10/30/2017 | Articles

At-The-Well: Ohio Federal District Court Allows Post-Production Cost Deductions From Oil and Gas Royalties

In line with case law in Pennsylvania, Texas, and other states, an Ohio court held recently that lessees may deduct post-production costs from the royalties that landowners receive from oil and gas leases. An opinion in the case, *Lutz v. Chesapeake Appalachia, LLC,* No. 4:09-cv2256, was decided and filed by the United States District Court for the Northern District of Ohio, Eastern Division, on October 25, 2017.

The *Lutz* case was originally filed by several landowners to dispute, *inter alia*, the removal of post-production costs, like those for gathering, compression, and transportation. The language of the leases at issue indicated that the landowner's royalties should be paid at "the market value at the well of one-eighth of the gas so sold or used…."

The plaintiff landowners argued that the Court should apply the "marketable-product" rule which supports that operators have an implied covenant to market the gas produced and are therefore also on the hook for post-production costs leading to the sale of said gas. Defendant Chesapeake argued that the "at-the-well" rule should be applied, allowing for the operator to deduct a proportionate amount of the post-production costs from the landowner's royalties.

After initially dismissing the case and being reversed on appeal, the lower court determined that the issue regarding post-production costs could not be determined under existing Ohio law and that, as a federal court, it lacked sufficient guidance to rule on an issue of state substantive law. Therefore, it certified a question to the Ohio Supreme Court requesting guidance on whether Ohio followed the "marketable-product" rule or the "at-the-well" rule.

The Ohio Supreme Court heard oral argument on the issue in early 2016 but ultimately declined to answer the question presented to it. Rather, said Court reiterated that, under Ohio law, oil and gas leases are contracts and should be interpreted using rules of construction which are applicable to all contracts.

In its most recent decision, the lower court indeed applied Ohio's general rules of contract construction, focusing on the parties' intent and whether the language of the lease was ambiguous. If the lease's language was ambiguous, it would be appropriate to consider external circumstances, such as the acts of the parties subsequent to the execution of the contract. For example, the Court could have considered that the operator failed to apply any post-production cost deductions to the landowners' royalties for several years after a well was drilled.

However, the Court determined that the language of the leases was not ambiguous. Rather, the reference in the royalty description of the value of the gas "at the well" was an unambiguous adoption of the "at-the-well" rule regarding the application of post-production costs.

Accordingly, the Court held that the leases allowed for a proportionate amount of post-production costs to be deducted from the royalties paid to the landowners.

Though likely to be appealed, the *Lutz* decision attempts to bring Ohio in line with other oil and gas producing states which follow the "at-the-well" rule. The Ohio Supreme Court's response to the certified question regarding said rule, however, indicates that Ohio courts may not always follow a one-size fits all approach. Ohio operators should expect more litigation in this area addressing differing royalty terms and more ambiguous lease language.

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