RENDERED: JUNE 28, 2013; 10:00 A.M.
NOT TO BE PUBLISHED

Commonwealth of Kentucky

Court of Appeals

NO. 2012-CA-001016-MR

NOBE BAKER, INDIVIDUALLY AND AS ADMINISTRATOR OF THE ESTATE OF JOANN BAKER; COLENE JACKSON WICKLINE; LILLIE JACKSON; LOWELL JACKSON AND WIFE, GENEVA LEE JACKSON; JEROLD JACKSON AND WIFE, VIRGINIA L. JACKSON; MERLE JACKSON AND WIFE, LOUELLEN JACKSON; HAROLD JACKSON AND WIFE, SANDRA JACKSON; CAROLYN RUTH J. KNUCKLES AND HUSBAND, CHARLES KNUCKLES AND SUE CAROL J. FARLEY AND HUSBAND, ANTHONY FARLEY — APPELLANTS

v.

APPEAL FROM HARLAN CIRCUIT COURT
HONORABLE JAMES L. BOWLING JR., JUDGE
ACTION NO. 11-CI-00310

MAGNUM HUNTER PRODUCTION, INC. — APPELLEE

OPINION
AFFIRMING

** ** ** ** **

BEFORE: CLAYTON, LAMBERT, AND VANMETER, JUDGES.

VANMETER, JUDGE: Appellants[1] appeal from the Harlan Circuit Court's Order granting Magnum Hunter Production, Inc.'s ("Magnum") motion to dismiss Counts I and IV of their jointly filed Complaint. Finding no error, we affirm.

Appellants leased natural gas production rights on their property in Harlan County to Daugherty Petroleum, Inc., now operating as Magnum, pursuant to two leases entered in 2004. The leases called for royalty payments of "one-eighth of the market price at the well for gas sold or gas so used from each well off the premises[.]" The two leases differ in the length of the primary term: one, entered into on October 30, 2004, has a primary term of one year; the second, entered into on May 7, 2004, has a primary term of three years. Both leases provide that they shall remain in effect "as long thereafter as oil, gas, casing-head gas, casing-head gasoline or any of this is produced from said leased premises[.]" Appellants alleged in the Complaint, in part, that Magnum breached the leases by deducting the costs it incurred in gathering, compressing, and treating the extracted gas prior to calculating the value from which it paid Appellants a one-eighth royalty (Count I). The Complaint further alleged that both leases have terminated due to a lack of production in "paying quantities" at the wells (Count IV). Magnum moved the court to dismiss Counts I and IV on the basis that each count failed to state a claim for relief under Kentucky law. The court dismissed those counts, and pursuant to

[1] Nobe Baker, individually and as Administrator of the Estate of Joann Baker; Colene Jackson Wickline; Lillie Jackson; Lowell Jackson; Geneva Lee Jackson; Jerold Jackson; Virginia L. Jackson; Merle Jackson; Louellen Jackson; Harold Jackson; Sandra Jackson; Carolyn Ruth J. Knuckles; Charles Knuckles; Sue Carol J. Farley; and Anthony Farley.

CR[2] 54.02 designated the Order final and appealable without any just reason for delay. This appeal followed.

For purposes of a motion to dismiss for failure to state a claim, we assume the material facts alleged in the complaint are true. *Fox v. Grayson*, 317 S.W.3d 1, 6 (Ky. 2010) (citation omitted). Therefore, the trial court should only grant such a motion if "'it appears the pleading party would not be entitled to relief under any set of facts which could be proved[.]'" *Id*. (citation omitted). Since no facts are in dispute on review of a motion to dismiss, we owe no deference to the trial court's determination and review the legal issues *de novo*. *Id*. (citation omitted).

On appeal, Appellants first argue the trial court erred by dismissing Count I of the Complaint because Magnum breached the terms of the leases by deducting gathering, compression and treatment costs prior to calculating royalty payments. We disagree.

