

ALERT ENERGY & NATURAL RESOURCES



Pennsylvania Trial Courts Hold that the Term “At the Wellhead” in Natural Gas Leases Allows Operators to Deduct Post-Production Costs

In two recent opinions in which Babst Calland represented oil and gas operators, Pennsylvania federal and state trial courts ruled that the term “at the wellhead” in natural gas leases must be interpreted to allow operators to deduct post-production costs when calculating royalty payments. *Coastal Forest Res. Co. v. Chevron U.S.A., Inc., et al.*, No. 2:20-cv-1119, 2021 WL 1894596 (W.D. Pa. May 11, 2021); *Dressler Family, LP v. PennEnergy Res., LLC*, A.D. No. 2017019357 (Butler Cty. C.P. Apr. 28, 2021). In doing so, the trial courts held that the Pennsylvania Supreme Court’s interpretation of the term “at the wellhead” in *Kilmer v. Elexco Land Servs., Inc.*, 990 A.2d 1147 (Pa. 2010) is not confined to issues of statutory interpretation, but also applies to leases.

In *Kilmer*, the Pennsylvania Supreme Court ruled that, among other things, the use of the net-back method to calculate royalties did not violate the Guaranteed Minimum Royalty Act (GMRA), 58 P.S. § 33,¹ which required leases to guarantee the lessor at least a one-eighth royalty of all gas recovered from the property. When calculating royalties, the net-back method provides a mechanism for determining allowable deductions for post-production expenses associated with bringing the oil or gas from the “wellhead” to the market where it is sold. In reaching its conclusion, the Court in *Kilmer* relied on a variety of sources specific to the oil and gas industry that stated a royalty is generally not payable from the operator’s gross profit, but from the net amount remaining after the deduction of post-production costs. 990 A.2d at 1157-58.

In the decade since *Kilmer*, disputes have arisen as to the scope of its holding. In particular, many lessors and operators have disagreed whether *Kilmer* should be confined to issues of statutory interpretation or applied more broadly to breach of contract claims. Within the span of a few weeks, two trial courts relied on *Kilmer* to dismiss breach of contract claims against operators accused of wrongfully deducting a royalty interest owner’s share of post-production costs from their royalty payments.

In *Coastal Forest*, the court held that a lease providing for royalties to be calculated from the “gross sales price received . . . at the wellhead” unquestionably permits

¹ This statutory minimum is now located in the Oil and Gas Lease Act, 58 P.S. § 33.3 (2013).

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use of the net-back method to calculate royalties. In granting Chevron's motion to dismiss, the court stated that "[u]nder *Kilmer*, 'at the wellhead' language means that the net-back method may be used for calculation. This is the only conclusion consistent with Pennsylvania law and industry custom." 2021 WL 1894596, at *6.

Similarly, in *Dressler Family*, the court held that a lease providing for royalties to be calculated from the "gross proceeds received from the sale of same at the prevailing price for gas sold at the well" likewise unambiguously allows for the deduction of post-production costs via the net-back method. In granting summary judgment to PennEnergy, the court found there was "no ambiguity within the four corners of the document" and that the lease was "subject to only one reasonable construction," which is to calculate royalties based on the market value of the gas "at the well." Slip Op. at 16-17. Since gas is not actually sold at the wellhead, post-production costs had to be deducted to establish that price. *Id.*, at 17. The court rejected the plaintiff's proposal to base the royalty on the gross price at the point of sale because doing so would disregard the phrase "at the well" and use the downstream price instead. *Id.*

Lawsuits between lessors and oil and natural gas operators as to whether post-production costs may be deducted when calculating royalties are common. Babst Calland actively tracks these cases in Pennsylvania and other states in the Appalachian Basin. If you have any questions about these disputes, please contact Mark K. Dausch at mdausch@babstcalland.com or 412-394-5655 or Cary M. Snyder at cmsnyder@babstcalland.com or 412-394-5672.

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