

Pennsylvania Supreme Court to Clear Up Uncertainty Under Pennsylvania Royalty Statute

July 21, 2009

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***As seen on Energy Law360.**

In an Order issued by the Supreme Court of Pennsylvania, Middle District, on June 16, 2009, the Court granted the Application to File a Reply Brief and the Petition for Exercise of Extraordinary Jurisdiction in the matter of *Kilmer v. Elexco Land Services, Inc.*, No. 46 MM 2009, and directed the parties to file briefs on the legal question set forth below. Recent decisions issued by the Court of Common Pleas in Susquehanna County (in the *Kilmer* case) and the United States District Court for the Middle District of Pennsylvania have left property owners and oil and gas producers in Pennsylvania with no clear answer to the question.

Legal Question: Whether the Pennsylvania Minimum Royalty Statute, at 58 P.S. § 33 (the "Royalty Statute"), invalidates an oil and gas lease providing for the deduction of "post-production" costs from a one-eighth royalty. The Royalty Statute provides that "a lease or other such agreement conveying the right to remove or recover oil, natural gas or gas of any other designation from lessor to lessee shall not be valid if such lease does not guarantee the Lessor at least one-eighth royalty of all oil, natural gas or gas of other designations removed or recovered from the subject real property."

The Kilmer Decision

On March 16, 2009, the Court of Common Pleas for Susquehanna County, Pennsylvania, in *Kilmer v. Elexco*, No. 2008-57 ("Kilmer"), granted summary judgment in favor of the producer. The lease in *Kilmer* provides for the subtraction of post-production costs from a royalty equal to one-eighth of the sales proceeds actually received by the Lessee from the sale of production from a well under the lease. For purposes of the lease, post-production costs are defined as a one-eighth share of "all costs actually incurred by Lessee from and after the wellhead to the point of sale, including, without limitation, all gathering, dehydration, compression, treatment, processing, marketing, and transportation costs incurred in connection with the sale of such production."

The court observed that (i) the statute does not define the term "royalty" and, on its face, the royalty statute "does not prohibit the inclusion of post-production costs to calculate the one-eighth royalty" and (ii) "the Defendant has made a persuasive argument that the custom in the oil and gas trade throughout the country is to include "post-production" costs in calculating the royalty." Accordingly, the court held that "the parties are, therefore, free to negotiate how that royalty shall be calculated, so long as the net result is not less than one-eighth."

The Supreme Court of Pennsylvania was subsequently asked to exercise extraordinary jurisdiction to review this case and thereby issue guidance to other courts wrestling with the same issue.

The Kropa Decision

On April 17, 2009, the United States District Court for the Middle District of Pennsylvania, in Kropa v. Cabot Oil & Gas Corporation, WL 1044610 ("Kropa"), denied the Defendant Cabot Oil & Gas Corporation's motion to dismiss on the same issue. In Kropa, the lease provided for a royalty of one-eighth of the amount realized from the sale of gas at the well, which the lease defined as "the amount realized less all costs of gathering, transportation, compression, fuel, line loss and other post-production expenses incurred downstream of the wellhead."

The Court acknowledged the decision of the Court of Common Pleas in Kilmer, but disagreed with its analysis, stating that "the issue presented is whether the mandatory one-eighth royalty is achieved if post-production costs are deducted before payment. To make such a determination, it is necessary to construe the term "royalty" as used in the statute. We are not convinced that merely because the statute is silent on whether post-production costs can be deducted means that such costs can in fact be legally deducted from the royalty."

Defendant argued that that, although a plain reading of the Royalty Statute would support the plaintiff's position, the term "royalty" should be construed to allow for the deduction of post-production costs because "[i]ndustry standards and practice from all of the oil and gas producing states and the case law from all such jurisdictions prove that Plaintiff is receiving ... a full one-eighth royalty." Contrary to Defendant's argument and the position of the Court in Kilmer, the Court concluded that not all jurisdictions have defined "royalty" as including a deduction for post production costs.

The Belcher Decision

On May 8, 2009, the United States District Court for the Middle District of Pennsylvania, in Belcher v. The Keeton Group ("Belcher"), declined to exercise its jurisdiction to hear a declaratory action involving facts substantially similar to those in Kilmer and Kropa. Recognizing that the Pennsylvania Supreme Court would likely be ruling on the issue in the near future, the Court decided not to "predict" what that ruling might be.

Observation

During 2008, many producers began competing for oil and gas leases in Pennsylvania for the purpose of ultimately drilling deep wells down to the Marcellus Shale, a deep geologic formation sitting below much of Pennsylvania. This competition resulted in attractive signing bonuses and lucrative royalties for property owners. Prior to 2008, most oil and gas leases in Pennsylvania involved only nominal, if any, signing bonuses and royalties typically were limited to one-eighth of the production. Inevitably, many property owners in Pennsylvania who were subject to older leases with less favorable terms, began to consider ways in which oil and gas leases could be terminated. Numerous cases, including the cases described in this article, have been filed in Pennsylvania over this issue.

The validity of thousands of oil & gas leases in Pennsylvania, some which have been in place for many years and "held by production", is at stake. A ruling in favor of the property owners which leads to the termination of these leases could also call into question rights of the producer to various wells, pipelines and related infrastructure put into place under these leases. As the Pennsylvania Supreme Court considers this issue, it will likely need to wrestle with the question of whether termination of a lease is an appropriate remedy.