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Chapter 9

The Shale Pay: Recent Trends in Royalty Claims and Emerging Issues Surrounding Wet Gas and Natural Gas Liquids

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Synopsis

In recent years, there have been a number of royalty disputes in state and federal courts in the Appalachian states, including Pennsylvania, Ohio, West Virginia, Virginia and Kentucky. Courts in these states have continued to develop their body of oil and gas law, addressing the proper royalty calculation under various lease forms and what constitutes the permissible scope of post-production cost deductions. Most recently, there has been an increase in class action royalty disputes, a significant and evolving area of law that raises issues regarding post-production cost deductions, allocation of these deductions, and affiliate transactions.

Additionally, in the last few years, when the industry has seen declining natural gas prices, there has been a strong focus on the production of "wet gas" or liquid rich gas in the Appalachian Basin region. Wet gas contains constituents that, if separated, have substantial independent and stand-alone marketability and value. Given the natural gas industry's intent to capture the additional value that wet gas has in the marketplace, royalty litigation in the Appalachian Region will likely naturally evolve and begin to focus on the calculation of royalties for wet gas.

§ 9.01. Recent Trends in Appalachian Royalty Cases.

[1] — Introduction to the Law on Royalty Calculation.

When calculating royalties paid under an oil and gas lease, there are two approaches to the treatment of post-production cost deductions from those royalty payments. Jurisdictions that have considered the issue are split. The majority of jurisdictions, including Pennsylvania, that have developed a body of law regarding this issue calculate royalties by applying the netback method of calculating royalties. The netback method follows the "at the well" or "at the wellhead" rule, allowing the deduction of post-production costs after the gas reaches the wellhead.[1] With this method, both the lessor and the lessee share proportionately in the costs of post-production — the costs that allow the lessee to typically sell the gas at a higher price and the lessor to typically collect a higher royalty payment. Generally, in these jurisdictions, post-production cost deductions are permitted where the oil and gas lease at issue contains reference to post-production costs or language to the effect of "at the well" or "at the wellhead."

The minority of jurisdictions that have ruled on post-production cost deductions follow the marketable product doctrine, which does not generally permit the deduction of most post-production costs from a lessor's royalty payment because the royalty is calculated based on the price of gas after it is in a marketable condition.[2] After the gas reaches that marketable condition, any subsequent post-production costs may be deducted. For ex-

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1 3-6 Williams & Meyers, *Oil and Gas Law*, § 645.2 (2014).

2 *Id*.

ample, courts in marketable product jurisdictions have found that the following language permits post-production cost deductions only after the gas is in a marketable condition : "gross proceeds received at the well," "market price at the well," "proceeds at the well," and "market value at the well."[3] West Virginia applies an extreme variation of the marketable product doctrine, the "point of sale" approach, where no post-production costs between the wellhead and the point of sale may be deducted from the royalty.[4] West Virginia only allows a narrow exception whereby deductions are permitted if the oil and gas lease at issue specifically identifies the deductions and the method for calculating those deductions.

[2] — Pennsylvania Law Regarding Royalty Calculation and the Deduction of Post-Production Costs.

Pennsylvania's Minimum Royalty Act (MRA), initially enacted in 1979 and amended recently in July 2013, guarantees all royalty owners of oil and gas leases at least a one-eighth royalty of any oil, natural gas, or gas recovered or removed from the leased property.[5] The MRA states that any oil and gas lease that does not include the minimum royalty will be escalated to include the one-eighth minimum royalty when the original state of any well drilled pursuant to such lease is altered.[6] The recent amendments to the MRA added certain royalty and royalty check stub responsibilities for interest owners of oil and gas leases. It added definitions for "check stub," "division order," "interest owner," and "McF," as well as creating detailed requirements for information that must be included on all check stubs or otherwise attached to the form of royalty payment.

Significantly, the MRA does not contain any language regarding the permissibility of post-production cost deductions from royalty payments. The MRA does not define post-production costs or explain how deductions of such may affect the guaranteed minimum royalty. However, in March 2010, the Pennsylvania Supreme Court began to fill that void by indicating

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3 Rogers v. Westerman Farm Co., 29 P.2d 887 (Colo. 2001); Wood v. TXO Prod. Corp., 854 P.2d 880 (Okla. 1992); Sternberger v. Marathon Oil Co., 894 P.2d 788 (Kan. 1995).

4 Estate of Tawney, 633 S.E.2d 22 (W. Va. 2006).

5 58 Pa. Stat. § 33 (2014).

6 *Id*.