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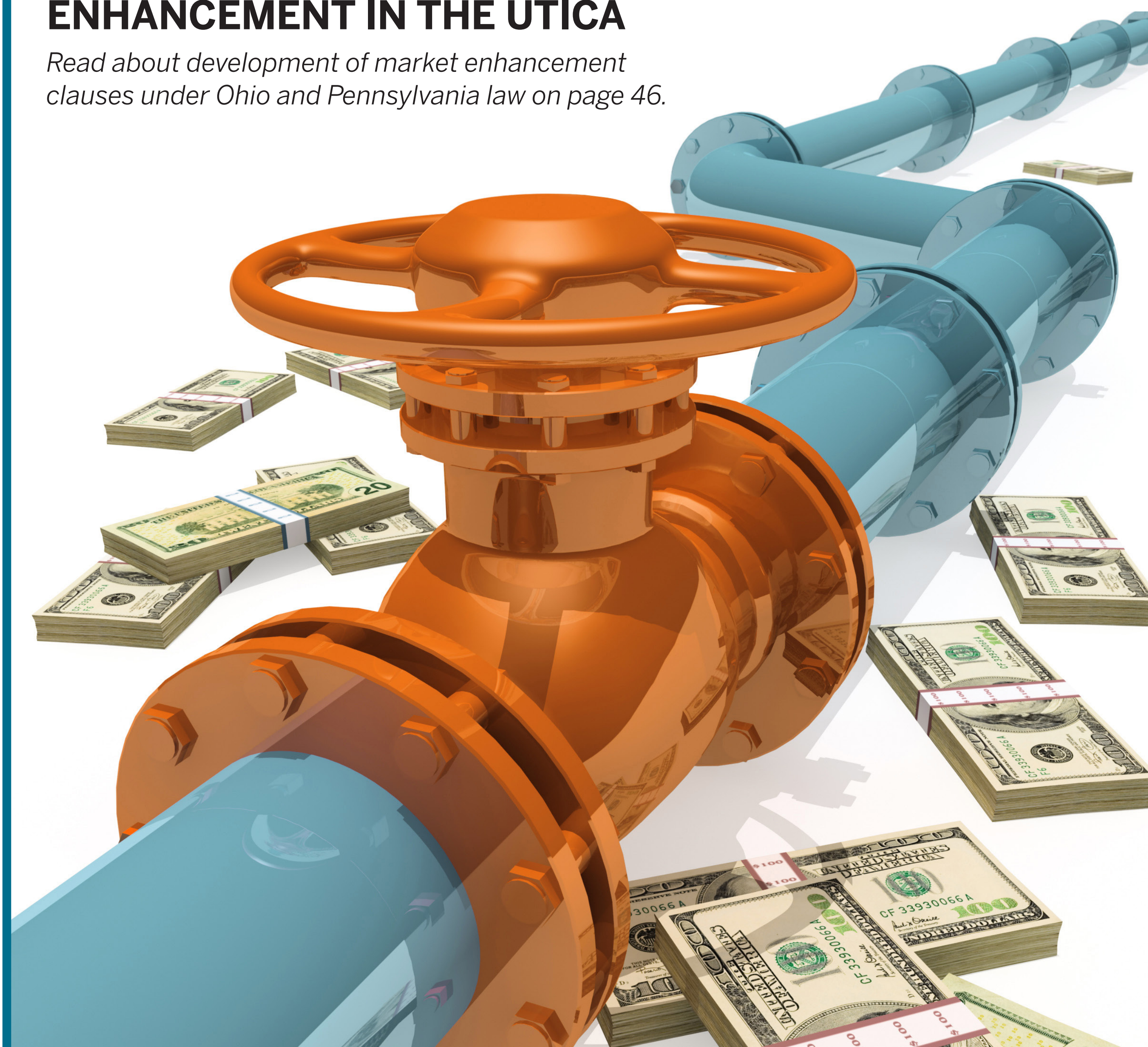

MARKETABILITY AND ENHANCEMENT IN THE UTICA

Read about development of market enhancement clauses under Ohio and Pennsylvania law on page 46.

