DISTRICT COURT, COUNTY OF GARFIELD, STATE OF COLORADO 109 8th Street, Suite 104 Glenwood Springs, Co. 81601	DATE FILED: October 31, 2013 CASE NUMBER: 2006CV317
Plaintiff(s): IVO LINDAUER, SIDNEY and RUTH LINDAUER and DIAMOND MINERALS, LLC on behalf of themselves and all others similarly situated v. Defendant(s): WILLIAMS PRODUCTION RMT COMPANY	COURT USE ONLY
GARFIELD COMBINED COURTS Phone Number: 970-945-5075 FAX Number: 970-945-8756	Case Number: 06CV317 Ctrm: B

ORDER RE: PLAINTIFFS' MOTION FOR DETERMINATION OF QUESTION OF LAW UNDER C.R.C.P. 56(h)

Plaintiffs have filed a motion for determination of law which raises the following issue: should the enhancement test be applied monthly to determine the deductibility of transportation costs in this case? For the reasons below, the Court answers in the affirmative.

In its August 19, 2003 order, the Court declared that the "enhancement" test applies to post-marketability transportation expenses, and that WPX bears the burden of proving that all transportation expenses assessed against the royalties comply with the enhancement test.[1] In the present motion, Plaintiffs argue that WPX must justify its

[1] The "enhancement" test is derived from the following rule of law: "[I]n those circumstances where the gas was marketable, and subsequent production costs were incurred to enhance the value of the already marketable gas, such subsequent costs may be shared by the lessors and lessees provided that certain conditions are met. Specifically, under these circumstances, the lessee has the burden to show that such costs were reasonable, and that the actual royalty revenues increased proportionately to the costs assessed against the royalties." *Rogers v. Westerman Farm Co.*, 29 P.3d 887, 903 (Colo. 2001) [internal citations omitted].

transportation costs on a monthly basis. In response, WPX argues that Colorado law does not require it to justify the reasonableness of its transportation costs on a monthly basis, and that the Court should apply the enhancement test "consistent with the prudent operator rule."

As an initial matter, the Court has not found, nor have the parties cited, any published cases that have addressed the issue at hand. The issue raised by Plaintiffs appears to be an issue of first impression.

Nevertheless, the Court concludes that WPX must justify the reasonableness of its transportation costs on a monthly basis under section 34-60-118.5(2), C.R.S., which states the following in relevant part:

> (2)(a) Unless otherwise agreed pursuant to paragraph (b) of this subsection (2), payments of proceeds derived from the sale of oil, gas, or associated products shall be paid by a payer to a payee commencing not later than six months after the end of the month in which production is first sold. Thereafter, such payments shall be made on a monthly basis not later than sixty days for oil and ninety days for gas and associated products following the end of the calendar month in which subsequent production is sold. Payments may be made annually if the aggregate sum due a payee for twelve consecutive months is one hundred dollars or less.
>
> (b) The payer and payee may provide, in a valid lease or other agreement, for terms or arrangements for payment that differ from those set forth in paragraph (a) of this subsection (2).
>
> (2.3) Notwithstanding any other applicable terms or arrangements, every payment of proceeds derived from the sale of oil, gas, or associated products shall be accompanied by information that includes, at a minimum:
>
> (a) A name, number, or combination of name and number that identifies the lease, property, unit, or well or wells for which payment is being made;
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> (b) The month and year during which the sale occurred for which payment is being made;

(c) The total quantity of product sold attributable to such payment, including the units of measurement for the sale of such product;

(d) The price received per unit of measurement, which shall be the price per barrel in the case of oil and the price per thousand cubic feet ("MCF") or per million British thermal units ("MMBTU") in the case of gas;

(e) The total amount of severance taxes and any other production taxes or levies applied to the sale;

(f) The payee's interest in the sale, expressed as a decimal and calculated to at least the sixth decimal place;

(g) The payee's share of the sale before any deductions or adjustments made by the payer or identified with the payment;

(h) The payee's share of the sale after any deductions or adjustments made by the payer or identified with the payment;

(i) An address and telephone number from which additional information may be obtained and questions answered.

(2.5) Upon written request by the payee, submitted to the payer by certified mail, the payer shall provide to the payee within sixty days a written explanation of those deductions or adjustments over which the payer has control and for which the payer has information, whether or not identified with the payment, and, if requested by the payee, such meter calibration testing and production reporting records that are required to be maintained by the payer in accordance with section 34-60-106(1)(e). The requirement to provide a written explanation of deductions or adjustments shall not preclude the payer from answering the inquiry by referring the payee to the royalty clause or payment provision in a lease or other agreement.

