of specific language in the lease that would manifest the intention of both parties to depart from the normal practices in the industry at the time the leases were executed and to saddle one of the parties with costs for services that benefit both, there is simply no justification for the wholesale change to past practice that would result from the circuit court's rulings on the certified questions.

4. The Circuit Court's Rulings on the Certified Questions is Contrary to Both West Virginia Law and The Majority Rule in the United States.

a. The Circuit Court's Finding is Inconsistent with Prior Decisions of the West Virginia Supreme Court of Appeals

The circuit court's position that language such as "at the well" in a lease does *not* indicate an intention of the parties to share post production costs is inconsistent with the decision of the West Virginia Supreme Court of Appeals in 2001 in the case of *Wellman v. Energy Resources, Inc., supra*. In that case, the Court recognized that language in the lease that provided that "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 . . . lessor to bear part of the costs of transporting the gas from the wellhead to the point of sale". *Id.*, n. 3, 210 W. Va. at 210, 557 S.E.2d at 264.

b. A Similar Rule in Other Jurisdictions

Courts in both New Mexico and Michigan have held that "at the well" language in a lease unambiguously provides for royalties to be calculated on the value of gas as it leaves the wellhead. *Creson v. Amoco Production Co.*, 129 N.M. 529 at 533, 10 P.3d. 853, 857 (2000),

Schroeder v. Terra Energy, Ltd., 223 Mich. App. 176, 565 N.W.2d 887 (1997). Other commentators include Mississippi, Louisiana, and Texas among the “plain terms” jurisdictions. Stewart, Jefferson D. and Maron, David F., Post-Production Charges to Royalty Interests: What Does the Contract Say and When Is It Ignored?, 70 Miss. L.J. 625 (2000) at 660 and n. 159.

5. Summary

For the reasons stated above, IOGA asserts strongly that leases that contain “at the well” or “at the wellhead” language clearly and unambiguously contemplate the deduction of post production expenses, and that the circuit court erred when it held otherwise. Expenses for transportation, line loss, compression, and gas processing fees have *always* been treated as post production expenses in West Virginia. The circuit court’s finding, if upheld, would unsettle the majority of natural gas leases in this state, result in an explosion of litigation, and takes West Virginia out of the mainstream of natural resource law.

B. Appalachian Gas is Marketable at the Well.

If this Court declines to rule that the language such as “at the well” or “at the wellhead” clearly and unambiguously permits the deduction of post-production costs, then under *Wellman, supra*, the lessee is solely responsible for all costs required to make the gas marketable.

The plaintiffs assert the positions that (1) West Virginia natural gas is marketable only after dehydration, compression, and gathering, (citing *Garman v. Conoco, Inc.*, 886 P.2d 652 (Col. 1994) and *Rogers, supra*) and (2) after it has been transported to a location where it is marketable (citing *TXO Production Corp. v. Commissioner of Land Office*, 903 P.2d 259, 263 (Okla. 1994)). See Plaintiff’s Brief in Support of Affirming Trial Court’s Rulings on Certified Questions, p.9. They then make the wholly unsupported leaps that (1) the gas isn’t marketable until it is delivered to TCO pool (that is, to the interstate pipeline) (2) in a form suitable for

introduction into that pipeline. The plaintiff's desired conclusion is that none of the gathering, compression, shrinkage, and processing costs can be shared, because in the plaintiff's view, all are required in order to make the gas marketable.

To the contrary, Appalachian gas is generally in marketable condition at the wellhead; in fact, gas does not have to be in a form suitable for introduction into an interstate natural gas pipeline in order to be marketable. Also, there is clearly a market for most Appalachian gas at the wellhead.

1. The General Rule in the United States

As commentators have observed, a number of jurisdictions, including Texas, Louisiana, and California, simply adhere to the rule that royalty is to be calculated at the well. *See*, for example, Lansdown, Scott, The Marketable Condition Rule, 44 S. Tex. L. Rev. 667 at 682 (2003). The West Virginia Supreme Court of Appeals, however, indicated that it found the rationale employed by courts in Colorado, Kansas, and Oklahoma persuasive in resolving the question of whether the lessor or the lessee should bear "post-production" costs in *Wellman*, *supra*.

