How Low Can It Go? Post Production Expenses / Leasing Best Practices

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Background to Oil and Gas Royalty Payments

- What is an oil and gas "royalty"?
  - An oil and gas "royalty" is a share of production or a share of income from the oil and gas produced through an oil and gas well.
- Common Types of Royalty Interests
  - Royalty Interest Created by Oil and Gas Lease
    - An oil and gas lease will contain a royalty clause pursuant to which the lessee agrees to the pay the lessor a royalty.
  - Non-Participating Royalty Interest (NPRI)
    - Carved out of oil and gas mineral estate.
  - Overriding Royalty Interest (ORRI)
    - Carved out of a working interest in lease.

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Royalty Statements

- Disbursement Decimal
- Volume
  - Gas – MCF (1,000 cubic feet)
  - NGLs (plant products) – GAL (theoretical gallons)
  - Condensate (oil) – BBL (barrel – 42 US gallons)
- BTU Content (on some statements)
  - Measure of heating content
- Price
- Taxes
  - May categorize
- Deductions
  - May categorize
  - May not be shown if using work back method
- Gross Proceeds / Net Proceeds

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Calculation of Disbursement Decimal

- If a royalty owner’s land is included in a pooled unit the royalty owner will be paid on a decimal interest that is often referred to as the “disbursement decimal,” “payment decimal,” or “net revenue interest.”
- Typically surface acreage allocation.
- A royalty owner’s disbursement decimal can be calculated with the following information:
  - Acreage in the unit covered by royalty owner’s oil and gas lease;
  - Total acreage of the unit; and
  - Royalty percentage in the royalty owner’s oil and gas lease.

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Calculation of Oil and Gas Royalty Payments

- In addition to the disbursement decimal, the amount of royalty payment a royalty owner receives will depend on:
  - Volume reported
  - Price reported
  - Taxes; and
  - Deductions of Post-Production Costs.
- Post-production costs will be the focus of today's presentation.

Costs of Production vs. Post-Production Costs

- Costs of production are "the costs of producing the gas from below the ground and bringing it to the wellhead." *Lutz v. Chesapeake Appalachia, L.L.C.*, 148 Ohio St.3d 524, 525 (2016).
  - Drilling, completing, equipping, and producing.
- Royalties are paid free of costs of production.
- Post-production costs are "the costs incurred after the gas is produced at the wellhead before it is sold." *Id.*
  - These costs are incurred between the wellhead and the location where the gas is sold (the "point of sale").
- A royalty owner may be charged for a share of post-production costs.

Types of Post-Production Costs

- Post-production costs include:
  - Gathering
    - Some companies include other costs listed below under gathering on royalty statements.
  - Dehydration
    - Removal of water from the gas stream in order to meet pipeline specifications.
  - Compression
    - Large interstate transportation pipelines operate at pressures of 1,000 psig of more.
    - Gas may also be compressed at compressor station to enter higher pressure gathering lines.
  - Separation

