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IN THE TWENTY-SIXTH JUDICIAL DISTRICT
DISTRICT COURT, STEVENS COUNTY, KANSAS
CIVIL DEPARTMENT

GILBERT H. COULTER and ELIZABETH S. LEIGHNOR, individually and as representative plaintiffs on behalf of persons or companies similarly situated,	)	
Plaintiffs,	)	
vs.	)	Case No. 98-CV-40
ANADARKO PETROLEUM CORPORATION,	)	
Defendant.	)	

PLAINTIFFS' RESPONSE TO DEFENDANT'S MEMORANDUM OF SUPPLEMENTAL AUTHORITY

INTRODUCTION

Anadarko carefully avoids discussing the holding in *Davis v. Key Gas Corp.*, 34 Kan. App. 2d 728, 124 P.3d 96 (2005), *rev. denied* 05/09/06. Instead, Anadarko distorts *dicta* in *Davis* in a desperate effort to undermine the analysis of the implied covenant to market in *Sternberger v. Marathon Oil Co.*, 257 Kan. 315, 331, 894 P.2d 788 (1995).

In *Davis* the defendant lessee paid royalty on the basis of the price it received from the purchaser of its gas immediately adjacent to the lease. Under the terms of their contract, the purchaser deducted various fees (repeatedly referred to in *Davis* as "transportation costs and other expenses") from 98% of an "index price" to compute what it owed for the gas which it purchased from the defendant.

The trial court issued its decision in *Davis* without the benefit of a trial and without making any findings of fact. Moreover, the parties never asked it to address the fundamental issues which this Court is being asked to decide in this case: Was the raw gas in marketable condition when it emerged from the well? Were any of the expenses being deducted from the royalty payments being incurred to produce the gas in a captive state or place it in marketable condition? Instead, the parties in *Davis* asked the trial court to interpret their contract as a matter of law. That is exactly what both it and the Court of Appeals did.

The plaintiff in *Davis* claimed that his royalty payments should not be reduced by the fees levied by the purchaser, because Exhibit A to the oil and gas lease prohibited the defendant lessee from imposing any share of such expenses on its lessor:

> It is agreed that Lessor shall bear no costs of gas treatment, dehydration, compression, transportation or water hauling charged to this lease by Lessee in its operations thereon.

In other words, instead of getting into a dispute with the defendant about the purpose for which the expenses in question were being incurred, the royalty owner chose to rely on the defendant's express promise not to reduce the royalty payments by such expenses, regardless of whether the gas would have flowed into the purchaser's gathering facilities without compression or was in marketable condition at such point of entry.

In response, the defendant lessee claimed that Exhibit A did not apply, because the expenses at issue had not been "charged to this lease by Lessee," but rather by its purchaser. The majority in *Davis* rejected the defendant's argument that it could avoid the prohibition by treating the expenses as reduction in revenue, instead of charging them against the lease:

> Under the facts of this case, the lessee who had control of and prevented the performance of its condition precedent requiring that the lessee charge certain costs to the oil and gas leases before it became liable for the lessor's portion of the costs will not be excused from liability due to the nonperformance of that condition precedent. To hold otherwise would frustrate the well-known rule that where liability under a contract depends upon a condition precedent, a party cannot avoid its liability by making the performance of the condition precedent impossible by preventing it.

34 Kan. App. at 729, Syl. ¶ 9.

ARGUMENT

I. ANADARKO'S RELIANCE ON DICTA IN *DAVIS* IS MISPLACED.

Anadarko's memorandum grossly distorts *Davis* by baldly asserting that before resolving the contractual dispute, "the Court of Appeals first considered the issue presented in this case, whether the deductions would have been proper under the lease royalty clause if the language of paragraph 9 of Appendix [*sic*] A was not present." (Anadarko's Memorandum, p. 2). Anadarko is wrong.

First, as is evident from the language in *Davis* cited by Anadarko itself, the court's discussion of the deductibility of the expenses in the absence of Exhibit A is based entirely upon a "concession" by the plaintiff. 34 Kan. App. at 737. Thus, contrary to Anadarko's assertion, the court was not called upon to reach a "conclusion" as to whether such "deductions would have been proper" under leases containing "at the well" in their royalty clauses, and did not do so.

Second, the only "concession" attributed by the court to the plaintiff in *Davis* is that in the absence of Exhibit A, the royalty clause "would have the same effect" on the issue of deductibility of expenses as the discussion of "at the well" in *Sternberger*. *Id.* With regard to this issue, *Sternberger* held that the words "at the well" in an oil and gas lease are "silent" with respect to the deduction of costs incurred to make the gas marketable, 257 Kan. at 315, thereby entitling the royalty owner to rely upon the implied covenant to market to prohibit such deductions. *Accord Rogers v. Westerman Farm Co.*, 29 P.3d 887 (Colo. 2001); *Wellman v. Energy Resources, Inc.*, 557 S.E.2d 254 (W.Va. 2001). Nothing in *Davis* remotely suggests that "at the well" authorizes Anadarko to deduct the expenses which are the subject of the dispute in this case.