Marketability and Enhancement in the Utica

Development of market enhancement clauses under Ohio and Pennsylvania law

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Pennsylvania and Ohio are the cradle of oil and gas development in the United States. More than a century ago, they were the leading producers of oil; they are where John D. Rockefeller made his Standard Oil fortune. But by World War I, the focus of oil and gas production shifted westward to states like Texas, Oklahoma and Kansas. This had a remarkable consequence on the development of oil and gas law. While Western states were developing an extensive body of case law regarding the interpretation of oil and gas leases, the case law in Pennsylvania and Ohio stagnated. In fact, although both states' supreme courts issued seminal opinions involving oil and gas leases in the late 19th century,[1] more than 100 years passed before they were again asked to weigh in on issues of consequence related to oil and gas leases.

So by the time landmen sought to develop leasehold positions in the Utica and Marcellus in the early 2000s, they did so without the benefit of direct court guidance on key issues like the deductibility of post-production costs. By that point, some states — like Oklahoma and Colorado — had adopted various forms of a "first marketable product" rule, pursuant to which post-production costs could be deducted from royalties only after a product was "marketable." Other states — like Texas — had developed an "at the well" approach, pursuant to which post-production costs could be deducted if the lease specified that royalties were to be paid based on the value of hydrocarbons "at the well." Beyond that, at least one Appalachian state — West Virginia — had issued a court opinion holding that post-production costs could be deducted in only very narrow circumstances.

In light of that uncertainty, many producers included "market enhancement clauses" in their leases, carving out a middle ground that permitted the deduction of postproduction costs, but only so long as the hydrocarbons were "marketable" and the post-production costs "enhanced" their value. The MEC originated from

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1 *Harris v. Ohio Oil Co.,* 48 N.E. 502 (Ohio 1897); *Akin v. Marshall Oil Co.,* 41 A. 748, 751 (Pa. 1898).

the Supreme Court of Oklahoma's decision in *Mittlestaedt*,[2] which held that lessors "must bear a proportionate share" of post-production costs if the lessee can show "(1) that the costs enhanced the value of an already marketable product, (2) that such costs are reasonable, and (3) the actual royalty revenues increased in proportion with the costs assessed against the nonworking interest."[3]

Although not all MECs are identical, an example is as follows:

> It is agreed between the Lessor and Lessee that, notwithstanding any language herein to the contrary, all oil, gas or other proceeds accruing to the Lessor under this lease or by state law shall be without deduction, directly or indirectly, for the cost of producing, gathering, storing, dehydrating and marketing the oil, gas and other products produced hereunder to transform the product into marketable form; however, any such costs which result in enhancing the value of the marketable 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.

With production came litigation. Soon after lessors began receiving royalty payments, litigation spiked in Ohio and Pennsylvania, often involving claims that producers were wrongfully deducting post-production costs under the lease terms.

Pennsylvania had not yet developed a body of case law governing the interpretation of gross proceeds payment provisions in oil and gas leases. Under Ohio law, however, it was well settled that oil and gas leases are contracts subject to traditional rules of contract interpretation. And long-standing Pennsylvania case law suggested that post-production costs may be deducted from royalty payments barring lease language to the contrary.[4] As parties began executing leases, however, it was unclear whether a court in either jurisdiction would interpret a gross proceeds lease to adopt an "at the well" rule, permitting the deduction of a pro rata share of postproduction costs, or a version of the "marketable product rule," limiting deductions under certain circumstances.

2 *Mittelstaedt v. Santa Fe Mins. Inc.,* 954 P.2d 1203 (Okla. 1998), *answer to certified question conformed,* 139 F.3d 912 (10th Cir.).

