



Money Talks: An Overview of Recent Production Deduction Cases

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Today's Presenter



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Today's Menu

- What are “post-production costs”?
- How did post-production costs become an issue?
- How do the oil and gas producing states handle this issue?
 - Any recent changes?



A Guiding Principle?

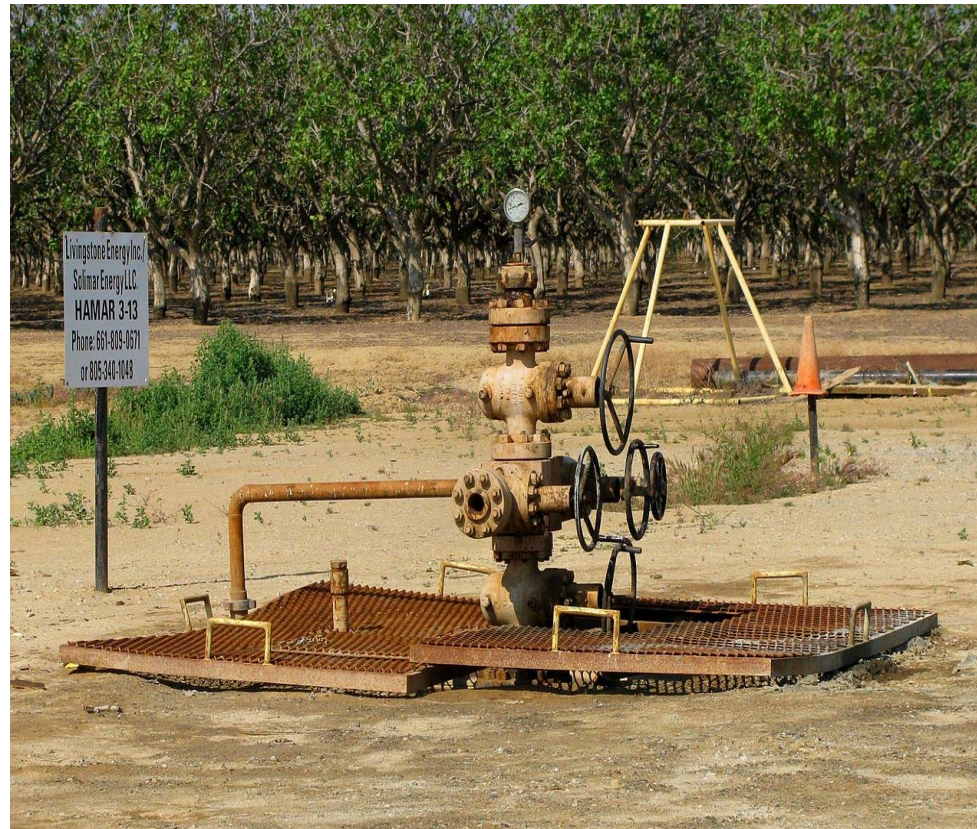
- No matter what they're talking about, they're talking about money
 - Todd's Second Political Principle

Defining Costs

- Most courts distinguish between:
 - Costs of production
 - Costs subsequent to production
- Royalty interests (whether lessor's royalty, ORRI, or NPRI) are free of the costs of “production”
- But, where does “production” phase stop and when does “post-production” phase begin?



“At the Wellhead”





Two Approaches

- Capture-and-hold
 - Costs of transporting, compressing, and processing or cleaning are charged proportionately against royalty interest where gas is sold “downstream” from the lease
- Marketable product
 - Lessee has implied duty to lessor to make production marketable and “production” does not end until the product is marketable



WEST VIRGINIA



West Virginia

- W. VA. CODE § 22-6-8 provides that leases with flat-rate well royalty must be converted to “1/8 at the wellhead” for new or reworked wells
- Can the lessee deduct post-production costs and use the net-back method to determine “1/8 at the wellhead”? Or does *Tawney* prohibit such deductions?
 - *Leggett v. EQT Prod. Co.*, 2016 U.S. Dist. LEXIS 7536 (N.D.W. Va., Jan. 22, 2016)



West Virginia

- *Wellman v. Energy Resources, Inc.*, 210 W. Va. 200, 557 S.E.2d 254 (2001)
- *Tawney v. Columbia Nat. Res., L.L.C.*, 219 W. Va. 266, 633 S.E.2d 22 (2006)



West Virginia

- *Wellman v. Energy Resources, Inc.*, 210 W. Va. 200, 557 S.E.2d 254 (2001)
 - If an oil and gas lease provides for a royalty based on proceeds received by the lessee, unless the lease provides otherwise, the lessee must bear all costs incurred in exploring for, producing, marketing, and transporting the product to the point of sale.

