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Chapter 22

Deduction of Post-Production Costs – An Analysis of Royalty Calculation Issues Across the Appalachian Basin

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Synopsis

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§ 22.01. Introduction.

Traditional royalty calculation analysis involved a determination of the physical point at which natural gas was to be valued for royalty purposes. Historically, a lease calling for a royalty based upon the value of production "at the wellhead" allowed the lessee to deduct the cost of transporting, compressing, treating, and processing natural gas to arrive at a wellhead value for purposes of calculating royalties. A minority view began to develop, however, which held that the lessee's implied covenant to market the gas requires the lessee to bear the costs of placing natural gas production in a marketable condition and thus to bear at least some post-production costs.[2]

In this chapter, these differing approaches have been analyzed in terms of whether the jurisdiction in question follows the "at the well" rule or the "marketable product" rule. The "at the well" rule holds that under most

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2 Patrick H. Martin and Bruce M. Kramer, 3-6 Williams & Meyers, *Oil and Gas Law*, § 645 (LexisNexis 2015) ("Williams & Meyers").

standard lease provisions, a royalty is only owed on "production," and production occurs when gas is captured at the wellhead. The lessee-operator is permitted to net-back all expenses incurred in processing, gathering, compressing, and transporting the gas to a marketplace, and the lessee can recoup all or its proportionate share of the commercial value the lessee adds to the gas after it is produced at the wellhead.[3]

Under the marketable-product rule, "production" is not viewed as being complete until the gas has been placed in the condition in which it can be sold (*i.e.*, "marketable"). Since "production" is the responsibility of the lessee, these costs fall to the lessee alone. Some jurisdictions hold that it is the lessee's obligation to bear all expenses necessary to put the natural gas in a marketable condition (such as dehydration, purification, and compression and gathering on the leasehold premises), but it is the obligation of the royalty owner to bear a proportionate share of the cost to transport the gas from the leasehold premises to the marketplace.[4] Additionally, some jurisdictions have read an implied covenant to market into every lease, regardless of its express terms, and hold that lessees have the obligation to bear not only all expenses required to put the gas in a marketable condition,[5] but also all expenses of transporting the gas to a viable marketplace.[6]

This chapter surveys the law governing royalty calculations within the Appalachian Basin states of Kentucky, Ohio, Pennsylvania and West Virginia. It addresses the majority "at the well" and minority "marketable product" rules, the origins and reasoning behind each rule, how each state has addressed the two rules to date, and how the issue might play out in states, like Ohio, that have yet to formally adopt one of the rules.

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3 *See*, *e.g*., Ramming v. Natural Gas Pipeline Co., 390 F.3d 366, 372 (5th Cir. 2004) (interpreting Texas law); Heritage Res., Inc. v. Nationsbank, 939 S.W.2d 118, 122 (Tex. 1996).

4 *See*, *e.g*., Mittelstaedt v. Santa Fe Minerals, Inc., 954 P.2d 1203 (Okla. 1998); Sternberger v. Marathon Oil Co., 894 P.2d 788 (Kan. 1995).

5 *See* Garman v. Conoco, Inc., 886 P.2d 652 (Colo. 1994).

6 *See*, *e.g*., Rogers v. Westerman Farm Co., 29 P.3d 887 (Colo. 2001); Savage v. Williams Prod. RMT Co., 140 P.3d 67 (Colo. Ct. App. 2005); Wellman v. Energy Res., Inc., 557 S.E.2d 254 (W. Va. 2001); Estate of Tawney v. Columbia Nat. Res., L.L.C., 633 S.E.2d 22 (W. Va. 2006).