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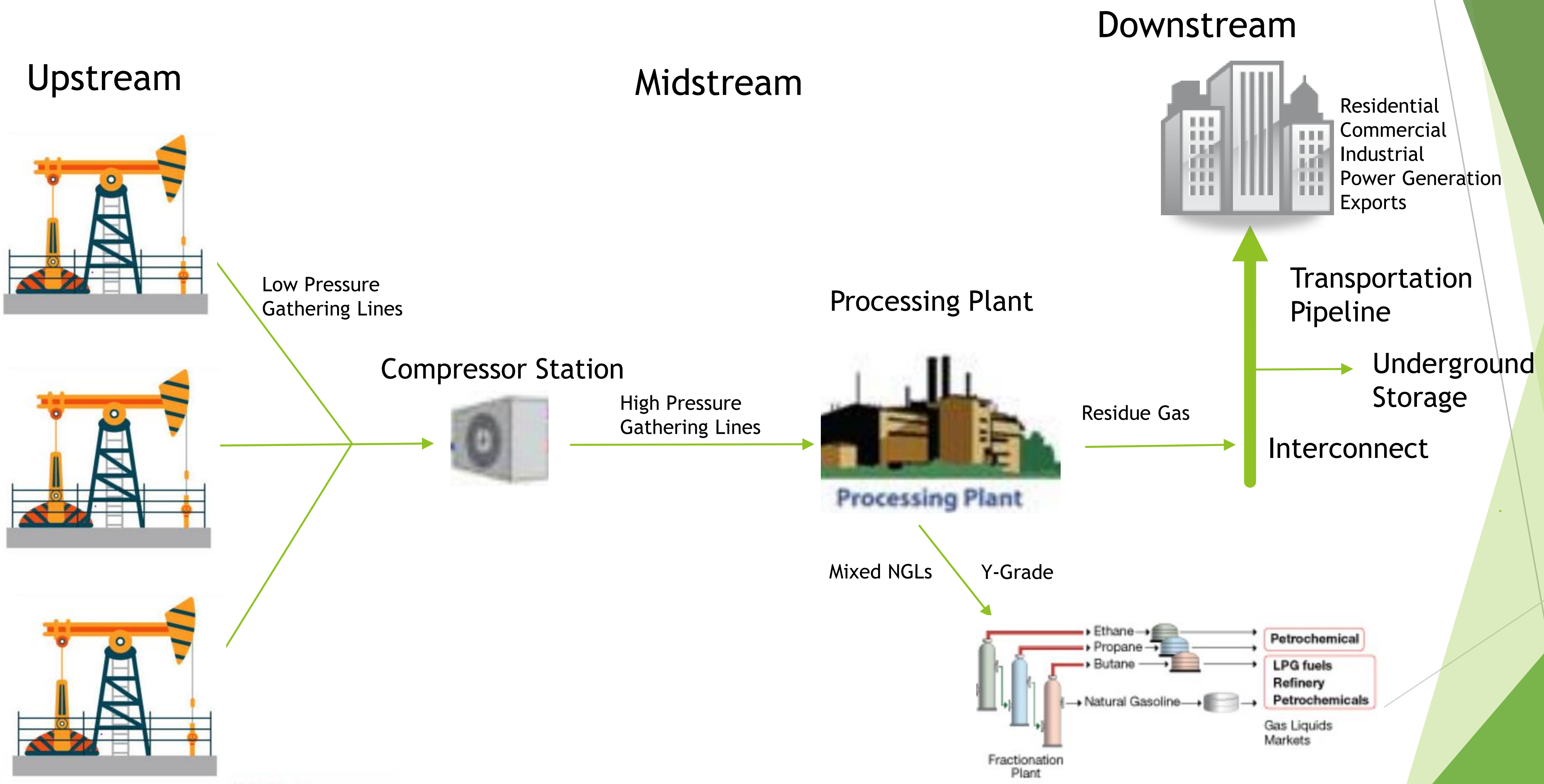
Types of Post-Production Costs

- Post-production costs include:
  - Processing
    - Stripping NGLs
    - Compression/Dehydration
    - Treating
    - Fractionation
  - Storage
  - Transportation
    - Typically used to refer to transportation from interconnect to downstream point of sale.
  - Marketing

