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The "Net-Back" Battle: Would Pennsylvania Landowners Share the Cost of a Natural Gas Severance Tax?

Pending proposals which would create a severance tax on natural gas in Pennsylvania seem to have raised more questions than answers. But a close comparison of Pennsylvania case law with that of other oil and gas producing states potentially answers one such question – will landowners share in the financial burden such a tax would create?

On March 3, 2015, Governor Tom Wolf introduced a budget containing a natural gas severance tax, which would be assessed "at the wellhead" but does not address whether the severance tax will be levied upon the operator before or after the deduction of landowner royalties. An alternate version of the severance tax, sponsored by Representative Scott Petri of the Pennsylvania House of Representatives, is based upon the market price of the gas and deliberately provides for the deduction of post-production costs and royalty payments *prior* to the assessment of the tax against the original operator, making it clear that a landowner will not share in any part of the natural gas severance tax. Under Governor Wolf's original version of the severance tax, however, it is unclear whether the operator could deduct a portion of the severance tax from the landowner's royalty.

Pennsylvania generally follows the "net-back method" of royalty calculation, whereby an operator may deduct post-production costs for the processing and transportation of gas to market. *Kilmer v. Elexco,* 990 A.2d 1147 (Pa. 2010). Furthermore, the statutes and treatises cited by the *Kilmer* court suggest that any costs incurred between the removal of natural gas from the ground and the actual sale of said gas would be permitted as deductions – to include "production or gathering taxes." *Id.* at 1157, *citing to* Howard R. Williams & Charles J. Meyers, *Manual of Oil and Gas Terms* § R (Patrick H. Martin & Bruce M. Kramer eds., 2009).

However, the Supreme Court of Kentucky, a state which also generally follows the net-back method, recently ruled that the Kentucky severance tax on natural gas could not be deducted from landowner royalties. *Appalachian Land Company v. EQT Production Company,* 2013-SC-000598-CL (Ky. 2015). The Court pointed out that the Kentucky severance tax statute indicated that the tax was levied upon taxpayers for the "privilege" of severing and processing natural gas. *Id.* at p. 4, *citing* Kan. Rev. Stat. § 143A.020(1). The court held that a landowner gives up his privilege of severing or processing natural gas when he executes a lease in favor of an operator; therefore, as royalty recipient, he is "not involved in severing or processing the gas" and should bear no responsibility for a severance tax. *Id.* at p. 7.

Another recent case from Texas, also a net-back method state, illustrates that the language of the lease itself may also be an important factor in determining whether landowner's would help foot a severance tax bill. In *Trinity Valley School, et al v. Chesapeake Operating, Inc., et al,* the court held that, because the language of the leases in question specifically prohibited post-production costs, the operator had no right to deduct post-production costs from the landowners' royalties. Case 3:13-cv-01082-K (U.S. Dist. Ct., N. Dist. Tex., Aug. 19, 2015). This case indicates that, regardless of the general royalty calculation method or how the statute might categorize a severance tax, the language of individual leases may control.

It is too early to know what version, if any, of the severance tax Pennsylvania will enact and whether it would contain language addressing landowner royalties. However, given the current state of Pennsylvania case law and the guidance provided by recent cases in other states, it is likely that the answer to the question of whether landowners would share in that burden will be determined by the language of the statute enacted and that of individual leases. These cases serve as a sharp reminder that a close and careful reading of any new statute and the leases it may affect is critical for natural gas operators in the state.

To read the proposed severance taxes, and the Texas and Kentucky decisions, please follow the below links.

Trinity Valley School, et al v. Chesapeake Operating, Inc., et al:
https://docs.justia.com/cases/federal/district-courts/texas/txndce/3:2013cv01082/229998/111

Appalachian Land Company v. EQT Production Company:
http://law.justia.com/cases/kentucky/supreme-court/2015/2013-sc-000598-cl.html

Governor Wolf’s proposed Executive Budget (severance tax on p. C1-16):
http://www.budget.state.pa.us/portal/server.pt/community/current_and_proposed_commonwealth_budgets/4566

Representative Petri’s alternate severance tax proposal:
http://www.legis.state.pa.us/cfdocs/Legis/CSM/showMemoPublic.cfm?chamber=H&SPick=20150&cosponId=18787