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Clarifying Kilmer: Post-Production Costs Are Assessed When Title Passes

United States Magistrate Judge for the U.S. District Court for the Western District of Pennsylvania

On June 18, 2015, United States Magistrate Judge Robert C. Mitchell issued an opinion in the case of *Pollock, et al. v. Energy Corporation of America,* 2:10-CV-01553 (W.D. Pa. June 18, 2015). The opinion was primarily issued to address the defendant's motion for judgment as a matter of law or new trial and dealt with a number of procedural issues; however, Judge Mitchell strongly addressed the issue of what costs can be deducted from a landowner's royalty.

In Pennsylvania, the oil and gas industry has long defined a royalty as "the landowner's share of production, free of expenses of production." *Kilmer v. Elexco,* 990 A.2d 1147, 1158 (Pa. 2010) (citing to Williams & Meyers, *Manual of Oil and Gas Terms* (2009)). However, the *Kilmer* court recognized that it is "unusual and impractical" for landowners to take natural gas royalties in kind and clarified that post-production costs may be deducted from landowner royalties when the Lessee has undertaken the job of treating, processing, marketing, and selling the natural gas produced under a lease which is silent as to post-production costs. *Id.* at 1158. Post-production costs appropriately deducted from a royalty include the Lessee's "costs of treatment of the product to render it marketable" and the "costs of transportation to market." *Id.* at 1157. Royalties are thereafter calculated as one-eighth the sale price of the gas, minus one-eighth of the post-production costs of bringing the gas to market. This calculation is commonly known as the "net-back" method and permits the calculation of royalties at the wellhead. *Id.* at 1158.

However, *Kilmer* and its progeny did not provide guidance as to whether post-production costs incurred by subsequent purchasers of the gas can also be deducted from the landowner's royalty. In *Pollock,* Energy Corporation of America ("ECA") was the Lessee and operator under the lease in question; its marketing subsidiary, EMCO, incurred a number of costs to market the gas produced from ECA wells. *Pollock* at 8; see also *Pollock, et al. v. Energy Corporation of America,* 2:10-CV-01553 (W.D. Pa. September 30, 2013). The landowners objected to ECA's deduction of said marketing costs from their royalty payments, arguing that costs incurred by EMCO, who was not the original Lessee, could not be deducted from the landowners' royalties. The Court concurred.

In his opinion, Judge Mitchell pointed out that, in previous opinions issued in the same case, the Court had always found that the proper inquiry in regard to post-production costs was "at the point at which the gas is sold" and "the point at which title passes," as opposed to focusing on whether the landowner had received a full one-eighth royalty or how the costs themselves were actually calculated. *Id.* at 3 and 7. Judge Mitchell found that the plaintiff's expert in the case had sufficiently presented evidence to the jury showing that title to the gas passed at the "receipt pool," before any transportation or marketing charges were incurred, and that it was therefore reasonable for the jury to determine that only EMCO had incurred the costs. *Id.* at 8. Ultimately, Judge Mitchell denied both of the defendant's motions and held that costs incurred by a successor-in-interest to the original Lessee could not be deducted from the landowners' royalties.

The production, transportation, and marketing of gas produced from wells involves a wide variety of stages and expenses. Although the decision has been excoriated as overly burdensome to companies which market and transport—but do not produce—gas, *Pollock* does provide useful guidance as to which companies along the chain should expect to absorb post-production costs.

The Pollock decision can be read by clicking here.