Physical Flow of Wet Gas



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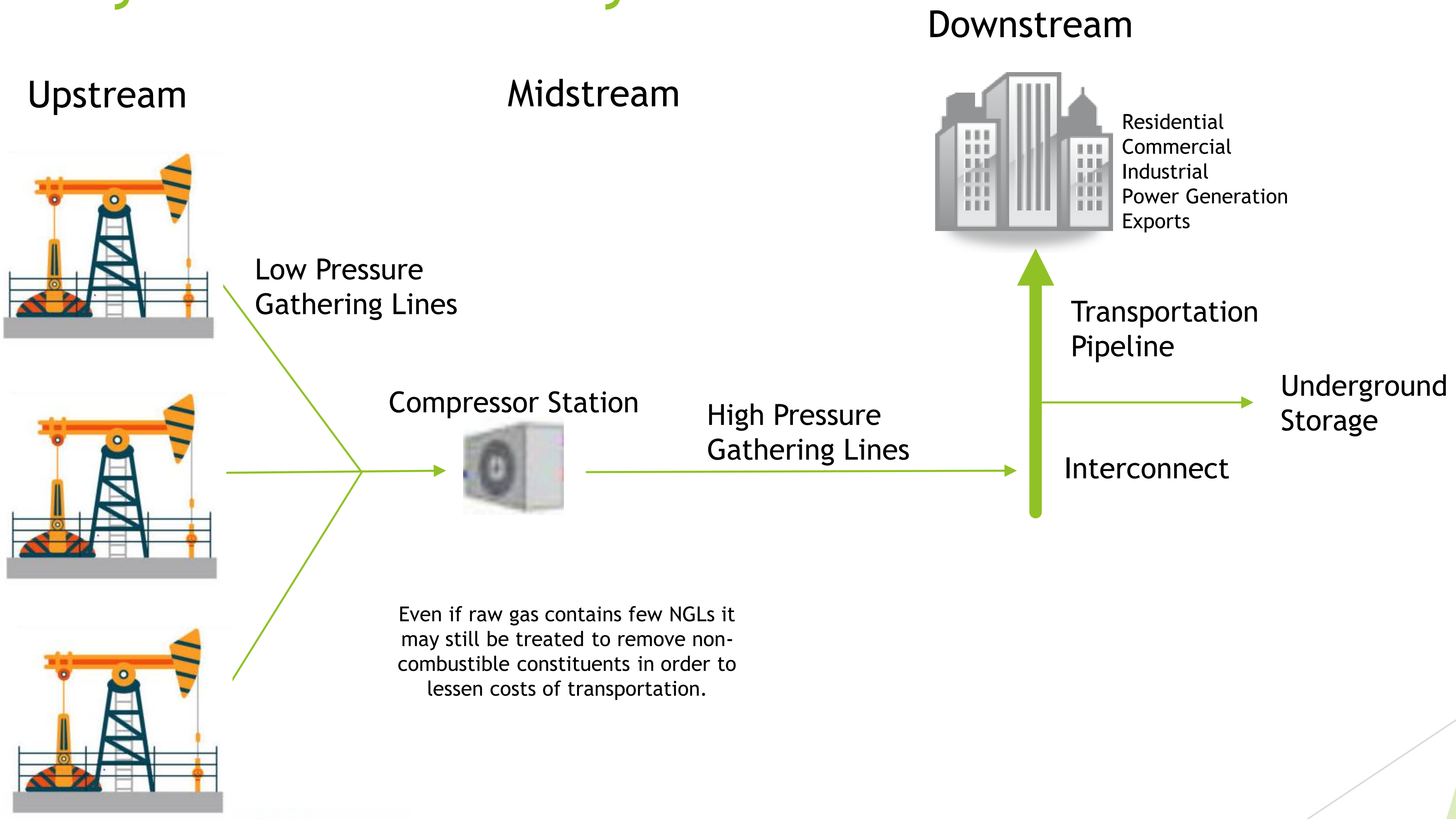
Physical Flow of Dry Gas



Even if raw gas contains few NGLs it may still be treated to remove non-combustible constituents in order to lessen costs of transportation.

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Who Owns Midstream?

- Smaller operators typically use independent “midstream” companies who may have AOI contact to build gathering system and charge for services.
  - Prior affiliation?
- Larger operators may use affiliate to build gathering system and perform midstream services.
  - This can facilitate price manipulation and inflated charges.

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Why is Gas Processed?

- Typically, because the raw gas produced at the wellhead cannot meet pipeline specifications without processing.
  - BTU Content
  - Impurities (CO_2, H_2S and H_2O)
- Can be processed because of additional revenue from sale of NGLs.

Types of Royalty Clauses

- Net
  - Oil and gas lease permits deductions of post-production costs.
- At the Wellhead
  - Treatment of post-production costs varies depending on state law.
- Market Enhancement
  - Oil and gas lease allows deductions of post-production costs *if* they enhance value of marketable product.
  - Disputes over interpretation.
- Gross
  - Oil and gas lease prohibits deductions of post-production costs.

