

Supreme Court of Ohio Hears Oral Argument in *Lutz v. Chesapeake*

Decision will determine if oil and gas companies can deduct post-production expenses from landowner royalties

PRACTICE AREA / INDUSTRY: ENERGY, OIL & GAS



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In a dispute between several landowners and Chesapeake Appalachia, L.L.C. (“Chesapeake”) over the decades-old rules governing how to pay post-production expenses, the Supreme Court of Ohio heard oral arguments today in *Regis F. Lutz et al. v. Chesapeake Appalachia, L.L.C.*

Case Background

Long before Ohio’s recent boom in oil and natural gas production, the federal government revised regulations governing the way the products get from the wells to the pipelines. Until the Federal Energy Regulatory Commission deregulated the natural gas industry in the early 1990s, natural gas was generally sold by the oil and gas producers at the wellhead. After deregulation, more frequently, the natural gas was taken by the producers to an offsite location to sell. This change in process caused the production companies to incur “post-production” costs that include, for example, compressing and dehydrating the gas, and the cost of transportation and logistics to get the gas to the point of sale location.

The deregulation created a dispute between landowners who signed leases in the 1960s and 1970s, over how to allocate these new costs of doing business. Both the landowners and Chesapeake agree that the company is responsible for all post-production costs. The dispute centers on whether the leases allow Chesapeake to deduct post-production costs before calculating royalties, thus requiring the landowners to share in the cost of post-production. The lease at issue states that the royalty payment to the landowner is based upon the price sold “at the well” and, furthermore, when the gas was sold someplace else, the landowner’s royalty would be based on the “market value at the well,” resulting in the landowner sharing pro rata in the costs of production (*i.e.*, a net value). The two sides interpret “market value at the well” differently. Chesapeake asserts that the majority of the oil and gas producing states follow the “at the well” rule permitting the deduction of post-production costs. The landowners argue that, following the industry de-regulation, there are no more true sales “at the well.” Accordingly, argue the landowners, Ohio’s implied covenant to market means that the producer should bear the responsibility to cover all post-production costs to make the gas marketable.

Potential Impact on Ohio's Oil and Gas Industry

If Ohio adopts the at-the-well rule, it would be similar to surrounding oil and gas producing states such as Michigan, Pennsylvania, and Kentucky, as well as Texas and Mississippi. Litigation surrounding the interpretation of royalty clauses has been robust in recent years. This is the Ohio Supreme Court's first case addressing issues surrounding such clauses, but surely will not be the last. Because the landowners in this case have presented this case as a putative class, a decision on the issue before the Court could have a significant monetary impact. Moreover, the Court's decision on this issue will have a significant impact on the industry, as a whole, which is evidenced by the amicus filings on behalf of the Ohio Oil and Gas Association and the American Petroleum Institute.

Synopsis of Oral Argument

The Supreme Court of Ohio will address the following certified questions from the United States District Court, for the Northern District of Ohio:

- Does Ohio follow the "at the well" rule, which would allow a drilling company to deduct post-production expenses when calculating oil and gas royalty payments to landowners?
- Does Ohio follow a version of the "marketable product" rule, which doesn't allow the gas company to deduct the expenses for preparing the oil and gas for sale in the market?
- Should Ohio courts not select a rule and attempt to determine the cost allocation based on the interpretation of oil and gas leases on a case-by-case basis?

Oral Argument

Oral argument in this matter resulted in a very active bench, with participation, in some form, by each of the seven Justices. Most active were Chief Justice O'Connor, and Justices Pfeifer and O'Donnell. Because of the complexities involved in the legal issues before the Court, much of the oral argument was almost educational in nature to provide context to the Court about the intricacies involved in the production of oil and gas, and the steps involved in taking natural gas to market. Chesapeake's argument was rather straightforward – the Court should follow the language in the lease. Counsel for the landowners, however, argued that the Court should ignore the "at the well" language in the lease because there are no more true sales of natural gas "at the well" in today's industry.

Both oralists performed quite well. Indeed, even one not as tied-in to litigation surrounding oil and gas in Ohio, would find this oral argument interesting and entertaining. The oral argument can be viewed at the following link: <http://www.ohiochannel.org/MediaLibrary/Media.aspx?fileId=147917>.

For further information on the subject matter of this alert, please contact:

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