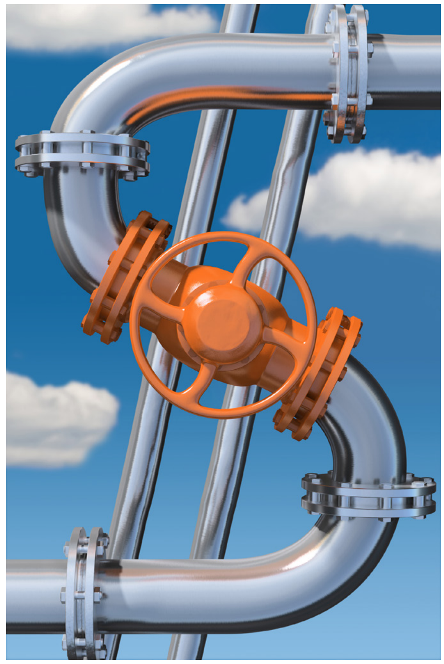
3 *Id.* at 1205.

4 *See, e.g., Akin v. Marshall Oil Co.,* 41 A. 748, 751 (Pa. 1898).

PENNSYLVANIA

Although there had not been significant case law in Pennsylvania by the time the Marcellus Shale play began, Pennsylvania had adopted a minimum royalty statute — the Pennsylvania Guaranteed Minimum Royalty Act — requiring that all leases must provide at least a one-eighth royalty (12.5%) on production sales.[5] Against that background, the Pennsylvania Supreme Court in 2010 was asked to evaluate whether a lease that expressly permitted post-production costs using the net back method that resulted in a royalty less than 12.5% of the value of the gross production of the well was permissible in light of the GMRA. In *Kilmer v. Elexco Land Services Inc.,* the Pennsylvania Supreme Court specifically rejected the first marketable product doctrine, holding that the netback payment method does not violate the GMRA.[6] In so holding, it explained that Pennsylvania is an "at the wellhead" state and that producers may deduct post-production costs from royalty payments barring lease language to the contrary.[7]

To date, however, no Pennsylvania court applied *Kilmer* in the context of an MEC lease. The closest that the authors are aware of is *Demchak v. Chesapeake*, in which a class of lessors with MEC clauses filed lawsuits alleging that the gas Chesapeake was producing was not "marketable" at the wellhead and thus post-production costs for gathering and processing could not be deducted. The parties in that litigation reached a class settlement, which was pending for court approval at the time Chesapeake entered Chapter 11 bankruptcy proceedings in Texas. Ultimately, the Southern District of Texas federal court approved the settlement, which provided for a monetary payment, and for future production permitted lessors to choose whether to receive an "in-basin" index price for their royalty calculations or to receive a "net back" price based on Chesapeake's downstream sales, less post-production costs.[8]



OHIO

The Ohio Supreme Court, like its Pennsylvania counterpart, was asked to resolve whether Ohio would adopt the first-marketable-product rule. In *Lutz v. Chesapeake Appalachia LLC*,[9] the Ohio Supreme Court declined to answer the question, holding instead that oil and gas leases are contracts and must be interpreted using traditional contract principles.[10] Subsequently, the federal District Court that had certified the question to the Supreme Court rejected the notion that Ohio follows the first-marketable-product rule.[11]

Like in Pennsylvania, the Ohio courts have not, to date, squarely answered the question of what it means for gas to be "marketable" for purposes of an MEC. There is, however, a fair amount of guidance providing insight on how the courts are viewing the key terms in the MEC. For example, an Ohio federal district court in *Zehentbauer* interpreted gross proceeds "computed at the wellhead" to mean that royalties are to be valued based on the wellhead value of the oil, gas and natural gas liquids and, allowing a pro rata deduction of post-production costs.[12] There, the lease calculated royalties "based upon the gross proceeds paid to Lessee for the gas marketed and used off the leased premises ... computed at the wellhead from the sale of such gas substance so sold by Lessee."[13] The producers sold the gas at the wellhead to midstream affiliates and paid lessors royalties on that price — a netback.[14] The lessors

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5 58 P.S. § 33.3.

6 *Kilmer v. Elexco Land Servs. Inc.,* 990 A.2d 1147, 1152, 1158 (Pa. 2010).

7 *See id.* at 1157.

8 *Id.* at pp. 5-6. The settlement relates to *Demchak Partners Ltd., et al. v. Chesapeake Appalachia LLC,* No. 13-2289 (M.D. Pa. 2013).

