IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF ARKANSAS
WESTERN DIVISION

CONNIE JEAN SMITH, individually and on behalf of all others similarly situated,	)	
Plaintiff,	)	
v.	)	Case No. 4:14-cv-435-BRW
SEECO, INC., n/k/a SWN PRODUCTION (ARKANSAS), LLC; DESOTO GATHERING COMPANY, LLC; SOUTHWESTERN ENERGY SERVICES COMPANY; and SOUTHWESTERN ENERGY COMPANY,	)	
Defendants.	)	

MEMORANDUM OF LAW IN SUPPORT OF DEFENDANTS' SECOND MOTION FOR PARTIAL SUMMARY JUDGMENT

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INTRODUCTION

This case is ripe for the Court to address a second issue which Plaintiff concedes is a central legal point under her lease. Resolving it will greatly focus our trial.

The lease states that SWN Production may deduct, before paying royalties, "all reasonable gathering, transportation, treatment, compression, processing and marketing costs that are incurred by Lessee in connection with the sale of such gas." The Court has ruled, as a matter of law and undisputed fact, that SWN Production "incurred costs under the meaning of the lease," rejecting the argument that SWN Production was somehow never obligated to pay for the post-production gathering services that DeSoto performed over the past decade. Dkt. #111 at 4. There now is a second related point for decision.

Equally unsupported is Plaintiff's argument that SWN Production is barred from deducting all post-production costs it incurred to the extent the amounts it was obligated to pay exceed *DeSoto's* "actual costs." Dkt. #1 (Complaint ¶26). As with the "incurred" issue, Plaintiff's position has no basis in the lease's text, which allows SWN Production to deduct its incurred costs for gathering services. The lease makes no distinction between costs that it incurs to affiliates versus to non-affiliates. Rather, the lease requires only that the costs incurred be "reasonable." Nor can Plaintiff rely on the "prudent operator standard" under Arkansas law to write new terms into her lease. Contrary to Plaintiff's position, neither the lease nor the prudent operator standard limits SWN Production's right to deduct costs to the operating or out-of-pocket costs of the service provider, whether it be Desoto or another vendor.

This issue is ripe for summary judgment, on a question of law that will focus this case as it nears trial in March 2016. Plaintiff has stated unequivocally that whether SWN Production is permitted to deduct gathering costs that include a profit charged by DeSoto is a question of law. Dkt. #100 (Pl.'s Reply to Defs.' Brief on Certified Questions at 1-2) ("[T]hese are *legal issues* that must be resolved in this case.") (emph. added). Given the Court's ruling that SWN Production incurs the gathering costs, and Plaintiff's concession that SWN Production and DeSoto are separate companies, and there is no veil-piercing issue in this case, there is no basis to prohibit SWN Production from deducting incurred costs simply because they exceed DeSoto's out-of-pocket expenses or provide a rate of return on DeSoto's billion-dollar investment in its gathering system.

This motion only concerns one issue: whether, under the terms of the lease, SWN Production may deduct the entire costs incurred for gathering services, or whether it is prohibited from deducting that portion of SWN Production's incurred costs that represent a return, if any, that DeSoto included in its charges.

FACTUAL BACKGROUND

1. To Develop this Area, SWN Production Hires DeSoto for Gathering Services.

Before 2004, little if any natural gas was produced from the Fayetteville Shale. Despite the risk, SWN Production was the first company to commit to developing this area, leasing over 400,000 acres of mineral rights before the first well was drilled. Defs.' Statement of Undisputed Material Facts ("SMF") ¶1. Today, SWN Production has thousands of gas wells in the Fayetteville Shale, has distributed millions in royalties, and has created hundreds of quality jobs in the state. Defs' SMF ¶2.

Recovery of natural gas not only requires securing mineral rights, but building infrastructure to transport gas from the wellhead to market. Each well must be connected to a gathering system, which is a large network of various smaller pipelines that ultimately connect with larger interstate pipelines. *Id.* ¶3.

SWN Production hired its affiliate DeSoto to provide gathering, compression, and treating services in the Fayetteville Shale, where Plaintiff's tract is located. DeSoto was willing to commit major capital to build a system with thousands of miles of pipe, compressors, dehydrators, and other facilities. To date, DeSoto has spent more than $1.2 billion in capital expenditures and operating costs on its gathering system. *Id.* ¶4. DeSoto's system serves not only SWN Production, but other major oil-and-gas producers like BP, XTO, BHP Billiton, and Chesapeake. *Id.* ¶5. In fact, these non-affiliated producers paid DeSoto over $400 million for gathering and treating services from 2012-14. *Id.* ¶6.

