

Royalty Litigation

Appalachian Producers Seminar

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Introduction

- In 2006, class action litigation in West Virginia resulted in new law regarding payment of royalty under certain oil and gas leases
- *Tawney v. Columbia Natural Resources, LLC* 633 S.E.2d 22 (W. Va. 2006), finds that standard language formerly believed clear is ambiguous and must be construed against lessee
- West Virginia producers can pay royalty on receipts less gathering and processing expenses when the lease contains unambiguous language that permits deductions

Statements By The Court

Implied duty to market includes the responsibility to:

- 1) get the oil or gas in marketable condition;
and
- 2) actually transport it to market.

Syllabus Points By Court

- 1) If an oil and gas lease provides that the lessor shall bear some part of the costs incurred between the wellhead and the point of sale, the lessee shall be entitled to credit for those costs to the extent that they were actually incurred and they were reasonable. Before being entitled to such credit, however, the lessee must prove, by evidence of the type normally developed in legal proceedings requiring an accounting, that he, the lessee, actually incurred such costs and they were reasonable

Syllabus Points By Court

- 2) If an oil and gas lease provides for a royalty based on proceeds received by the lessee, unless the lease provides otherwise, the lessee must bear all costs incurred in exploring for, producing, marketing, and transporting the product to the point of sale

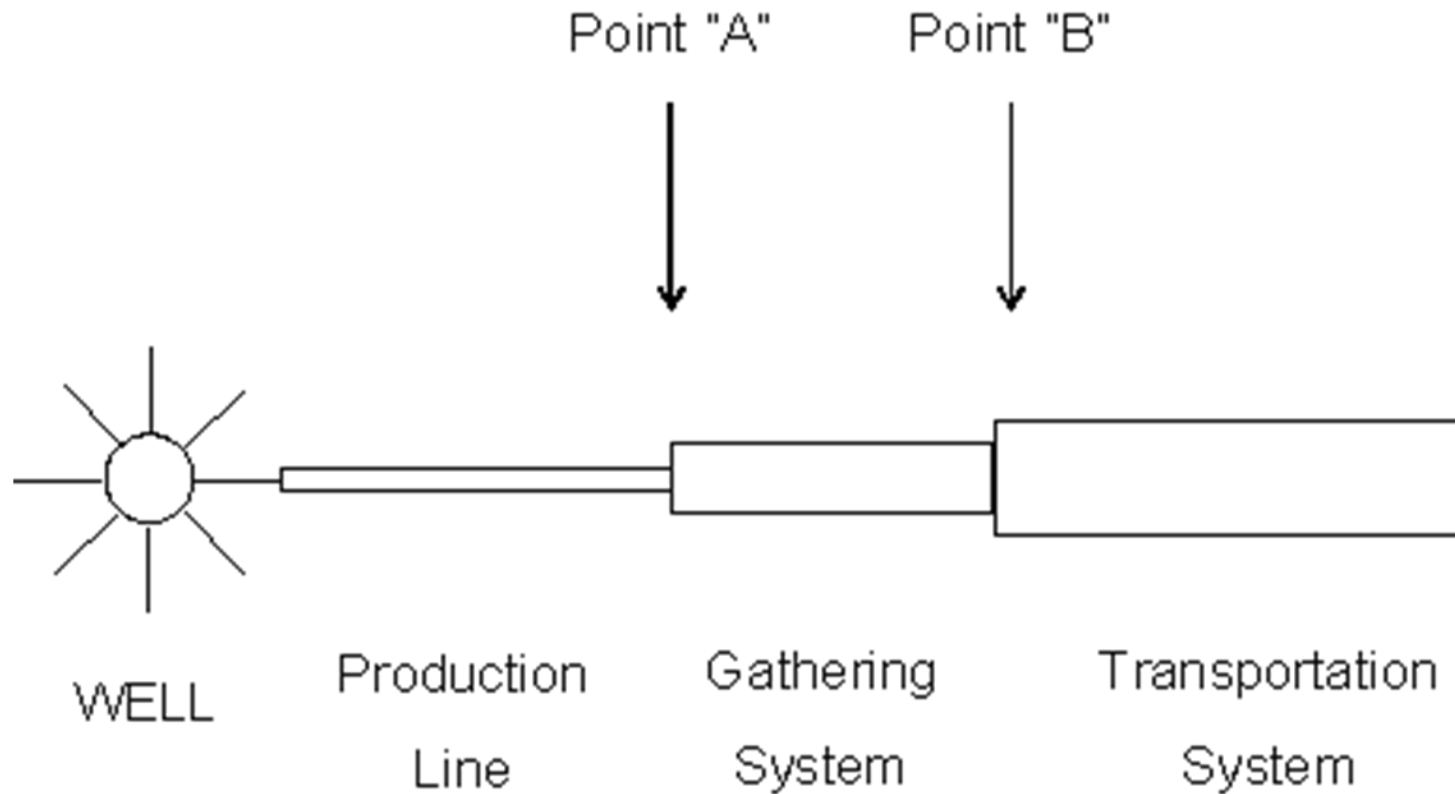
- 3) The general rule as to oil and gas leases is that such contracts will be liberally construed in favor of the lessor, and strictly as against the lessee