9 71 N.E.3d 1010 (Ohio 2016).

10 *Id.* at 1012 ("In Ohio, oil and gas leases are contracts. 'The rights and remedies of the parties to an oil or gas lease must be determined by the terms of the written instrument.'" (quoting Harris, 48 N.E. at 505) (internal citation omitted)).

11 *Lutz v. Chesapeake Appalachia LLC,* No. 4:09-cv-2256, 2017 WL 4810703, at *7 (N.D. Ohio Oct. 25, 2017) ("This Court concludes that the Ohio Supreme Court would adopt the 'at the well' rule, simply applying the clear and unambiguous language in the leases."); *see id.* at *8 ("Construing the lease under the 'marketable product' rule would ignore the clear language that royalties are to be paid based on *'market value at the well.'"), aff'd,* 807 F. App'x 528 (6th Cir. 2020).

12 *Zehentbauer Fam. Land LP v. Chesapeake Expl. LLC,* 450 F. Supp. 3d 790, 806 (N.D. Ohio 2020), *aff'd sub nom Zehentbauer Fam. Land LP v. TotalEnergies E&P USA Inc.,* 2022 WL 294081 (6th Cir. Feb. 1, 2022).

13 *Zehentbauer,* 2022 WL 294081, at *2.

14 *Id.*

claimed, however, that their royalties should be based on the gross proceeds received by the affiliates in transactions downstream of the well.[15] The federal District Court rejected that argument, finding that the producers' payment practices were consistent with the terms of the lease.[16]

In February, the 6th Circuit reviewed the District Court's decision in *Zehentbauer* where it interpreted "computed at the wellhead." In challenging the District Court's decision, the lessors argued on appeal that because the lease defined "gross proceeds" as "the total consideration paid for oil, gas, associated hydrocarbons, and marketable by-products produced from the leased premises," it meant that the producers had to pay royalties on the downstream sales price.[17] The 6th Circuit rejected that argument, stating that defining gross proceeds as "including 'marketable by-products' does not require that the royalties be based on downstream sales of finished by-products."[18] In doing so, it explained that a "marketable product is one that is 'capable of' being marketed; it is not a 'finished' by-product."[19] The 6th Circuit therefore takes the view that one must look at the stream of raw hydrocarbons at the wellhead when determining marketability, not the separate downstream natural gas liquids and processed gas components.[20]

More directly on point, in May 2020, Gulfport Energy Corp. moved to confirm an arbitration award issued by the American Arbitration Association in *Shugert Family Investments LLC* v. *Gulfport Energy Corp.* concerning the MEC.[21] In that arbitration, the lessors claimed that Gulfport breached the MEC by deducting post-production costs from royalty payments.[22] The arbitrator in the case, Southern Methodist University Professor John S. Lowe, ruled that the gas produced in Belmont County, Ohio, was marketable near the wellhead and had rejected the argument that gas was "marketable" only once it met interstate pipeline specifications.[23] The Southern District of Ohio confirmed the arbitration award.[24]

It may not be long until an Ohio court has the opportunity to squarely address some of the key terms of the MEC. There are currently cases pending before the Southern District

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15 *Id.* at *2.

16 *Id.* at *3.

17 *See Zehentbauer,* Brief of Plaintiffs-Appellants, 2020 WL 3634946 at *12-13.

18 *Zehentbauer,* 2022 WL 294081, at *3.

19 *Id.* at *3.

20 *Id.*

21 *Gulfport Energy Corp. v. Shugert Fam. Invs. LLC*, Case No. 2:20-CV-02469-MHW-KAJ (S.D. Ohio) ("Gulfport Case").

22 May 15, 2020 Pet. to Confirm Arbitration Award, Gulfport Case, ECF No. 1 ¶ 3.

23 *Id.* ¶ 5.

24 Oct. 21, 2020, Order Granting Gulfport's Mot. for Summ. J. & Confirming the May 10, 2020 Final Arbitration Award, Gulfport Case, ECF No. 15.