Most States Have Rules / Doctrines as to Post-Production Costs When Not Specified

- Most states have adopted rules on treatment of post-production costs when an oil and gas lease is silent on deductions or contains some version of "at the wellhead" language.
- This issue had frequently arisen because following the deregulation of the gas industry there is no market at the wellhead and almost no gas is sold in arms-length transactions at the wellhead.

Most States Have Rules / Doctrines as to Post-Production Costs When Not Specified

- "At the Well Rule" (Majority Rule):
  - The At the Well Rule is also commonly referred to as the "Net Back Rule."
  - It allows the market value at the well to be determined using the work-back method.
  - Under the work-back method, the value at the well is calculated by taking the proceeds received in the first arms-length sale downstream and subtracting the post-production costs and expenses incurred between the wellhead and location of that first sale downstream.

Some States Have Rules / Doctrines as to Post-Production Costs When Not Specified

- "Marketable Product Rule" (Minority Rule):
  - The oil and gas company is prohibited from charging a royalty owner for some or all of the costs between the wellhead and the point of sale because the lessee, alone, bears the cost of making gas marketable.
  - No consistency on when gas is marketable.
    - Some states follow a version of the "first marketable product rule" and allow deductions once has deemed to be in marketable form even if not in location of commercial market.
    - Other states require gas to be in marketable form and in location of a commercial market or downstream point of sale.
- A royalty owner prefers to be in a jurisdiction which follows the Marketable Product Rule.

Rationale for the At the Well Rule

- Contract Interpretation
  - When a contract specifies the point at which royalties are valued, implied duties should not alter that agreement. The words "at the wellhead" should be given meaning. The work-back method provides a way to value gas at the wellhead when gas is no longer sold at that location and there is no commercial market at that location.
  - The marketable product rule runs the risk of giving the lessor the benefit of a bargain which was not made.
- Consistency
  - Ensures lessors do not obtain different royalties based on when and where in the production process the gas is sold.

Criticisms of the At the Well Rule

- Fairness
  - Some courts have argued that the At the Well Rule is unfair because lessors lack the expertise to negotiate royalty clauses that protect their interests.
  - Lessees have complete control over post-production costs and can easily manipulate those costs. The at-the-well approach has been criticized as giving lessees a windfall.
  - Lessors have no input on cost-bearing decisions as a working interest owner does and should not bear such costs.
    - The At the Well Rule has been criticized for turning royalty interest holders into working interest owners without the attendant rights.
  - There is a great disparity in bargaining power and knowledge between lessor and lessee.

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Rationale for the Marketable Product Rule

- The lessee has a duty to produce a marketable product and the lessee, alone, should bear the expense of making the product marketable.
- The duty to create a marketable product is a corollary to the implied duty to market. The duty involves both bringing the gas to market and obtaining the best price reasonably possible.
- States who have adopted a version of this rule have often found "at the wellhead" language or language which does not specify whether deductions are permitted to be ambiguous.
- The implied duty is often justified for reasons similar to those set forth in the criticisms of the At the Well Rule related to the control and inherent advantage lessees have.

Criticisms of the Marketable Product Rule

- Less Clarity
  - Courts appear to have universally declined to adopt a definition of “marketable” or “product.”
- Reading Meaning Out of Contracts
- Unnecessary Expansion of the Implied Duty to Market
  - Traditionally viewed as a duty to market gas as a prudent operator.
  - Arguably created a new implied covenant to “prepare for market.”
- Waste
  - By imposing a greater share of post-production costs on the lessee, it lowers the threshold at which operating costs exceeds the production’s value, ending production sooner.

Which States Follow Which Rule?

- At the Well Rule (Majority Rule):
  - Texas;
  - Louisiana;
  - Mississippi;
  - North Dakota;
  - Kentucky;
  - Pennsylvania;
  - California;
  - Michigan; and
  - Montana.
- Marketable Product Rule (Minority Rule):
  - Oklahoma;
  - Kansas;
  - Colorado;
  - West Virginia;
  - Virginia (maybe); and
  - New Mexico (maybe).

