

Deducting Post-Production Costs From Fee Royalty

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The phone rings. It's your owner relations department. They just received a call from a lessor who has been taking a closer look at the information provided along with the lessor's oil and gas royalty checks. The lessor wants to know why you are deducting post-production costs, such as transportation or compression of gas, when calculating the lessor's royalty.

The deductibility of post-production costs can have significant implications for an oil and gas lessee. Several commentators have addressed this issue in-depth over the years.¹ This article is intended to provide an introduction to the deductibility of post-production costs under fee oil and gas leases.²

Production Costs vs. Post-Production Costs

Normally, the lessee under an oil and gas lease, not the lessor, is responsible for paying the expenses of exploration and production.³ These generally include the costs associated with geophysical surveying, drilling, testing, completing, and reworking a well, as well as secondary recovery.⁴

Post-production costs that may, or may not, be deductible when calculating the royalty generally include gross production and severance taxes, transportation costs, and the costs of dehydrating, compressing, or otherwise processing gas (such as the extraction of liquids from gas or casinghead gas).⁵

Lease Provisions

When determining whether post-production costs are deductible from the royalty, the lease should be carefully examined. Sometimes the lease terms will specify whether post-production costs are deductible. For example, as part of the royalty clause, a lease may provide:

Lessee shall have the right to deduct from Lessor's royalty on any gas produced hereunder the royalty share of the cost, if any, of compression for delivery, transportation and/or delivery thereof.⁶

But what if the lease does not include a provision such as the one above? Or what if the lease provides for the payment of royalty based on market value or net proceeds "at the well"⁷ but does not spell out the types of post-production costs that are deductible before the royalty is calculated? Is that enough?

"At the Well"

The following is an example of a gas royalty provision with “at the well” language:

Royalties to be paid by Lessee are: . . . (b) on gas, including casinghead gas or other gaseous substance, produced from said land and sold or used, the market value at the well of one-eighth (1/8) of the gas so sold or used, provided that on gas sold at the well the royalty shall be one-eighth (1/8) of the amount realized from such sales[.]⁸

*Bice v. Petro-Hunt, L.L.C.*⁹ provides an example of the majority view on deducting post-production costs when the royalty clause contains “at the well” language.¹⁰ In *Bice*, the North Dakota Supreme Court determined whether processing costs for sour gas were properly deducted when calculating the royalty under oil and gas leases that contained “market value at the well” language. The Court noted that the majority of oil and gas producing states have adopted the “at the well” rule and “interpret the term ‘market value at the well’ to mean royalty is calculated based on the value of the gas at the wellhead.”¹¹ The Court also noted that in states that have adopted the “at the well” rule,¹² a lessee has the option of calculating the market value at the well through the “comparable sales method” or the “work-back” (a/k/a “net-back”) method.¹³ The comparable sales method involves “averaging the prices that the lessee and other producers are receiving, at the same time and in the same field, for oil or gas of comparable quality, quantity, and availability.”¹⁴ Under the work-back method, the “market value at the well” is determined by deducting reasonable post-production costs (incurred after the product is extracted from the ground) from the sales price received at a downstream point of sale.¹⁵

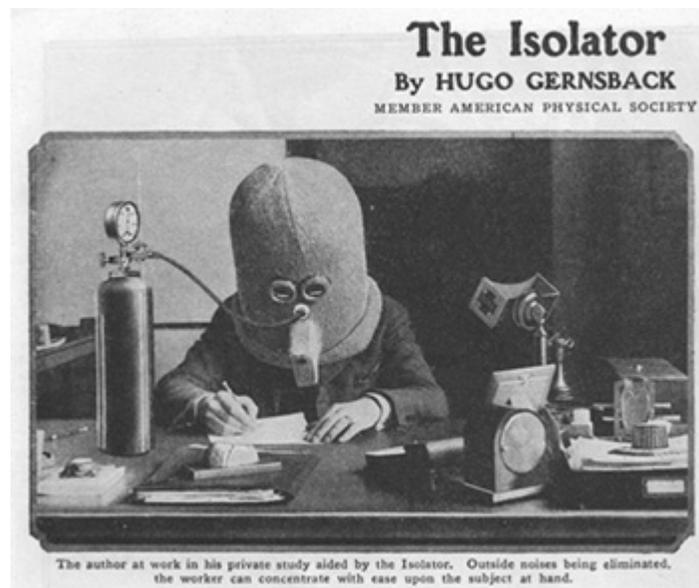
The Court found that the gas at issue had “no discernible market value at the well before it is processed”¹⁶ The Court reasoned that “[s]ince the contracted for royalty is based on the market value of the gas at the well and the gas has no market value at the well, the only way to determine the market value of the gas at the well is to work back from where a market value exists”¹⁷ Adopting the “at the well” rule, the Court held that the operator properly deducted post-production costs for processing prior to calculating the royalty.¹⁸