Third, both the majority and the dissent in *Davis* repeatedly refer to the expenses involved in that case as "transportation," which is a term of art in *Sternberger*, where the producer was allowed to charge its royalty owners a pro-rata share of the costs of "transporting" gas in marketable condition to a distant market. If the plaintiff in *Davis* conceded that the expenses involved in that case were being incurred to transport marketable gas, then the court's statement that such costs "apparently" would have been deductible in the absence of Exhibit A means that the facts in that case were diametrically opposed to what is happening here. (Plaintiffs have already shown that Anadarko is charging the accounts of its royalty owners with expenses it is incurring to produce the gas in a captive state and place it in marketable condition. *See, e.g.*, ¶¶ 40-91 of Plaintiffs' Proposed Findings of Fact contained in Plaintiffs' Proposed Findings and Conclusions of Law.) But in the absence of **any** factual findings in *Davis*, it is simply impossible to know what was actually happening on the gathering system in that case.

Fourth, neither the majority nor the dissent in *Davis* ever discuss the concept of "marketability." This omission is significant, because "[t]he lessee under an oil and gas lease has the duty to produce a marketable product, and the lessee alone bears the expense in making the product marketable." *Sternberger*, 257 Kan. at 315, Syl. ¶ 2. Obviously, the court in *Davis* was not called upon, and made no effort, to apply the holdings in *Sternberger* to the (unknown) facts in that case.

Under *Sternberger* Anadarko cannot require any members of the plaintiff class to bear any of the costs which it is incurring to produce the gas and place it in marketable condition. Nothing in *Davis* contradicts this well-established law. (*See, e.g.*, ¶¶ 1-28 of Plaintiffs' Proposed Conclusions of Law contained in Plaintiffs' Proposed Findings of Fact and Conclusions of Law.)

II. *DAVIS* PROHIBITS ANADARKO FROM USING ITS SALES OF GAS TO AN AFFILIATE TO REDUCE ITS ROYALTY OBLIGATIONS TO THE PLAINTIFF CLASS

The actual value of *Davis* to the case at hand is ignored by Anadarko. Anadarko has argued that its wellhead sale of gas to its affiliate establishes its royalty obligation, and by that arrangement, it has relieved itself of its obligation under the oil and gas leases to produce the gas or place its in marketable condition. *Davis* squarely rejects that defense by holding that a producer cannot reduce its royalty payments by contracting with a third party to perform activities which its royalty owners are not obligated to pay for.

The holding in *Davis* dovetails with the basic principle in oil and gas law that prohibits a producer from structuring its operations and transactions in a manner that benefits itself to the detriment of its royalty owner. *See Temple v. Continental Oil Co.*, 182 Kan. 213, 220, 230 P.2d 1039, 1046 (1958) (the producer must act "***in furtherance of the interests of both lessor and lessee***") (emphasis in original) (citing *Fischer v. Magnolia Petroleum Co.*, 156 Kan. 367, 133 P.2d 95 (1943)); *Myers v. Shell Petroleum Corp.*, 153 Kan. 287, 110 P.2d 810 (1941); *Berry v. Wondra*, 173 Kan. 273, 246 P.2d 282 (1952); *Rush v. King Oil Co.*, 220 Kan. 616, 619, 556 P.2d 431, 435 (1976) (The implied covenants require the lessee to act "for the common advantage of the both lessor and lessee.").

The quintessential example of manipulative behavior in the context of the lessor-lessee relationship is the self-dealing that occurs when a producer attempts to limit its royalty obligation by relying on the price which it receives from an affiliate for gas, as opposed to the price which the affiliate receives when the gas is sold in the market to which it is delivered. Producers cannot base or justify their royalty payment practices on a transaction with an affiliate. *Howell v. Texaco Inc.*, 112 P.3d 1154, 1160 (Okla. 2004) ("We hold that an intra-company gas sale cannot be the basis for calculating royalty."); *Atlantic Richfield Co. v. Farm Credit Bank*, 226 F.3d 1138, 1166 (10th Cir, 2000) ("If, however, the lessee is a corporate affiliate of the purchaser and the sale is not at an arm's length, the sale price will not be accepted as presenting the market price or market value.") *Davis* simply applies this prohibition to transactions which the producer structures with third parties so as to enable it to avoid fulfilling its contractual obligations.

In apparent recognition that it cannot impose gathering costs on its royalty owners by incorporating them into the price which it receives from its affiliate, Anadarko falls back on the claim that the <u>location</u> of its operations dictates whether they are deductible. As *Sternberger* recites, this argument was rejected by the Kansas Supreme Court more than 40 years ago. *Davis* simply underscores the propriety of this result: a producer cannot arrange operations under its control to benefit itself to the detriment of its royalty owners.

Instead of breathing life into Anadarko's location-based defenses, *Davis* demonstrates that fundamental principals of contract law support and re-enforce the Kansas Supreme Court's analysis of the implied covenant to market in *Sternberger*.

CONCLUSION

Anadarko relies on *dicta* in *Davis* because the holding in that case actually undercuts its position in this case.

Anadarko distorts the *dicta* in *Davis* by erroneously suggesting that the court in that case concluded that expenses incurred to produce gas and place it in marketable condition are deductible from royalty payments when the royalty clause contains "at the well" language.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that on this 23rd day of May, 2006, a true and correct copy of this PLAINTIFFS' RESPONSE TO DEFENDANT'S MEMORANDUM OF SUPPLEMENTAL AUTHORITY was placed in the United States mail, first class postage prepaid, addressed to:

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