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Deduction of Post-Production Expenses from Royalty Payments in Ohio

A federal court recently addressed two contentious issues affecting calculation of royalty payments from production of shale gas in Ohio: (1) whether operators may deduct post-production expenses (costs for gathering, compression, treatment, processing, transportation, and dehydration) when calculating royalty payments; and (2) whether operators are required to pay royalties on all gas extracted at the wellhead – including gas that is lost between the wellhead and the point of sale (i.e. "line loss" gas). *Lutz v. Chesapeake Appalachia, L.L.C.,* No. 4:09-cv-2256, Dkt. 142 (N.D. Ohio, Oct. 25, 2017) (Judge Sara Lioi).

In 2009, a group of five lessors commenced a putative class action suit in the federal district court for the Northern District of Ohio against Chesapeake Appalachia, L.L.C., Columbia Energy Group, and NiSource, Inc. The lessors claimed that, since 1993 the producers had been "deliberately and fraudulently" underpaying the gas production royalties owed to the lessors by (1) deducting post-production expenses from the royalty payments, (2) calculating royalty payments on volumes less than the amount of gas produced at the wellhead, and (3) using a sale price that was less than the market price for gas. In response to a motion by the producers, the court dismissed the entire complaint as time-barred by the statute of limitations. On appeal of that order, the Sixth Circuit determined that the breach of contract claim was not entirely time-barred because each alleged monthly underpayment would constitute a separate breach of contract that triggered a new accrual period under the statute of limitations. *Lutz v. Chesapeake Appalachia*, L.L.C., 717 F.3d 459, 470 (6th Cir. 2013). As a result, the lessors may assert a breach of contract claim for alleged underpayments that occurred during the four years prior to commencement of the action. The Sixth Circuit also noted that the lessors "may be entitled to equitable tolling" of the limitations period on the basis of "fraudulent concealment" – i.e. the claim that the monthly royalty statements misrepresented how the royalties were calculated.

On remand to the District Court, the parties filed cross-motions for summary judgment on the breach of contract claim. The leases at issue had three different royalty clauses, which appear in pertinent part below:

> (1) "The royalties to be paid by Lessee are . . . (b) on gas, including casinghead gas or other gaseous substance, produced and sold or used off the premises or for the extraction of gasoline or other product therefrom,

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> the market value at the well of one-eighth of the gas so sold or used, provided that on gas sold at the wells the royalty shall be one-eighth of the amount realized from such sale."
>
> (2) "[Lessor] to receive the field market price per thousand cubic feet for one-eighth (1/8) of all gas marketed from the premises."
>
> (3) "Lessee covenants and agreed to deliver to the credit of the Lessor, as royalty, free of cost, in the pipeline to which the wells drilled by the Lessee may be connected the equal one-eighth part of all Oil and/or Gas produced and saved from said leased premises."

At the time, the Ohio Supreme Court had not previously addressed whether Ohio law allowed for deduction of post-production expenses from royalty payments. Rather than decide the issue in the first instance, the District Court submitted the following certified question of law to the Ohio Supreme Court:

> 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 Ohio Supreme Court accepted the certified question and heard oral arguments in January 2016. The Ohio Supreme Court issued an opinion in November 2016 with an unexpected ruling: a five-justice majority of the court declined to answer the certified question. The opinion stated as follows:

> Under 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 decline to answer the certified question and dismiss this cause.

Lutz v. Chesapeake Appalachia, L.L.C., 71 N.E.3d 1010, 1013 (Ohio 2016).

Two justices filed dissenting opinions. Justice Paul E. Pfeifer argued that Ohio law would recognize the "marketable product" rule, and thus likely disallow deduction of post-production expenses. By contrast, Justice William N. O'Neill contended that Ohio law would recognize the "at the well" rule, which permits deduction of post-production expenses.

Which rule to apply?

In the wake of the Ohio Supreme Court's opinion, Chesapeake renewed its summary judgment motion on the breach of contract claims based on leases containing the "market value at the well" language in the royalty clause. Adhering to the Ohio Supreme Court's directive that "traditional rules of contract construction" should be applied to determine the propriety of deducting post-production expenses, the District Court closely examined the provisions of the royalty clause and other terms of the lease. The District Court concluded that the Ohio Supreme Court would apply the "at the well" rule to the leases containing the "market value at the well" language. The Court determined that the phrase "at the well" in the royalty clause refers to the location where the gas is to be valued for calculation of a royalty. However, if gas is not sold "at the well," but rather has to be processed and transported to a point of sale further downstream, then there are no proceeds "at the well" for calculation of royalty. When the point of sale is downstream of the well, the producer has incurred post-production costs to not only transport the gas, but also to process the gas into a marketable product. The market value of the gas "at the well" can still be calculated, however, by reducing the sale price by the post-production expenses incurred. Since the gas produced pursuant to the leases at issue was not sold "at the well," the district court concluded that Chesapeake did not breach the contract by deducting post-production expenses from the royalty amounts.