A similar result was reached in *Emery Resource Holdings, LLC v. Coastal Plains Energy, Inc.*¹⁹ In *Emery*, the federal district court in Utah was asked to interpret oil and gas leases that contained “at the well” royalty clauses²⁰ and determine whether post-production gathering and processing costs were deductible.²¹ The Court noted that “[t]he majority of courts . . . have found ‘at the well’ royalty clauses to mean that natural gas is valued for royalty purposes at its wellhead location and condition.”²² Predicting what a Utah court would do when faced with this situation,²³ the Court in *Emery* held that the “at the well” language in the leases was clear and that the parties intended for the royalty to be calculated according to the market value at the well.²⁴ Thus, the Court allowed the operator to deduct post-production costs incurred from the wellhead separators to the pipeline in determining the market value at the well prior to calculating the royalty.²⁵

In some states, however, including the words “at the well” in the royalty provision may not be enough. For example, in *Rogers v. Westerman Farm Co.*²⁶ the Colorado Supreme Court determined whether post-production costs were properly deducted under leases that provided for royalty “at the well” or “at the mouth of the well.” The Court held that the leases were “silent” as to the allocation of post-production costs, even with “at the well” language.²⁷ The Court held that “[a]bsent express lease provisions addressing allocation of costs, the lessee’s duty to market requires that the lessee bear the expenses incurred in obtaining a marketable product. Thus, the expense of getting the product to a marketable condition and location are borne by the lessee.”²⁸ After the product is “marketable,” any further costs incurred in improving the product or transporting it may be shared by the lessor and lessee.²⁹ The point at which the gas is “marketable” is a question of fact for the judge or jury to decide.³⁰ Thus, in Colorado,³¹ lease language that defines the royalty as being payable “at the well” or “at the mouth of the well” is not enough to allocate post-production costs.³²

Conclusion

Now is the time for lessees under fee oil and gas leases to carefully examine their records, on a lease-by-lease basis, and determine whether they are properly deducting post-production costs prior to calculating the royalty. The deductibility of post-production costs depends on the lease terms and the laws of the state where the leased lands are located. Lessees should not, and in some states cannot, rely on “at the well” language to provide for the deduction of post-production costs. As needed, lessees should modify their lease forms to specifically provide for the deduction of post-production costs and identify all of the post-production costs that are deductible.



How to increase attention to detail in title examination.

¹ See Patrick H. Martin & Bruce M. Kramer, *Williams & Meyers, Oil and Gas Law* § 645, Footnote 1 (2014) for citations to such articles.

² This article is not intended to provide a comprehensive analysis of the law on the deductibility of post-production costs or the law of any particular jurisdiction. The reader should consult with competent legal counsel regarding the law that applies to any particular situation and jurisdiction.

³ Patrick H. Martin & Bruce M. Kramer, *Williams & Meyers, Oil and Gas Law* § 645.1 (2014).

⁴ *Id.*

⁵ *Id.* § 645.2.

⁶ *Id.* § 643 (quoting a Mid-Continent lease form).

⁷ The term “at the well” is often included in the royalty clause of an oil and gas lease in defining the point of valuation of the oil and gas. Patrick H. Martin & Bruce M. Kramer, *Williams & Meyers, Manual of Oil and Gas Terms* 63 (2009).

⁸ *Brown, The Law of Oil and Gas Leases, 2nd Edition* § 6.13 (2014) (emphasis added).

⁹ 768 N.W.2d 496 (N.D. 2009).

¹⁰ *Id.* at 499.