The "Point of Sale"

Statement from the *Tawney* Opinion:

“Language in an oil and gas lease that provides that the lessor’s 1/8 royalty (as in this case) is to be calculated “at the well,” “at the wellhead,” or similar language, or that the royalty is “an amount equal to 1/8 of the price, net all costs beyond the wellhead,” or “less all taxes, assessments, and adjustments” is ambiguous and, accordingly, is not effective to permit the lessee to deduct from the lessor’s 1/8 royalty any portion of the costs incurred between the wellhead and the point of sale.”

Point of Sale



Drafting New Leases

- *Accordingly, this Court now holds that language in an oil and gas lease that is intended to allocate between the lessor and lessee the costs of marketing the product and transporting it to the point of sale must*
 - *Expressly provide that the lessor shall bear some part of the costs incurred between the wellhead and the point of sale,*
 - *Identify with particularity the specific deductions the lessee intends to take from the lessor's royalty (usually 1/8), and*
 - *Indicate the method of calculating the amount to be deducted from the royalty for such post-production costs.*

Post Trial Proceedings

- June 27, 2007, trial court reviewed and sustained \$270,000,000 punitive damage award
- Jury could conclude CNR royalty statements indicated deductions were not taken

Post Trial - Punitives Review

- “...the volume that was represented on the accounting statement to have been produced was never as much as the true volume actually produced.”
- “...the column containing the ‘rate’ at which Plaintiffs [gas] (sic) was purportedly sold was misrepresentation, because the gas was never sold at that rate and was very substantially less than the ‘market value’ or the ‘highest price reasonably obtainable’ for which Defendants were obligated to sell the gas.”

Punitive Damages Upheld

- “CNR reported deductions of “0.00” when the truth is that, beginning in 1993, significant sums of money were deducted from the royalty interest for gathering, processing and related expenses.”

Post Trial

- **Motions for New Trial denied September 25, 2007**

Appeal

- Substantive rules established by *Tawney* decision not directly reviewed
- Some clarification of *Tawney* rules may occur

Appeal – Substantive Issues

- Can fixed price contracts be the basis for calculation of royalty?
- “Best price available” standard?

Appeal

- Are any flat rate royalty leases valid in West Virginia?
- If flat rate leases are all invalid, can the ruling be applied retroactively?

Other Issues

- Procedural
- Evidentiary
- Substantive
 - Punitive damages
 - One minute pick up test
 - Sufficiency of royalty statements
 - Statutes of limitation
 - Other issues

Legislation Proposed – Not Enacted

- Producers would not be required to pay royalty on reasonable line loss, or on actual transportation charges made by a third party.
- Producers would not be permitted to deduct the cost of transporting gas from the wellhead to the point of delivery into a third party transportation line.

Proposed Legislation – Not Enacted

- Producers that transport for others for a fee could deduct amount charged, not exceeding costs approved by regulatory authorities -- costs from the wellhead to lines that transport for others not deductible.
- Royalty could be calculated using reasonable, arms-length prices under long term contracts if the only consideration paid was for gas. If a long term contract did not qualify under the factors set forth in the legislation, then first of the month index less reasonable post-production expenses could be used to pay royalty.

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