Oil and Gas Alert: Supreme Court of Kentucky Adopts 'At The Well' Rule For Post-Production Costs; Producers Solely Responsible for Severance Tax Payments

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In companion decisions released on August 20, 2015, the Supreme Court of Kentucky confirmed that Kentucky follows the “at the well” rule with respect to post-production costs, but held that the payment of severance taxes must be borne solely by the producer.

In *Baker v. Magnum Hunter Prod., Inc.*, the Court affirmed the lower court’s decision in favor of the lessee, holding that the phrase “market value at the well” has an established meaning in Kentucky that allows for the deduction of post-production costs in calculating the value of the lessor’s royalty.

In *Appalachian Land Co. v. EQT Prod. Co.*, the Court addressed the following question certified by the Sixth Circuit Court of Appeals:

Does Kentucky’s “at-the-well” rule allow a natural-gas processor to deduct all severance taxes paid at market prior to calculating a contractual royalty payment based on “the market price of gas at the well,” or does the resource’s at-the-well price include a proportionate share of the severance taxes owed such that a processor may deduct only that portion of the severance taxes attributable to the gathering, compression and treatment of the resource prior to calculating the appropriate royalty payment?

The Court rejected both options presented in the question, instead holding that, in the absence of a specific lease provision apportioning severance taxes, a lessee may not deduct severance taxes or any portion thereof prior to calculating a royalty value.

Click here to read *Baker* and here to read *Appalachian Land Co.*

Background and claims

Baker v. Magnum Hunter Prod., Inc.

This case involves a breach of contract and declaratory judgment action in which the plaintiffs (landowner-lessors) claim that defendant (lessee) miscalculated and underpaid their gas royalties under the terms of their respective leases.

The leases of the plaintiffs included the following royalty clause:

Lessee covenants and agrees: . . . To pay Lessor one-eighth of the market price at the well for gas sold or for the gas so used from each well off the premises.

Plaintiffs claimed that the above lease language did not permit defendant to deduct post-production costs in calculating royalties other than bona fide costs of transporting “marketable” gas to the point of sale. Plaintiffs further urged the Court to adopt this variation of the “marketable product” or “first marketable product” rule, which does not permit the deduction of costs necessary to render raw gas marketable from the value of the lessors’ royalty.

The trial court granted defendant’s motion to dismiss, and the Court of Appeals of Kentucky affirmed, holding that the phrase “market price at the well for gas” was unambiguous and permitted defendant to deduct reasonable costs of transportation and processing prior to calculating the market value of the lessors’ royalty.

The Supreme Court of Kentucky affirmed the lower courts’ decisions. The Court held that the phrase “market price at the well” has an established, judicially-recognized meaning under Kentucky law that allows for the deduction of post-production costs before calculating royalty. The Court further refused to adopt any variation of the “marketable product” rule, holding that the implied duty to market does not extend beyond “sell[ing] the gas at a reasonable price at the well side,” which price may properly be determined by “working back from a downstream sale by deducting the downstream costs[.]” Finally, the Court noted that its decision was consistent with Pennsylvania’s and North Dakota’s “recent rejection of the ‘first marketable product’ approach,” in *Kilmer v. Elexco Land Servs., Inc.* and *Bice v. Petro-Hunt, L.L.C.*, and was “fair in every sense,” because it prevents landowners from getting a windfall by receiving more than one-eighth of the value of the raw gas produced from their property.

Appalachian Land Co. v. EQT Prod. Co.

This case involves a class action filed in the U.S. District Court for the Eastern District of Kentucky in which the plaintiffs (lessors) claim that the defendant (lessee) underpaid their gas royalties under the terms of their respective leases by improperly deducting severance taxes.

The lease of the lead plaintiff contained a royalty clause on natural gas extracted from the land “at the rate of one-eighth (1/8) of the market price of gas at the well.” In determining the value of plaintiffs’ royalty, defendant would deduct from the sale price all post-extraction processing costs, transportation costs, and severance taxes. Defendant then paid plaintiffs one-eighth of the remainder.

Plaintiffs argued that defendant, in arriving at a “market price” for royalty purposes, should not have deducted severance taxes, and thus these allegedly improper deductions resulted in an underpayment of royalties. Defendant argued that severance taxes are post-production costs that are properly deducted in determining the value of a lessor’s royalty.

The U.S. District Court for the Eastern District of Kentucky granted defendant's motion for judgment on the pleadings, holding that the Sixth Circuit Court of Appeals' decision in *Poplar Creek Dev. Co. v. Chesapeake Appalachia, L.L.C.*—upholding the deduction of post-production costs from the value of the lessor's royalty—extends to severance taxes.

On appeal, the Sixth Circuit Court of Appeals certified the above-listed question to the Supreme Court of Kentucky because the issue of apportionment of natural gas severance taxes had not been directly addressed under Kentucky law.

The Supreme Court of Kentucky accepted the certified question, but declined to adopt either of the Sixth Circuit Court of Appeals' alternative interpretations of Kentucky law—both of which would permit some deduction of severance taxes as a post-production cost. Instead, the Court concluded that a lessee may not deduct severance taxes or any portion thereof prior to calculating a royalty absent a specific contractual provision apportioning severance taxes. Observing that KRS 143A.020(1) levies a tax "[f]or the privilege of severing or processing natural resources," the court reasoned that the tax is properly levied on the lessee-producer alone. The Court also reasoned that, even if the tax is construed as a property tax, it is still borne solely by the lessee-producer because title to the gas vested with the lessee the moment it brought the gas to the wellhead.

Notably, the Supreme Court of Kentucky distinguished several opinions in other jurisdictions permitting the deduction of severance taxes as post-production costs, noting that statutes in those jurisdictions specifically provide for the payment of severance taxes by the royalty owner.

Questions

If you have any questions about the Supreme Court of Kentucky's decisions, please contact: John Keller (614.464.6389), W. Jonathan Airey (614.464.6346), Greg Russell (614.464.5468), Pete Lusenhop (614.464.8263), or Timothy McGranor (614.464.8205).