West Virginia

- In *Wellman v. Energy Resources, Inc.*, 210 W. Va. 200 (2001), the Supreme Court of West Virginia adopted the marketable product doctrine and held that "West Virginia holds that a lessee impliedly covenants that he will market oil or gas produced." *Id.* at 211.
  - The Supreme Court of West Virginia concluded that lessor shall only bear part of the costs incurred between the wellhead and the point of sale if an oil and gas lease provides that lessor shall bear part of those costs and the costs were actually incurred and reasonable.

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West Virginia

- In *Estate of Tawney v. Columbia Natural Res., LLC*, 219 W. Va. 266, 633 S.E.2d 22 (2006), the Supreme Court of West Virginia found "wellhead-type" language ambiguous and held that the implied duty to market requires the lessee to "bear all the costs incurred in exploring for, producing, marketing, and transporting the product *to the point of sale*." (Emphasis added.) *Id.* at 268.
  - "This Court now holds that 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." *Id.* at 274.

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West Virginia

- In *Leggett v. EQT Prod. Co.*, 239 W. Va. 264 (2017), the Supreme Court of West Virginia declined to extend *Tawney* to the minimum royalty statute.
  - "[B]oth *Wellman* and *Tawney* involved the leasing parties' use of the term 'at the wellhead' in their freely-negotiated leases. Accordingly, those Courts were free to utilize common law principles pertaining to oil and gas leases and contracts generally—the implied covenant to market and construction of a contract against the drafter, respectively—to interpret the lease and resolve the issue. Utilizing these common law principles to interpret a statute, however, is not legally sound." *Id.* at 274.
- Within a year of that decision the West Virginia legislature overruled *Leggett* by amending state law to provide that royalties on flat rate leases must be paid "free from any deductions for post-production expenses, received at the first point of sale to an unaffiliated third-party purchaser in an arm's length transaction for the oil or gas so extracted, produced or marketed." W. Va. Code § 22-6-8 (2018).

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West Virginia

- However, in a recent federal case *Young v. Equinor USA Onshore Properties, Inc.*, 982 F.3d 201 (4th Cir. 2020), the Federal Court relied on *Leggett* to allow the "work-back" method to be used in an "at the well" lease.
  - The rationale in this decision appears to be at odds with *Wellman* and *Tawney.*
  - Operators have claimed it calls into question the continued vitality of *Wellman* and *Tawney* but it remains to be seen what will be done in the future.

Next Logical Question:
What rule does Ohio follow?

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The Answer: *Neither*

- In *Lutz v. Chesapeake Appalachia, L.L.C.*,148 Ohio St. 3d 524, 71 N.E.3d 1010, 2016-Ohio-7549, the Northern District Court certified the following question to the Supreme Court of Ohio:
  - "Does Ohio follow the 'at the well' rule (which permits the deduction of post-production costs) or does it follow some version of the 'marketable product' rule (which limits the deduction of post-production costs under certain circumstances)?“
- The Supreme Court of Ohio held “[u]nder Ohio law, an oil and gas lease is a contract that is subject to the traditional rules of contract construction. Because the rights and remedies of the parties are controlled by the specific language of their lease agreement, we declined to answer the certified question and dismiss this cause.” *Lutz* at 524.
- “If the language of the leases is ambiguous, we cannot give effect to the parties' intent, because we do not have extrinsic evidence. If the language of the leases is not ambiguous, then the federal court should be able to interpret the leases without our assistance.” *Lutz* at 527.

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Lutz (2016)

- Justice O'Neill Dissent Argues for At the Well Rule
  - "In response to the federal court's question, I would hold that in Ohio, the 'rights and remedies of the parties to an oil or gas lease must be determined by the terms of the written instrument.' *Chesapeake Exploration, L.L.C. v. Buell*, 144 Ohio St. 3d 490, 2015-Ohio-4551, ¶ 53. Where a lease provides that the lessor's royalty is based on value at the well, Ohio follows the "at the well" rule. I would further hold that 'at-the-well,' under Ohio law, is defined as the gross proceeds of a sale minus postproduction costs." *Lutz* at 528.
  - "My view is that application of the marketable-product rule runs the risk of giving the lessor the benefit of a bargain not made." *Lutz* at 529.
- Just Pfeifer Dissent Argues for Marketable Product Rule.
  - "I would answer the question certified by the federal court, and I would state that Ohio follows the marketable-product rule." *Lutz* at 527.
  - "Three significant factors influence my answer: the complete control that lessees have over postproduction costs, the ease with which these costs could be manipulated, and the fact that, in most instances, the lessee drafts the lease document." *Lutz* at 527.
  - "Because there is no longer a market at the wellhead, the amount due a lessor should be based on the price at the first discernible market downstream." *Lutz* at 528.