West Virginia

- *Wellman v. Energy Resources, Inc.*, 210 W. Va. 200, 557 S.E.2d 254 (2001)
 - If an oil and gas lease provides that the lessor shall bear some part of the costs incurred between the wellhead and the point of sale, the lessee shall be entitled to credit for those costs to the extent that they were actually incurred and they were reasonable. Before being entitled to such credit, however, the lessee must prove, by evidence of the type normally developed in legal proceedings requiring an accounting, that he, the lessee, actually incurred such costs and that they were reasonable.



West Virginia

- *Tawney v. Columbia Nat. Res., L.L.C.*, 219 W. Va. 266, 633 S.E.2d 22 (2006)
 - Language in an oil and gas lease that is intended to allocate between the lessor and lessee the costs of marketing the product and transporting it to the point of sale must expressly provide that the lessor shall bear some part of the costs incurred between the wellhead and the point of sale, identify with particularity the specific deductions the lessee intends to take from the lessor's royalty (usually 1/8), and indicate the method of calculating the amount to be deducted from the royalty for such post-production costs.





West Virginia

- *Tawney v. Columbia Nat. Res., L.L.C.*, 219 W. Va. 266, 633 S.E.2d 22 (2006)
 - Language in an oil and gas lease that provides that the lessor's 1/8 royalty (as in this case) is to be calculated “at the well,” “at the wellhead,” or similar language, or that the royalty is “an amount equal to 1/8 of the price, net all costs beyond the wellhead,” or “less all taxes, assessments, and adjustments” is ambiguous and, accordingly, is not effective to permit the lessee to deduct from the lessor's 1/8 royalty any portion of the costs incurred between the wellhead and the point of sale.



West Virginia

- On Nov. 17, 2016, the West Virginia Supreme Court of Appeals answered Judge Stamp's certified questions
 - Essentially, the court said “NO” to post-production-deduction question and “YES” to the does-*Tawney*-apply question

West Virginia

- The Court's answers in detail:
 - When W. Va. Code § 22-6-8(e) states that landowner must receive a royalty of not less than $\frac{1}{8}$ of the amount realized "at the wellhead," royalty is not to be diluted by costs and losses incurred downstream from wellhead before marketable product is rendered





West Virginia

- The Court's answers in detail:
 - W. Va. Code § 22-6-8(e) also requires that the lessee cannot deduct from the statutory 1/8 royalty “any expenses that have been incurred in gathering, transporting, or treating the oil or gas after it has been initially extracted, any sums attributable to a loss or beneficial use of volume beyond that initially measured, or any other costs that may be characterized as post-production”



West Virginia

- But, the Court's decision was split 3-2
 - *See Leggett v. EQT Prod. Co.*, 2016 WL 6835732 (W. Va. Nov. 17, 2016)
 - Justice Benjamin wrote the opinion, joined by Justices Davis and Workman
 - Justices Loughry and Ketchum dissented
 - *Tawney* shouldn't apply because this case involves statutory, not contract, interpretation



West Virginia

- A curious thing happened on the way to the courthouse
 - On May 10, 2016, Justice Benjamin was defeated for re-election to the West Virginia Supreme Court of Appeals
 - Beth Walker elected as his replacement
 - On Jan. 27, 2017, the Court granted EQT's request for a rehearing



West Virginia

- *Leggett v. EQT Prod. Co.*, 800 S.E.2d 850 (W. Va. 2017)
 - W. VA. CODE § 22-6-8 provides that leases with flat-rate well royalty must be converted to “1/8 at the wellhead” for new or reworked wells
 - Can the lessee deduct post-production costs and use the net-back method to determine “1/8 at the wellhead”? Or does *Tawney* prohibit such deductions?
 - Certified question from federal district court