Federal courts sitting in diversity actions have recently addressed this issue and held that Kentucky follows the "at-the-well" rule, which permits a lessee to deduct the costs of gathering, compression and treatment prior to determining the market value of the gas before apportioning the appropriate royalties. *See Poplar Creek Dev. Co. v. Chesapeake Appalachia, L.L.C.*, 636 F.3d 235 (6th Cir. 2011); *Appalachian Land Co. v. EQT Prod. Co.*, 2012 WL 523749 (E.D. Ky. Feb. 16, 2012); *Thacker v. Chesapeake Appalachia*, 695 F.Supp.2d 521 (E.D. Ky. 2010); *In re KY USA Energy, Inc.*, 448 B.R. 191 (Bankr. W.D. Ky. 2011). Appellants urge

[2] Kentucky Rules of Civil Procedure.

this court to not follow the federal precedent interpreting Kentucky law on this issue, and instead treat the phrase "market price at the well for gas" found within the leases as ambiguous, adhere to the rules of construction for ambiguous terms, and thereby afford the language its plain meaning. *See Oliver v. Louisville Gas & Elec. Co.*, 732 S.W.2d 509, 511 (Ky. App. 1987) (holding an oil and gas lease is subject to the same rules of construction as any contract).

"Market value at the well" is defined in Black's Law Dictionary as "[t]he value of oil or gas at the place where it is sold, minus the reasonable cost of transporting it and processing it to make it marketable." 1085 (9th ed. 2011). Kentucky law has adopted this definition, stating:

> the value at the wells shall be ascertained from the evidence of the market value after the oil has completed its journey through the channels of commerce and has been sold in the market. It is but a means adopted and prescribed to find the market value of the oil at the well where it was produced. There is seldom, if ever, a market at the place of production. The product must be carried to the markets. The value at the place of production is the selling price less the cost of transportation to the place of sale.

Cumberland Pipe Line Co. v. Commonwealth, 228 Ky. 453, 463, 15 S.W.2d 280, 284 (1929). We find the phrase "market price at the well for gas" to be unambiguous, and therefore hold the leases provide that Magnum may deduct reasonable costs of transportation and processing prior to calculating market value from which to pay out the royalties.

Appellants also argue that gathering, compression and treatment costs should not be considered transportation and processing costs as defined in the leases. We disagree. *Poplar Creek* addressed this issue and held that gathering, compression and treatment costs were indistinguishable from transportation costs. 636 F.3d at 244. The Court noted that both gathering and compression costs are necessarily incurred prior to transporting the natural gas, and treatment costs increase the value of the gas at the market. *Id*. The Court held that under the definition of "market value at the well" expressed in *Cumberland Pipe Line*, gathering, compression and treatment costs are to be deducted from the market price in order to determine the gas's value at production. *Poplar Creek*, 636 F.3d at 244. In line with that reasoning, here, those costs were appropriately deducted in accordance with the leases' language stating that royalties will be paid on the "market value at the well." As a result, the trial court did not err by dismissing Count I of the Complaint.

As their final point on appeal, Appellants maintain that if this court interprets the leases to permit royalties to be paid after the deduction of transportation costs, then by definition the wells are not producing in "paying quantities" at the wellhead for purposes of extending the terms of the leases beyond their primary terms. We disagree.

Each lease's primary term has expired and therefore they remain in effect under the clause extending the leases "as long as either oil or gas is being produced from the wellhead." Appellants concede that gas is being produced and that they

are receiving royalty payments on said production, but nonetheless assert that gas is not being produced in "paying quantities" since it must be gathered, compressed and treated prior to its sale.

We note that the leases do not mention the term "paying quantities;" rather, the leases provide that they are to be extended so long as gas is produced. The term "paying quantities" as used in an oil and gas lease, with respect to production at a wellhead, has been held to mean "such quantities as are susceptible of division between the parties and as will yield a royalty to the lessor that justifies the occupancy of and interference with his lands by the operations." *Warfield Nat. Gas Co. v. Allen*, 248 Ky. 646, 654, 59 S.W.2d 534, 538 (1933). Here, a sufficient amount of gas is being produced at the wellheads to pay Appellants a royalty. Therefore, we decline to award any merit to Appellants' argument. Accordingly, the trial court did not err by dismissing Count IV of the Complaint.

The Order of the Harlan Circuit Court is affirmed.

ALL CONCUR.

BRIEFS FOR APPELLANTS:

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