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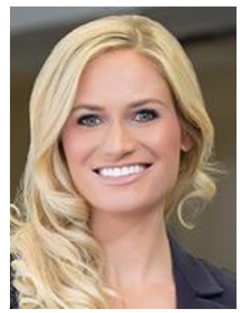
4th Circ. Royalty Ruling A Win For W.Va. Gas Producers

By **Lauren Varnado and David Dehoney** (January 5, 2021, 4:24 PM EST)



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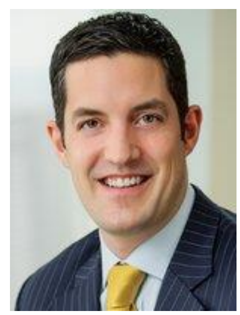

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On Dec. 1, 2020, the U.S. Court of Appeals for the Fourth Circuit issued its decision in Young v. Equinor USA Onshore Properties Inc., ruling for the first time on the deductibility of post-production costs in calculating gas royalties at the wellhead under West Virginia law.

The court unanimously sided with the producers, Equinor USA Onshore Properties and SWN Production Co., and held that they are entitled to deduct post-production costs in calculating royalties under the plaintiff royalty owners' oil and gas lease. In so holding, the Fourth Circuit affirms that the work-back or netback method is an appropriate method for calculating a wellhead price on which to pay gas royalties at the wellhead in West Virginia.

The Fourth Circuit's decision in Young follows recent case law from the West Virginia Supreme Court endorsing the use of the netback method in calculating royalties under the West Virginia flat-rate statute. The Fourth Circuit concluded that the same reasoning applies to the calculation of royalties under leases with at-the-wellhead royalty language. Thus, SWN and Equinor were allowed to deduct post-production costs to determine the wellhead price of gas.

While the Fourth Circuit's approval of the netback method is not a novel development in oil and gas jurisprudence, it confirms that oil and gas lessees may use the netback method to calculate royalties at the wellhead regardless of whether the royalty obligation is grounded in statute or in contract.

The Young lease provided for a 14% royalty on "the net amount realized by Lessee ... at the wellhead," which was to be calculated by taking "the gross proceeds received by Lessee from the sale of oil and gas minus post-production costs incurred by Lessee between the wellhead and the point of sale." The lease identified seven categories of post-production costs to be deducted in calculating the wellhead price of gas:

- Treating and processing;
- Separation;

- Transportation;
- Compression;
- Metering;
- Marketing charges and fees; and
- "Any and all other costs and expenses of any kind or nature incurred in regard to the gas, or the handling thereof, between the wellhead and the point of sale."

The crux of the Youngs' lawsuit was that Equinor and SWN breached the lease by deducting post-production costs in calculating gas royalty payments. The Youngs relied on West Virginia royalty cases Estate of Tawney v. Columbia Natural Resources LLC and Wellman v. Energy Resources Inc. to argue that at-the-wellhead lease language is ambiguous, and that Equinor and SWN must bear all costs, including post-production costs incurred to render the gas marketable, under the Young lease.[1]

The district court granted summary judgment for the Youngs, holding that Equinor and SWN wrongfully deducted post-production costs in calculating gas royalties because the Young lease lacked a "mathematical formula" for post-production deductions.

The Fourth Circuit disagreed, and held that at-the-wellhead royalty language has what it called a "precise and definite" meaning that does not demand "Einsteinian proof" of the method of calculating the amount of post-production deductions — the simple netback formula (gross proceeds minus identified post-production costs) and the identification of deductible post-production costs in the Young lease was sufficient.

Important to the Fourth Circuit's decision was the West Virginia Supreme Court of Appeals' 2017 decision in Leggett v. EQT Production Co., which expressly endorsed deducting post-production costs from the value-added downstream price of gas to calculate a wellhead price where gas is sold downstream of the well. While Leggett concerned the calculation of royalties under the West Virginia flat-rate statute,[2] the court found that the same analysis applies to the calculation of royalties under the Young lease.

Accordingly, the Fourth Circuit concluded that the work-back method endorsed by the West Virginia Supreme Court of Appeals in Leggett was an equally appropriate method for calculating royalties under the Young lease.

The Fourth Circuit criticized the district court for relying on its own 2018 decision in the Kay v. EQT Production case, in which the district court held that post-production deductions are improper under leases that do not specify a method of calculating the amount of deductions.[3] The court did not hold back in its assessment that the Kay case was wrongly decided.

The Fourth Circuit was similarly critical of the Tawney and Wellman decisions, noting that those decisions ignore the impact of deregulation of the natural gas market, which moved the point of sale of gas from the wellhead to liquid trading points at pipeline interconnections and other downstream locations. The court emphasized that disallowing post-production deductions in calculating royalties at the well results in an unfair windfall for the royalty owners, by effectively rewriting the parties' contract to require the producer to bear all post-production costs incurred from the wellhead to distant, downstream markets and even to points of sale in other states.

The Fourth Circuit's approval of the netback method to calculate the wellhead price of gas under a lease that calls for royalties at the wellhead is far from groundbreaking. However, there are several important takeaways from the decision that are broadly applicable in calculating royalties under West Virginia oil and gas leases:

- Where a lease provides for royalties to be calculated at the wellhead by deducting post-production costs from a downstream value-added price, the lessee may use the netback method to calculate the wellhead price of gas and pay royalties based on that price.

- The West Virginia Supreme Court's analysis of deductibility of post-production costs under the West Virginia flat-rate statute in Leggett equally applies to determine deductibility under at-the-well oil and gas lease language.

In short, the Fourth Circuit's decision calls into further question the continued vitality of Tawney and Wellman. But the holding of Leggett is still intact, and applies to oil and gas leases that, like the West Virginia flat-rate statute, provide for royalties "at the well" or "at the wellhead."

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[1] Estate of Tawney v. Columbia Natural Resources LLC, 633 S.E.2d 22 (W. Va. 2006); Wellman v. Energy Resources Inc., 557 S.E.2d 254, 265 (W. Va. 2001).

[2] W. Va. Code § 22-6-8 (1994).

[3] Kay Co. LLC v. EQT Production Co., No. 1:13-cv-151 (N.D. W. Va. Jan. 5, 2018).