<u>Market Enhancement Clauses and ‘Deductions’</u>: Do I Have a Claim Against the Gas Company for Improper Royalty Payments?

An extremely hot issue at the present time involves post-production costs or “deductions” that landowners are seeing subtracted from their gas royalty checks. Typically, boilerplate Oil and Gas Leases offered to landowners clearly permit the gas company to deduct post-production costs for the cost of producing, gathering, storing, separating, treating, dehydrating, processing, transporting and marketing the oil and gas.

In the 2010 Pennsylvania Supreme Court’s decision in <u>Kilmer v Elexco Land Services, Inc. et al</u>., 605 Pa.413, 990 A.2D 147 (Pa. 2010), the Pennsylvania Supreme Court *held that post-production costs such as gathering, compression, transportation and others are properly shared by royalty owners through proceeds deductions unless the Oil and Gas Lease expressly provides otherwise*.

Most leases signed by landowners before 2008 were boilerplate leases and did not have Addendum language addressing royalty calculation issues and post-production costs. However, beginning around 2008, leases were heavily negotiated as gas company competition for Marcellus Shale leaseholds became fierce. As a result of these negotiations landowners strengthened royalty provisions in the form Addendum added to the boiler plate gas lease. Landowners sought Addendum terms addressing royalty calculation in effort to eliminate or reduce post-production costs.

One common royalty addendum provision, often referred to as a “Market Enhancement Clause”, began to surface in many Oil and Gas Lease Addendum. The “Market Enhancement Clause” provides as follows:

> ***<u>MARKET ENHANCEMENT CLAUSE</u>***
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> *All oil, gas or other proceeds accruing to Lessor under this lease or by state law shall be without monetary deduction, directly or indirectly, for the cost of producing, gathering, storing, separating, treating, dehydrating, compressing, processing, transporting, and marketing the oil, gas and other proceeds produced hereunder to <u>transform the product into **marketable form**</u>; however, any such cost which result in <u>enhancing</u> the value of the **<u>marketable</u>** oil, gas or other products to receive a better price may be deducted from Lessor’s share of production so long as they are based on Lessee’s actual cost of such enhancements. However, in no event shall Lessor receive a price that is less than, or more than, the price received by Lessee.*

Many landowners understood this Market Enhancement Clause to eliminate, or at worst, reduce the post-production costs that a gas company could subtract from their royalty share. Unfortunately many landowners with the Market Enhancement Clause Addendum term are now starting to receive royalty checks and are suffering from severe sticker shock when they see the often substantial deductions companies are taking for post production costs.

The most often cited company for taking post-production costs under the Market Enhancement Clause is Chesapeake Appalachia, LLC ("Chesapeake"). Chesapeake is on record taking the position that the gas produced from leases in northeastern Pennsylvania is in a "marketable condition" <u>at the well head</u>. In fact, Chesapeake actually sells the gas at the wellhead to their wholly owned subsidiary Chesapeake Energy Marketing, Inc. ("CEMI"). CEMI is a marketing company which takes title and possession of gas at the wellhead and incurs costs and expenses to transport the gas from the wellhead to the downstream point of sale. Chesapeake concludes that under the Market Enhancement Clause they are permitted to deduct these post-production costs, including gathering and transportation fees, from the wellhead to the downstream point of sale asserting that these costs "**enhance**" the value of marketable gas. Although some companies apparently share Chesapeake's interpretation of the Market Enhancement Clause, not all oil and gas companies are interpreting the Market Enhancement Clause in the same fashion.

The question arises whether the gas is truly in "marketable form" at the wellhead or whether marketability actually occurs at the first interstate pipeline receipt point where gas is often sold. A second question arises as to whether Chesapeake's sale to CEMI, an affiliated third party, constitutes a true market transaction appropriately establishing the gas price from which landowners royalties are calculated or whether the starting point for royalty calculation should be set at the first <u>non-affiliated</u> third party transaction.

Interestingly, the defendant gas companies in the <u>Kilmer</u> argued that they should be permitted to deduct the post-production costs from the wellhead to the downstream point of sale as these costs are necessary to turn the gas into a *marketable commodity*. The companies in <u>Kilmer</u> acknowledged that gas at the wellhead requires extensive post-production activities necessary to process the gas into a marketable product. Chesapeake now asserts the opposite.

Unfortunately for landowners it appears that the only way to resolve this issue is to formally challenge Chesapeake's position seeking to settle or litigate this issue through court action or arbitration, depending upon the dispute resolution terms in the lease. If these issues go unchallenged, the status quo will continue and landowners will continue to receive their royalty checks with significant post-production costs deductions.

Whether landowners want to pursue a claim against a gas company for improper royalty payments is a personal decision that should only be made after fully understanding your rights and options. Landowners who believe they are improperly receiving royalty payments should contact a legal professional experienced in oil and gas matters to discuss their options and explore whether raising a claim against the gas company for improper royalty payments is right for them. Remember, only with a full understanding of these issues and your options will you be able to make a decision that his right for you and your particular circumstances.

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