West Virginia

- In *Leggett II*, the Court held that the flat-rate statute permits “net-back” method of calculating royalty, even though *Tawney* generally disallows such deductions under lease language
 - In the majority, the two dissenters and the new justice, plus one other justice concurred
 - One justice dissented



OHIO

Ohio

- *Lutz v. Chesapeake Appalachia, L.L.C.*, 71 N.E.3d 1010 (Ohio 2016)
 - Putative class action
 - Federal district court certified question
 - “Does Ohio follow the ‘at the well’ rule . . . or does it follow some version of the ‘marketable product’ rule . . . ?”
 - Ohio S.Ct.: OGL is a contract subject to traditional rules of contract construction
 - Specific lease language controls
 - If ambiguous, court needs extrinsic evidence; if not, district court can interpret w/o assistance
 - Declined to answer and dismissed case





COLORADO

Colorado

- *Lindauer v. Williams Production RMT Co.*, 381 P.3d 378 (Colo. App. 2016)
 - Posed two unanswered questions under Colorado law relating to post-production cost deductions
 - Colorado Supreme Court declined to review this decision in Sept. 2016
 - An earlier Colorado case, *Garman v. Conoco, Inc.*, 886 P.2d 652 (Colo. 1994), served as a basis for *Wellman* and *Tawney*



Colorado

- *Lindauer* Question No. 1:
 - Must costs incurred to transport natural gas to market beyond the first commercial market “enhance” the value of the gas, such that the actual royalty revenue increases, to be deductible?

Colorado

- *Lindauer* Question No. 2:
 - If the enhancement test applies to such transportation costs, must the enhancement, and the reasonableness of the costs, be shown on a month to month basis?



Colorado

- *Lindauer Answer No. 1:*
 - No, transportation costs beyond the first commercial market need not enhance the value of the gas, such that actual royalty revenues increase in proportion to those costs, to be deductible from royalty payments
- No need to reach the second question





OTHER STATES

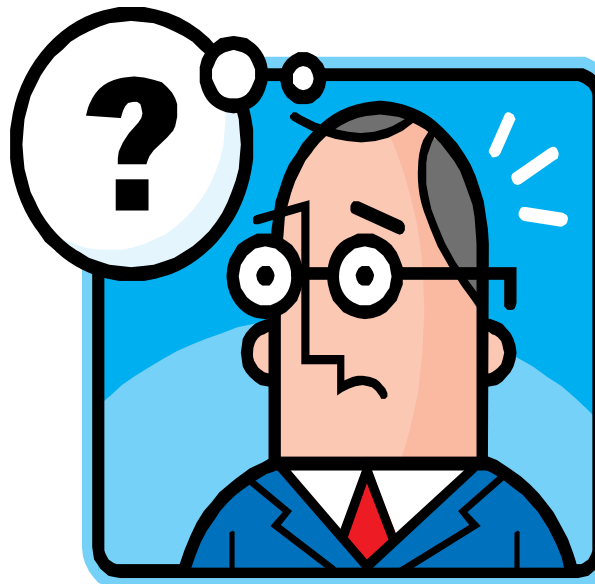
Other States

- Texas
 - *Chesapeake Exp., L.L.C. v. Hyder*, 483 S.W.3d 870 (Tex. 2016)
- Pennsylvania
 - *Kilmer v. Elexco Land Servs., Inc.*, 990 A.2d 1147 (Pa. 2010)
- North Dakota
 - *Bice v. Petro-Hunt, L.L.C.*, 768 N.W.2d 496 (N.D. 2009)
- New Mexico
 - *Creson v. Amoco Prod. Co.*, 10 P.3d 853 (N.M. App. 2000)
- Oklahoma
 - *Mittlestadt v. Santa Fe Minerals, Inc.*, 954 P.2d 1203 (Okla. 1998)
- Kansas
 - *Sternberger v. Marathon Oil Co.*, 894 P.2d 788 (Kan. 1995)





QUESTIONS?



Thank You



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