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Takeaways From *Lutz* (2016)

- The specific royalty language that the parties agree to in an oil and gas lease is *extremely* important.
- Whether a share of post-production costs may be charged against a royalty owner's oil and gas royalty payments will depend on that specific language.

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Lutz (2017) – Federal Court’s “Erie Guess”

- After return of the *Lutz* case, the Northern District Court held that the Supreme Court of Ohio would adopt the At the Well Rule, by applying the clear and unambiguous language of the oil and gas leases at issue. *Lutz v. Chesapeake Appalachia, LLC*, No. 4:09-cv-2256, 2017 U.S. Dist. LEXIS 176898 (N.D. Ohio Oct. 25, 2017).
- The Federal Court found that use of the language “market value at the well” appears meaningless in isolation because the gas is not sold at the wellhead. However, if the term is understood to identify the location at which the gas is valued for purposes of calculating a lessor’s royalties, then the language has meaning. *Id*. at * 18.

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Market Enhancement Clause

- Short History
- Specific language varies but Market Enhancement Clauses ("MECs") typically provide that post-production costs can only be deducted *if* they enhance the value of marketable products to receive a better price.
- Misleading claims often made about MECs in oil and gas lease negotiations.
- Many oil and gas companies treat oil and gas leases containing MECs as net royalty leases and deduct all post-production costs.
- Even oil and gas companies who do not deduct all post-production costs under MECs typically claim most post-production costs can be deducted.
- The interpretation of MECs is subject to frequent dispute and litigation over MECs is becoming more prevalent.
- No clear Ohio case establishing how MECs will be interpreted.
- Royalty owners want to avoid all of the issues related to MECs by negotiating gross language.

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Royalty Clause

- Royalty owners want a gross royalty clause which prohibits:
  - Requires payment on gross proceeds;
  - Explicitly prohibits the deduction of post-production costs;
  - Prevents affiliate transactions from being used for purposes of royalty calculation; and
  - Does not contain any language with special industry meaning that impairs negotiated protections.
- The language used in the royalty clause can drastically impact the amount of royalties a royalty owner receives.

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Royalty Clause

- Be careful of the specific language used in a royalty clause.
  - Even if a royalty clause contains the words “free of cost” or “gross proceeds,” or contains language specifically prohibiting the deduction of post-production costs, the inclusion of other language can negate the meaning of that protective language.
- Royalty owners should work with an oil and gas attorney who has experience in royalty litigation to attempt to ensure the royalty language protects them.
  - Royalty clauses are frequently litigated and their interpretation often depends on how courts have defined certain words and phrases.

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Audit Clause

- Royalty owners want to negotiate an audit clause.
- In addition to carefully reviewing royalty statements, an audit clause provides a mechanism for royalty owners to be able to confirm that they are being paid correctly.
- Royalty owners should negotiate a strong audit clause which:
  - Does not contain unreasonable restrictions; and
  - Provides that the oil and gas company shall bear the cost of the audit if deficiencies are uncovered that exceed a certain percentage of the cost of the audit.
    - Audits are expensive.

Best Practices After Leasing

- Negotiating strong royalty language is only 1/2 of the battle.
- Royalty owners need to monitor their royalty statements, or have their royalty statements reviewed by a knowledgeable third party, to ensure that the royalty language is being followed by the lessee.
  - Check whether taxes and post-production costs are being deducted.
  - Have someone familiar with pricing review the prices to determine if they raise red flags.
    - Improper deductions are frequently hidden in pricing.
- It is also important to check:
  - Disbursement decimals;
  - Reported volumes against state records;
  - Reported products; and
  - Taxes.

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Questions?

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