DeSoto provides gathering and compression services to SWN Production under a gathering contract—the Dedicated Field Services Agreement, as amended. *Id.* ¶7. Under the Agreement, DeSoto must accept the gas at receipt points near SWN Production's wells and deliver it at much higher pressures to delivery points into interstate pipelines. *Id.* ¶8. In consideration for these and other services, SWN Production is contractually obligated to pay DeSoto fees based on metered volumes of gas. *Id.* ¶9.

What DeSoto charges SWN Production is typical of rates charged in the Fayetteville Shale, and often considerably lower. For example, Plaintiff received royalties from non-party producer BHP, which produces gas from the same 30 acres of her land at

issue. Ex. 8 (K. Pearson Decl. ¶53). The gas is gathered for BHP by non-affiliate Crestwood, pursuant to a gathering contract. *Id.* Plaintiff's check statements from BHP show that the fees deducted from her royalties by BHP for gathering, treatment, compression, and fuel range from $0.84 to $1.07/Mcf. Ex. 8 ¶54; Ex. 13 (C. Smith Dep. Ex. 1, CS-0000180); Ex. 14 (C. Smith Dep. Ex. 3). By contrast, SWN Production's deductions from her royalties for the same services ranged from $0.75 to $0.79/Mcf for a comparable period: as much as 30% lower. Ex. 8 (K. Pearson Decl. ¶54). Further, SWN Production gets a better deal from DeSoto for gathering services than from other gathering companies it does business with, such as Arkansas Midstream Gas Services. *Id.* ¶52. DeSoto charges SWN Production the same or less than what DeSoto charges other, non-affiliated production companies in the Fayetteville Shale. *Id.* ¶50.

2. Plaintiff Alleges SWN Production Improperly Deducts Affiliate "Profits."

Plaintiff entered into an oil and gas lease with SWN Production, effective June 20, 2005, for her acreage in the Fayetteville Shale. SMF ¶10. Her claims are largely based on the royalty clause, principally the last sentence:

> In consideration of the premises, lessee [*i.e.*, SWN Production] covenants and agrees: . . .
>
> 2. Lessee shall pay Lessor one-eighth of the proceeds derived from the sale of all gas (including substances contained in such gas) produced, saved, and sold by Lessee. Proceeds are defined as the actual amount received by the Lessee for the sale of said gas. In calculating the proceeds derived from the sale of gas produced, saved, and sold by Lessee, ***Lessee shall be entitled to deduct all reasonable gathering, transportation, treatment, compression, processing and marketing costs that are incurred by lessee in connection with the sale of such gas*.**

Id. ¶11, Ex. 12 ¶2 (emph. added). The clause allows SWN Production to deduct certain incurred post-production costs, so long as they are "reasonable." The lease has no limits on who may perform the required services—whether SWN Production itself, an affiliate, or an unaffiliated company. SMF ¶12-13.

Plaintiff claims a "scheme" to deduct "inflated" and "unreasonable" costs "from amounts owed to royalty owners." Dkt. #1 (Complaint ¶1). She says that SWN Production's deductions for post-production services performed by an affiliate (DeSoto) are prohibited because the fees are "not 'cost-of-service' based" and "marked-up to provide additional revenue and a profit and/or return on invested capital to DeSoto Gathering . . . ." *See id.* ¶26. SWN Production paid gathering fees that "greatly exceeded DeSoto Gathering's actual costs," she alleges, and then "passed these inflated fees along to Plaintiff and the Class by deducting them from royalty payments." *Id.*

In the end, there is no genuine dispute on this core issue: SWN Production is not prohibited from deducting costs incurred simply because they are from an affiliate, or they are more than the vendor's "actual costs" or they provide the vendor with return on its investment. Defendants are entitled to judgment as a matter of law.

STANDARD OF REVIEW

The Court is well familiar with the summary-judgment standards. Summary judgment is proper "if the movant shows that there is no genuine dispute as to any material fact and the movant is entitled to judgment as a matter of law." FED. R. CIV. P. 56(a). The "facts must be viewed in the light most favorable to the nonmoving party only if there is a genuine dispute as to those facts." *Torgerson v. City of Rochester*, 643 F.3d

1031, 1042 (8th Cir. 2011) (en banc) (quotes omitted). "To avoid summary judgment, Plaintiff must do more than simply show that there is some metaphysical doubt as to the material facts and must come forward with specific facts showing that there is a genuine issue for trial." *Id*.