As stated above, section 34-60-118.5(2)(a) requires that all royalty payments be paid on a monthly basis unless otherwise stated in the lease agreement. When making a monthly payment, WPX must also provide information to the payee regarding "[t]he payee's share of the sale after any deductions or adjustments made by the payer or identified with the payment" as required under subsection (2.3)(h). In addition, under subsection (2.5) WPX must provide the payee with "a written explanation of those

deductions or adjustments over which the payer has control and for which the payer has information" upon request by the payee.

Ultimately, the relevant provisions of section 34-60-118.5(2) support Plaintiffs' position that the enhancement test must be applied on a monthly basis to determine whether transportation costs may be deducted from the royalty payments. In this case, the parties seem to agree that WPX has routinely made its royalty payments on a monthly basis. It also appears from the parties' briefs that WPX has routinely charged its royalty payees with a pro-rata share of the transportation costs and has deducted those costs from each of the monthly royalty payments. In so doing, WPX must account for each and every deduction (including for transportation costs) applied to a monthly royalty payment, and must be able to provide a written explanation for each deduction upon the request of any payee.

Thus, it necessarily follows that in order to comply with the mandates of 34-60-118.5(2), WPX must justify the reasonableness of any monthly deductions for transportation costs by proving that such costs comply with the enhancement test. The reasonableness of those costs must be established as the deductions are applied which means that, under the facts here, the enhancement test will be applied on a monthly basis. Otherwise, it would be impossible for WPX to comply with the mandates of 34-60-118.5(2) if it deducted its transportation costs from the monthly royalty payments without justifying the reasonableness of those costs when they are charged to the payee.

In its response, WPX argues that requiring a producer to apply the enhancement test on a monthly basis ignores the fact that most transportation contracts

are "inherently long-term, and occur over the course of many months and even years, and certainly are not capable of evaluation on a month-by-month basis." Nonetheless, the long-term nature of transportation contracts does not relieve WPX of its statutory duty under section 34-60-118.5(2) to account for all deductions and adjustments applied to a monthly royalty payment, and to provide an explanation to the payee for each deduction upon request. At the very least, this statutory duty implies that WPX must be able to justify the reasonableness of each and every deduction for transportation costs that is applied to a royalty payment at the time the deduction is made. If, as here, the royalties are paid monthly, then WPX must justify the reasonableness of its transportation costs on a monthly basis. As the Court noted in its prior order, this requires WPX to show that those costs are reasonable and that the actual royalty revenues increased proportionately to the costs assessed against the royalties. To conclude otherwise would allow WPX to skirt its statutory obligations by applying monthly deductions for transportation costs without justifying the reasonableness of those costs as required by law.

Moreover, WPX's reliance on the "prudent operator rule" and the implied duty to market is unavailing. In essence, WPX argues that there is no duty to apply the enhancement test on a monthly basis because neither the prudent operator rule nor the implied duty to market is evaluated on a monthly basis. The prudent operator rule merely governs the lessee operator's duties to the lessor with regard to the amount of development the operator should undertake during the duration of the lease. *See Magnolia Petroleum Co. v. Wilson*, 215 F.2d 317, 318 (10th Cir. 1954). Similarly, the implied duty to market simply imposes a duty on the operator to develop the leased

property "in a manner that is reasonable and prudent, considering the circumstances and conditions." *Mountain States Oil Corp. v. Sandoval*, 109 Colo. 401, 408, 125 P.2d 964, 967 (1942).

However, neither rule has any bearing on WPX's legal duty to justify the reasonableness of its transportation costs, or on its statutory duty to provide an explanation for any deductions applied to a monthly royalty payment. The prudent operator rule and implied duty to market are designed primarily to protect the lessor's economic interest in the oil and gas by ensuring that the operator uses due diligence in developing the property. *See id.* Whether the operator was diligent in developing the property is an issue that arises before the oil and gas is marketable. *See Rogers v. Westerman Farm Co.*, 29 P.3d 887, 903 (Colo. 2001) ("[T]he implied covenant to market requires that the lessee produce gas and incur those expenses necessary to place gas in a condition acceptable for market."). In contrast, the enhancement test creates a separate and distinct rule that applies to post-production costs incurred after the oil and gas is ready for market. *Id.* Contrary to WPX's position, the enhancement test cannot simply be subsumed into the implied duty to market.

Ultimately, the Court concludes that WPX's position is untenable. WPX ignores the fact that it must provide a justification for all deductions applied to royalty payments when those deductions are made, and not at some indeterminate time in the future. The law does not allow WPX to deduct transportation costs from a monthly royalty payment without justifying the reasonableness of such costs when they are charged to the payee.

Accordingly, the Court concludes as a matter of law that WPX must apply the enhancement test on a monthly basis in order to determine the reasonableness of its post-production transportation costs.

Based on the foregoing, IT IS ORDERED that Plaintiffs' Motion for Determination of Question of Law Under C.R.C.P. 56(h) is granted.

DATED this 31st day of October, 2013.

BY THE COURT:

Denise K. Lynch
District Court Judge