Oil and Gas Alert: U.S. District Court Certifies Question to Supreme Court of Ohio Relating to Deduction of Post-Production Costs

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The U.S. District Court for the Northern District of Ohio recently certified an important question of law concerning the deduction of post-production costs to the Supreme Court of Ohio:

1. 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)?

See *Lutz v. Chesapeake Appalachia, L.L.C.*, N.D. Ohio No. 4:09-cv-02256. Post-production costs are incurred generally in preparing gas for and in some cases transporting gas to market, and can include such things as compression, dehydration and the extraction of natural gas liquids. Whether these costs can be deducted can have a direct effect on the amount of royalties due to lessors.

Although several oil and gas jurisdictions have expressly adopted either the "at the well" rule or some version of the "marketable product rule," including Texas, Louisiana, North Dakota, Michigan, Montana, Pennsylvania, Oklahoma, Colorado and Kansas, only one Ohio appellate court has examined the issue. In *Schmidt v. Tex. Meridian Res.*, a decision from 1994, the Fourth District Court of Appeals declined to adopt either rule "until such time as the issue has been considered by the Ohio Supreme Court" or other appellate jurisdictions in Ohio, instead deciding the case on other grounds. The Northern District of Ohio, recognizing that "Courts across the country are split" regarding the two approaches and that "there is no controlling precedent in the decisions of the Ohio Supreme Court," certified the question to the Supreme Court of Ohio.

The Supreme Court of Ohio will now review the memoranda submitted by the parties and issue an order identifying whether it will answer or decline to answer the question.

Background and Claims

The case involves a putative class action in which the plaintiffs (landowner-lessors) claim that defendant (lessee) underpaid their gas royalties under the terms of their respective leases.

The leases of the named plaintiffs have three varieties of royalty clauses:

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, the market value at the well of one-eighth of the gas so used or used, provided that on gas sold at the wells the royalty shall be one-eighth of the amount realized from such sale.
2. Lessee 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 agrees 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.

Plaintiffs claim, among other things, that the above lease language does not allow the lessees to deduct post-production costs—i.e., the costs incurred after the gas is produced at the wellhead and before it is sold farther downstream—from their respective royalties. Defendants argue that the lease language allows the use of the “netback method,” which determines the wellhead valuation of gas by allocating a pro-rata share of post-production costs to the royalty interest.

The question was certified to the Supreme Court of Ohio on April 1, 2015.