ARGUMENT AND AUTHORITIES

Plaintiff's lease does not prohibit SWN Production from deducting costs it incurs that include a return for the service provider. Her position requires ignoring (and rewriting) the lease's plain terms. In interpreting this contract, the Court will give effect to the intent of the parties, considering the meaning of the words used as they are taken and understood in their ordinary and plain meaning. *Smith v. Arrington Oil & Gas, Inc.*, 664 F.3d 1208, 1212 (8th Cir. 2012) (Arkansas law). Given the lease's terms, the undisputed legal separation of DeSoto, and cases addressing this very issue, SWN Production is entitled to a ruling as a matter of law that it is not prohibited from deducting gathering, treating, and compression costs it incurs that include a rate of return for the service provider regardless of whether it is an affiliated or unaffiliated company.

I. The Lease Does Not Limit Deductions to a Vendor's "Actual Costs."

Plaintiff's position that SWN Production may only deduct DeSoto's actual costs that are based on DeSoto's "cost-of-service" has no support in the lease. *See* Dkt. #1 at ¶¶26, 30, 38. The royalty clause limits deductions to *SWN Production's* costs—not the vendor's costs. Ex. 12 (Pl.'s Lease §2) ("Lessee shall be entitled to deduct all reasonable gathering, transportation, treatment, compression, processing and marketing costs that are incurred *by Lessee*") (emphasis added). Despite conceding that SWN Production and

DeSoto are separate companies and there is no issue of piercing the corporate veil in this case, Plaintiff is again disregarding the companies' corporate separateness, ignoring the lease's plain terms, and trying to rewrite the parties' bargain.

Further, courts confronting this very question have held that affiliate and non-affiliate charges are not to be treated differently, even when the charges include a return for the vendor.

The New Mexico Supreme Court considered whether a lease without any terms relating to affiliate transactions (like the lease here) prohibited the lessee from deducting post-production costs charged by an affiliate that exceeded "actual costs." *ConocoPhillips Co. v. Lyons*, 299 P.3d 844, 860-61 (N.M. 2012). The court held there was no evidence that the drafters of the lease form "intended to treat affiliated and non-affiliated transactions differently when deducting post-production costs," and found "no support for [the plaintiff's] contention that deductions for affiliated transactions must be limited to actual costs." *Id.* at 861. Accordingly, it ruled that while "deductions used in calculating Lessee's royalty obligations must be reasonable," they are not limited to the affiliate's actual costs. *Id.* The same result should hold here. The lease requires that SWN Production's incurred costs are "reasonable" and they are not limited to DeSoto's or any vendor's actual costs, since those words appear nowhere in the lease. *See* Dkt. #1 at ¶26.

Likewise, a federal court rejected the same argument Plaintiff makes here: that a producer is not entitled to deduct a cost that includes a return for an affiliate. *See In re Aurora Oil & Gas Corp.*, 460 B.R. 470, 494-95 (Bankr. W.D. Mich. 2011). The plaintiff claimed that even though the lease's royalty provision permitted the lessee (Aurora) to

deduct its "cost incurred," the deductions improperly included "intercompany profit," because its billings were from two affiliates. *Id.* In an attempt to overcome the lack of support in the language of the lease for its position, the plaintiff pointed to accounting practices in joint operating agreements, where "some joint working interest owners agree to reduce charges by 20% to take into account the profit component included within their market-rate billings." *Id.* The court rejected the argument:

> While joint venturers may agree to this limitation, and while this limitation may be reasonable, *there is no indication in the record that the parties bargained for this reduction*. Moreover, a subsidiary is, in the court's view, a third party, a distinct though related entity. *In the absence of contractual language or fraud requiring the court to disregard the corporate veil, the court will not re-cast the parties' bargain* simply because, in the very different setting of joint operating agreements, some commercial actors have struck that bargain as a matter of convenience and accommodation.

Id. (emphasis added). The court held that the lessee "shall be permitted to deduct the *full amount* of the [affiliates'] charges, *without regard to the profit component*, if any, included therein." *Id.* (emphasis added). The court similarly rejected a challenge to costs for compression and treating: "If Aurora incurred the costs, even if they were charged by its subsidiary, and even if Aurora might eventually derive a benefit from those charges, it still incurred the costs. [The plaintiff] did not bargain for any special protection with respect to the charges for CO_2 and compression." *Id.* at 487.