The cases from those jurisdictions cited by the plaintiffs support neither the overly broad propositions for which they are cited, nor the plaintiffs' entirely unsupported leaps beyond those propositions. In *Mittelstaedt v. Santa Fe Minerals, Inc.*, 954 P.2d 1203 (1998), the Oklahoma Supreme Court reviewed several of its earlier cases, including *TXO Production Corp. v. Commissioner of Land Office*, *supra*., as well as cases from Colorado and Kansas, including *Garman*, *supra*, also cited by the plaintiffs. The Court noted that the compression and dehydration costs at issue in the *TXO* case were incurred *at the wellhead and on the lease*, not downstream. *Mittelstaedt*, 954 P.2d 1205. Also, in the *TXO* case, delivery to the purchaser's

pipeline occurred *at the leased premises*. *Mittelstaedt.*, at 1206. The rule in Oklahoma is *much different* than the proposition advanced by the plaintiffs:

In sum, a royalty interest may bear post-production costs of transporting, blending, compression, and dehydration, when the costs are reasonable, when actual royalty revenues increase in proportion to the costs assessed against the royalty interest, when the costs are associated with transforming an already marketable product into an enhanced product, and when the lessee meets its burden of showing these facts.

Id., at 1210.

The plaintiffs also admit that *Rogers* held that gas is marketable when it is (1) in the physical condition such that it is acceptable to be bought and sold in a commercial market place, and (2) it is in the location of a commercial marketplace. Plaintiff's Brief in Support of Affirming Trial Court's Rulings on Certified Questions, p.27. Finally, the *Rogers* court held "[i]f gas is marketable at the physical location of the well, then transportation costs may be shared between the lessee and the lessor". *Id.*, 29 P.3d at 900.

Even in Colorado, Kansas, and Oklahoma, costs beyond the lease are deductible if they enhance the value of the gas and are reasonable and actually incurred. Therefore, it is clear that the overwhelming majority view in the United States is that post-production expenses that meet those criteria are deductible.

2. Appalachian Gas is Marketable at the Well

The simple fact that there are companies such as CNR that are in the business of gathering, transporting, compressing, and arranging the processing of typical Appalachian gas leads to the inescapable conclusion that Appalachian gas is marketable at the well. In many cases, production gas is fed directly into local distribution systems for use by local end users without any further treatment or processing. Not all of the gas produced in West Virginia is of a sufficiently high heating value so as to require it to be processed for local consumption or,

for that matter, before being introduced into an interstate pipeline. And even if the locally produced gas has a relatively high heating value, the local distribution company can often avoid having to process the gas to remove the heavier hydrocarbons by simply blending the local gas with lower heating value gas from another source before use³. Finally, many leases call for the lessor to receive “free” gas for his own use; in this case, wellhead gas is fed directly from the wellhead or from small-diameter production pipeline.

VII. The Circuit Court’s Decision Would Unsettle An Enormous Number of Leases In West Virginia

A. The Plaintiffs Are Advocating a Profound Change to the Law in West Virginia Concerning Natural Gas Leases

This Court in *Wellman, supra*, stated:

there has been an attempt on the part of oil and gas producers in recent years to charge the landowner with a pro rata share of various expenses connected with the operation of an oil and gas lease such as the expense of transporting oil and gas to a point of sale, and the expense of treating or altering the oil and gas so as to put it in a marketable condition.

Id., 210 W. Va. at 210, 557 S.E.2d at 264. This perception of the interests that are attempting to bring about change to the statue quo is not universally shared. See, for example, this comment in the South Texas Law Review:

Recently, royalty owners have begun what might fairly be described as a concerted attack on the deductibility of post-production costs.

Lansdown, Scott, *supra*.

B. That Change Would Affect Leases for All Minerals, Including Coal.

IOGA submits, based on the arguments and history contained herein, that it is the plaintiffs in this case who are attempting what amounts to an assault on the status quo, and, if the

³ One exception to this rule would be “sour” gas; that is, gas that contains a significantly high concentration of sulfur compounds that renders that gas unsafe for use. In this case, the producer/lessee would be solely responsible for bearing the expense of “sweetening” the gas (removing the sulfur compounds) in order to make the gas marketable.

circuit court's rulings on the certified questions is allowed to stand, the number of natural resource leases that would be unsettled in West Virginia would be enormous, not just for natural gas, but for all minerals. Even for coal leases, would the language "at the mine" or "at the mine mouth" in a coal lease be similarly meaningless? If a coal lease provides "net of all costs to market", is that language meaningless? What about the term "FOB mine" – does that not specify who pays the transportation costs?