Royalties on "line loss" gas

The District Court also granted summary judgment to Chesapeake on the lessors' claim that they should be paid royalties based on the volume of gas produced "at the well" even if the amount of gas actually sold is less. The lessors contended that Chesapeake should bear the financial consequences of gas "lost" between the wellhead and the sale point. In response, Chesapeake argued that no royalty is required on "line loss" gas because

Chesapeake did not receive any revenue for that gas. According to Chesapeake, "how can it be required to pay a lessor royalties on such nonexistent revenue from these lost volumes?" The District Court, agreeing with a number of other courts that have addressed the issue, ruled in Chesapeake's favor.

Tolling of statute of limitations for "fraudulent concealment"

The District Court also addressed the lessors' claim that the four-year limitations period applicable to the breach of contract claim should be tolled based on Chesapeake's alleged fraudulent concealment of its methodology for calculating the royalty payment. The lessors claimed that Chesapeake did not use the actual market price for gas when calculating the royalty. Instead, Chesapeake used a lower fixed price set by "forward sale" contracts between Chesapeake and gas purchasers.

To establish equitable tolling of the limitations period under Ohio law, the lessors had to demonstrate that a reasonably prudent person would have no way of knowing about the alleged fraud due to the inaccuracies in the royalty statements. This "reasonably prudent person" standard imposes an obligation on the party seeking equitable tolling to have exercised due diligence to investigate possible wrongdoing. There was no dispute that the statements accompanying the monthly royalty payments accurately set forth the actual gas price used to calculate the royalties, and that this price was lower than publicly available market price according to the Appalachian Basin Index (a/k/a the TCO Index). There was also no dispute that none of the lessors ever actually read the statements that accompanied the royalty checks, much less relied on them. Instead, the lessors admitted that all they looked at was the amount of each check. Further, none of the lessors ever compared the sale price set forth in those statements to the TCO Index price.

The District Court determined that equitable tolling did not apply because the lessors had a means to ascertain the actual sale price used to calculate the royalty payments – the information on the monthly statements. These statements were not fraudulent in that they accurately stated the sale price used to calculate the royalty. The court rejected the lessors argument that they never had a reason to check the accuracy of the sale price. "[I]f plaintiffs expect to toll the statute of limitations, due diligence requires that they had checked. All they needed to do was access the TCO Index and compare the price displayed on their check stubs to the index price. They admittedly never did so."

As a result of this ruling, the scope of the lessors' breach of contract claims is limited to royalty payments made during the four years previous to commencement of the lawsuit in 2009.

Claims remaining for further proceedings

As noted above, the summary judgment order only addressed the group of leases containing the "market value at the well" royalty clauses. As of October 25, 2017, neither Chesapeake nor the lessors had moved for summary judgment on the breach of contract claim involving the other two groups of leases. Yet to be determined is whether Judge Lioi will apply the "at the well" rule to the royalty provisions of the other leases. One group of leases states that royalties will be calculated based on the "field market price per thousand cubic feet for one-eighth (1/8) of all gas marketed from the premises." The other royalty clause describes the payment "as royalty, free of cost, in the pipeline to which the wells drilled by the Lessee may be connected the equal one-eighth part of all Oil and/or Gas produced and saved from said leased premises." Also unresolved is whether the case will be certified as a class action and whether additional discovery is necessary. Judge Lioi ordered the parties to submit proposals by November 8, 2017 on how to proceed with adjudicating the remaining claims.

What does this mean for Ohio producers?

The October 25, 2017 order is definitely a win for the industry. Although the impact of the order is likely limited to leases with language similar to the "market value at the well" royalty provision, Judge Lioi's order offers a well-reasoned approach to application of the "at the well" rule to royalty provisions that reference calculation of royalties at the wellhead. The lessors could eventually appeal Judge Lioi's decision to the Sixth Circuit, although such an appeal will likely have to await disposition of the remaining claims. At present, this decision is not binding on any other court in Ohio – even on other judges in the Northern District.

Judges in other federal courts within the Sixth Circuit, and certainly Ohio Common Pleas courts, could reach a contrary conclusion. Unfortunately, the Ohio Supreme Court declined to resolve the uncertainty in Ohio law when presented with the opportunity to do so. Going forward, Ohio courts (whether state or federal) will still have to take a case-by-case approach to each royalty suit involving deduction of post-production expenses. Nevertheless, Judge Lioi's order is sure to serve as persuasive authority for how to resolve such cases. Stay tuned for further updates.

For questions related to issues affecting calculation of royalty payments from production of shale gas in Ohio described in this alert, please contact Robert M. Stonestreet at (681) 265-1364 or rstonestreet@babstcalland.com.

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