Here, as in *Lyons* and *Aurora*, the lease says nothing about deductions for affiliate services or limiting deductions to a service provider's "actual costs." Further, as was true in *Aurora*, there is no issue of piercing the corporate veil in this case. Dkt. #104 at 1-2.

Plaintiff's lease stands in marked contrast to leases that do limit a lessee's right to deduct costs for services provided by an affiliated company. For example, in a case that Plaintiff has cited, Dkt. #104 at 13, a Texas court considered a lease that permitted royalty deductions only if the costs were "charged at arms-length by an entity unaffiliated with Lessee." *Trinity Valley School v. Chesapeake Operating, Inc.*, 2015 WL 4945911, at *4 (N.D. Tex. 2015). The lease in that case further provided that cost deductions "shall never exceed $0.75 per Mcf." *Id.* Here, unlike the lease in *Trinity Valley*, which addressed costs charged by an affiliated versus non-affiliated entities, Plaintiff's lease has no limitations.

Not only is Plaintiff's argument wrong based on the lease, but it is also illogical. The Court has held that the issue remaining in the case is whether the costs incurred were reasonable. And Plaintiff's own expert witness, Daniel Reineke, admits that if a non-affiliated company charged the same rate DeSoto charges for the same gathering service, that it would be a reasonable cost that SWN Production can deduct in full. See Ex. 15 (Reineke Dep. at 92-93, 226). There is simply no reason why a rate that Plaintiff's own expert admits would be reasonable if charged by a non-affiliated company somehow becomes unreasonable when charged by an affiliate. Simply put, because SWN Production can pass through a cost that includes a profit or return for a non-affiliated service provider, there is no basis in the lease to treat costs incurred with respect to an affiliated service provider differently.

Moreover, Plaintiff's entire argument that the gathering and treatment fees are "inflated and unreasonable" because they "are not based on cost-of-service," (*See* Dkt. #1

at ¶¶26, 30, 38) is based on a fundamentally flawed premise—that cost-of-service excludes any return or profit whatsoever and is limited solely to what Plaintiff calls "actual costs." Even assuming for the purpose of this motion only that DeSoto was required to base its rate on a cost-of-service analysis, Arkansas courts have expressly held that "cost of service must include a fair return in order that the utility can maintain its financial integrity, attract new capital, and compensate the owners of the property for the risks involved." *Consumer Utilities Rate Advocacy Div. of Atty. Gen. Office v. Ark. Pub. Serv. Comm'n*, 184 S.W.3d 36, 41 n.1 (Ark. Ct. App. 2004); *see also Bryant v. Ark. Pub. Serv. Comm'n*, 941 S.W.2d 452, 455 n.1 (Ark. Ct. App. 1997). And this makes perfect sense. If a company's cost-of-service did not include any return, it would not be able to attract the capital necessary to expand or improve its facilities over time. Nor would it be able to maintain its financial integrity.

Thus, Plaintiffs entire argument that the portion of the fees that SWN Production pays to DeSoto that SWN Production shares with the royalty owners are inflated and improper because they might include a return to DeSoto is wholly incorrect because under Arkansas law, the cost of service includes a "fair return." Any suggestion by Plaintiff that SWN Production can only deduct part of the cost it incurs based on DeSoto's cost-of-service is simply wrong as a matter of the lease and Arkansas law.

II. Arkansas Law Does Not Permit Plaintiff to Imply Terms to Add New Duties.

To the extent Plaintiff argues that the prudent-operator standard, Ark. Code §15-73-207, somehow creates *implied terms* in the lease that prohibit SWN Production from deducting costs that include DeSoto's profit, her argument fails.

Section 15-73-207(b)(2) states that a mineral lessee must "develop and operate the leased mineral estate as a prudent operator for the mutual benefit of the mineral lessor and lessee." Of course, this standard, which requires consideration of the interests of *both* the lessor and lessee, is antithetical to a fiduciary obligation, which would require the lessee to exalt the interests of the lessor over its own. Rather, this statute codifies the commonly-accepted "prudent operator" standard as the "test for determining whether a lessee has breached any of the implied covenants" in an oil and gas lease. *SEECO, Inc. v. Hales*, 22 S.W.3d 157, 170 (Ark. 2000). The prudent-operator standard is "merely an oil-and-gas specific version of the duty of good faith and fair dealing inherent in all contracts." *Wallace v. XTO Energy, Inc.*, 2014 WL 4202536, at *4 (E.D. Ark. 2014). A duty of good faith is not to be "construed to give rise to new obligations not otherwise contained in the contract's express terms." *U.S. v. Basin Elec. Power Co-Op.*, 248 F.3d 781, 796 (8th Cir. 2001); *see also Hill v. Sw. Energy Co.*, 2013 WL 5423847, at *3 (E.D. Ark. 2013) (dismissing claim for violation of the covenant of good faith and fair dealing because "the parties' lease *simply does not address* frack waste fluid from drilling on non-neighboring land.") (emphasis added). Additionally, "the obligation to act in good faith does not create a cause of action for violation of that obligation." *Preston v. Stoops*, 285 S.W.3d 606, 609-10 (Ark. 2009).