IOPA believes that the terms "at the mine" or "at the mine mouth" and "at the wellhead" are equally meaningful terms, and express agreements of the parties that contain such language should continue to be enforced by the Courts in this state exactly as they have always been.

VIII. Prayer For Relief

IOPA respectfully requests that this Court limit its decision to leases which contain "at the well" or "at the wellhead" language, and rule that leases which contain "at the well" or "at the wellhead" language clearly and unambiguously contemplate the deduction of post-production expenses after the wellhead.

In the alternative, IOPA respectfully requests that this Court rule that Appalachian gas is in marketable condition when it leaves the well and that a market exists for the gas at the wellhead.

In the alternative, IOGA respectfully requests that this Court answer both certified questions as presented by the Circuit Court of Roane County in the affirmative or for such other relief as may be appropriate.

Respectfully submitted,



Herschel H. Rose III
(WVSB No. 3179)
Steven R. Broadwater
(WVSB# 462)
Rose Law Office
500 Virginia Street, East, Suite 1290
Charleston, West Virginia 25335
(304) 342-5050
(304) 342-0455 FAX

Dated: March 17, 2006

IN THE WEST VIRGINIA SUPREME COURT OF APPEALS

ESTATE OF GARRISON G. TAWNEY, by
LELA ANN GOFF, Executrix,
LELA ANN GOFF and VERNON B. GOFF,
husband and wife, JANICE E. COOPER and
CLIFFORD B. COOPER, husband and wife,
LARRY G. PARKER, JOHN W. PARKER,
RICHARD L. ASHLEY, MYRTLE JONES,
by her Attorney-in-Fact, ORTON A. JONES,

Plaintiffs,

v.

Civil Action No. 03-C-10E
Circuit Court of Roane County

COLUMBIA NATURAL RESOURCES, LLC,
f/k/a COLUMBIA NATURAL RESOURCES, INC.,
a Texas corporation; NISOURCE INC., a
Delaware corporation; and COLUMBIA
ENERGY GROUP, a Delaware corporation,

Defendants

CERTIFICATE OF SERVICE

I, Steven R. Broadwater, do hereby certify that service of the "Amicus Curiae Brief on behalf of The Independent Oil and Gas Association of West Virginia, Inc." was made upon the parties listed below by mailing a true and exact copy thereof to:

Marvin W. Masters
THE MASTERS LAW FIRM, L.C.
181 Summers Street
Charleston, West Virginia 25301

Michael W. Carey
George M. Scott
Robert E. Douglas
CAREY, SCOTT, & DOUGLAS, PLLC
707 Virginia Street, East, Suite 1701
Charleston, West Virginia 25301

Scott S. Segal
THE SEAGAL LAW FIRM
810 Kanawha Boulevard, East
Charleston, West Virginia 25301

W. Henry Lawrence
Steptoe & Johnson, PLLC
Bank One Center, Sixth Floor
PO Box 2190
Clarksburg, WV 26302-2190

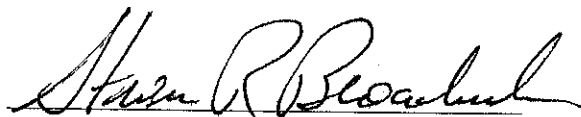
Patricia Proctor
Steptoe & Johnson, PLLC
1000 Fifth Avenue, Suite 250
PO Box 2195
Huntington, WV 25722-2195

J. Thomas Lane
J. Mark Adkins
BOWLES, RICE, McDAVID, GRAFF & LOVE
Post Office Box 1386
Charleston, West Virginia 25325-1386

Timothy M. Miller
Joseph S. Beeson
Jessica A. Blake
ROBINSON & McELWEE PLLC
Post Office Box 1791
Charleston, West Virginia 25326

in a properly stamped and addressed envelope, postage prepaid, and deposited in the United

States mail this 17th day of March, 2006.



Steven R. Broadwater (WVSB No. 462)