¹¹ *Id.* at 500-501 (citing Byron C. Keeling & Karolyn King Gillespie, *The First Marketable Product Doctrine: Just What is the Product?*, 37 St. Mary's L.J. 1, 51 (2005); Edward B. Poitevent, II, *Post-Production Deductions from Royalty*, 44 S. Tex. L. Rev. 709, 716 (2003); and Brian S. Wheeler, *Deducting Post-Production Costs When Calculating Royalty: What Does The Lease Provide?*, 8 Appalachian J.L. 1, 7 (2008)).

¹² The Court noted that Louisiana, Mississippi, Texas, California, Kentucky, Montana, and New Mexico follow the “at the well” rule. *Bice*, at 501 (citing *Babin v. First Energy Corp.*, 96 1232, p. 2 (La. App. 1 Cir. 3/27/97); 693 So.2d 813, 815; *Heritage Res., Inc. v. NationsBank*, 939 S.W.2d 118, 122 (Tex. 1996); *Piney Woods Country Life Sch. v. Shell Oil Co.*, 726 F.2d 225 (5th Cir. 1984) (interpreting Mississippi law); *Elliott Indus. Ltd. P'ship v. BP America Prod. Co.*, 407 F.3d 1091, 1109–10 (10th Cir. 2005); *Atlantic Richfield Co. v. State*, 214 Cal. App. 3d 533, 262 Cal.Rptr. 683, 688 (1989); *Montana Power Co. v. Kravik*, 179 Mont. 87, 586 P.2d 298, 303 (1978); *Reed v. Hackworth*, 287 S.W.2d 912, 913 (Ky. 1956)).

¹³ *Bice*, at 501.

¹⁴ *Id.* (quoting Keeling & Gillespie, *supra*, at 31-32).

¹⁵ *Id.* (quoting Keeling & Gillespie, *supra*, at 32).

¹⁶ *Id.* at 502.

¹⁷ *Id.* The Court noted that the comparable sales method was unavailable to calculate the royalty in this case because “no comparable sales exist since the gas is not saleable at the wellhead.” *Id.*

¹⁸ *Id.* For an in-depth analysis of the Court's decision in *Bice*, see David E. Pierce, *Royalty Jurisprudence: A Tale of Two States*, 49 Washburn L.J. 347, 370-374 (2009).

¹⁹ 15 F.Supp.2d 1231 (D. Utah 2012).

²⁰ Most of the leases included the words “at the well” in the royalty clause. *Id.* at 1237. Two of the leases provided for royalty on “the proceeds from the sale of the gas, as such, for gas from wells where gas only is found” *Id.* at 1238. The Court examined the language surrounding this clause and concluded that “the parties intended all products produced from the wells to be valued at the prevailing market rate at the wellhead” rather

than “some location downstream and away from the leased premises.” *Id.* at 1238-39.

²¹*Id.* at 1235.

²²*Id.* at 1240 (citations omitted).

²³Noting that the Utah Supreme Court has not directly ruled on the deductibility of post-production costs in oil and gas operations, the Court in *Emery* looked to the Utah Supreme Court's decision in *Rimledge Uranium and Mining Corp. v. Federal Resources Corp.*, 374 P.2d 20 (1962). *Emery*, at 1241. In *Rimledge*, the Utah Supreme Court found that where a deed of uranium mining claims provided for a royalty of 15% “of all gross proceeds from the sale of ore,” the parties intended for the royalty to be based on the sale proceeds of raw ore, or the fair market value of raw ore in the vicinity, rather than the value of concentrated ore after processing in the mill. *Emery*, at 1242.

²⁴*Id.*

²⁵*Id.*

²⁶29 P.3d 887 (Colo. 2001).

²⁷*Id.* at 902.

²⁸*Id.*

²⁹*Id.*

³⁰*Rogers*, at 906.

³¹Other states that have rejected the “at the well” rule include Arkansas, Oklahoma, Kansas and West Virginia. *Bice*, *supra*, at 501 (citing *Keeling & Gillespie*, *supra*, at 51; *Wheeler*, *supra*, at 10).

³²For an in-depth analysis of the Court's decision in *Rogers*, see *Pierce*, *supra*, at 358-364; see also *Martin & Kramer*, *supra*, at § 645.

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