Plaintiff's lease does not restrict *who* SWN Production may select to do post-production services (an affiliate or non-affiliate) or *what* pricing it must accept—rather, it requires only that its deductions be "reasonable" and "incurred." Ex. 12 (Pl.'s Lease §2). The details are left to SWN Production to decide as producer. When a contract provides a

party with discretion, it is "inappropriate to use the implied covenant to, in effect, rewrite the bargained-for terms of the contract by limiting the . . . party's discretion." *Basin Elec.*, 248 F.3d at 797. That is precisely what Plaintiff is attempting here by arguing that the lease or Arkansas law prohibits the deduction of affiliate profits where the lease has no such restrictions.

Moreover, section 15-73-207(b) expressly limits the prudent operator standard, including the language "for the mutual benefit of the mineral lessor and mineral lessee" to the "development and operation of *the mineral estate*," *i.e.*, to the operator's activities regarding the leased land. There is no case holding the "prudent operator" or "mutual benefit" standard of conduct would apply to an oil and gas operator's decisions about off-lease activities, such as gathering and compression systems, treating facilities, processing plants, pipelines, or marketing facilities. Absent a specific lease provision, nothing in that standard could require lessees to provide or obtain post-production services for lessors without any return included as part of the cost.

Finally, to the extent Plaintiff argues *Atlantic Richfield Co. v. Long Trusts*, 860 S.W.2d 439, 444-45 (Tex. App. 1992) creates some sort of "duty not to profit" the argument is misplaced because *Long Trusts* does not involve duties owed to royalty owners at all and because it relied on a fiduciary duty that does not exist under Arkansas law.

First, *Long Trusts* involved a contractual principal-agent relationship between working interest owners—it did not involve lessors or royalty owners. The Court held that a contract between an operator and a working-interest owner that allowed the

operator to sell the working-interest owners' share of the produced gas "for the best price obtainable in the area" created a fiduciary, principal-agent relationship between the operator and working-interest owner. The Court held that because of the fiduciary nature of that relationship, the operator could not profit, through use of a subsidiary, at the principal's expense. Consequently, the source of the duty in Long Trusts was the *fiduciary* relationship running from an agent to its principal. *Id.* at 455.

Arkansas law expressly provides that lessees like SEECO do not owe any fiduciary relationship to royalty owners. Section 15-73-207(a) of the Arkansas Code expressly negates a fiduciary relationship, stating that "a mineral lessee under an oil and gas lease does not owe a fiduciary duty or a fiduciary obligation to a mineral lessor."

Indeed, *Long Trusts* distinguished fiduciary relationships, like the agency relationship that ARCO had with Long Trusts, from non-fiduciary relationships like those involving lessors and lessees. It noted that "the present [*Long Trusts*] case does not concern royalty owners." The court explained that "[a] lessee . . . is *not* an agent with respect to the sale of the lessor's gas because the lessor has no gas to sell. An oil and gas lease conveys title to the gas in place, subject only to the contractual obligation to pay royalty on gas that is produced." *Id.* at 445 (emph. added). An Arkansas oil and gas lease has the same effect: "The gas lease constitutes a present sale of all of the gas in place at the time such lease is executed; and as the gas leaves the well head, the entire ownership thereof is in the lessee, none being reserved in the lessor." *Hilliard v. Stephens*, 637 S.W.2d 581, 583 (Ark. 1982).

CONCLUSION AND PRAYER

For these reasons, Defendants request that the Court grant this Motion for Partial Summary Judgment and find as a matter of law that SWN Production is not prohibited from deducting costs incurred simply because they include some component of profit or return for DeSoto, as well as all other relief to which Defendants are entitled.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I certify that, on January 4, 2016, this brief was filed electronically through the Court's CM/ECF system and served on Plaintiff by transmission of the Notice of Electronic Filing through the Court's CM/ECF system to Plaintiff's counsel of record.

/s/R. Paul Yetter
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