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ONE J

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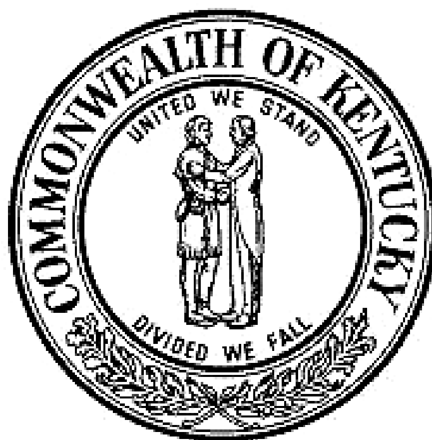
KENTUCKY



Sarah Lange[*]

On August 20, 2015, the Supreme Court of Kentucky issued two opinions addressing the deduction of post-production costs from royalty payments under oil and gas leases.

In *Baker v. Magnum Hunter*, the court held that Kentucky is an "at the well" state, rather than following the "marketable product" approach to royalty calculations, whereby, absent language to the contrary, royalties under an oil and gas lease are calculated based on the value of the gas extracted at the well.[1] In this case, two sets of landowners jointly brought suit seeking damages and a declaration of their rights, alleging that the

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1. 473 S.W.3d 588 (Ky. 2015).

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lessee production companies had miscalculated and underpaid royalties due under the leases. The leases at hand provided that, with respect to gas, the "Lessee covenants and agrees…to pay Lessor one-eighth of the market price at the well for gas sold or for the gas so used from each well off the premises." The "at the well" rule provides that, if the gas is not sold at the well-head, but is refined or processed in some way and moved to a place of sale downstream from the well, in most jurisdictions, "royalties" entitlement remains its portion of the raw gas initially "produced," so that in calculating "royalty," the lessee may deduct from its downstream receipts any "post-production" costs incurred to market the gas.[2] Due to the raw gas produced from the wells not being suitable for sale at the well, prior to sale, the Lessee gathers, compresses, and treats the raw gas, and then transports the enhanced product to downstream purchasers. The Lessee then deducts its gathering, compression, treatment and transportation costs prior to calculating the landowners' one-eighth royalty share on the remaining net revenue. For the purposes of such valuation under standard "market price (value) at the well" royalty clauses, the lessee is solely responsible for the costs of production, of bringing the gas to the well, but post-production costs for such marketing-related enhancements as accumulating, compressing, processing and transporting the gas may be deducted from gross receipts before the calculation of the royalty share.[3] The Court noted that Kentucky law has long embraced the principles of "at the well" royalty calculations and thereby affirmed the Kentucky Court of Appeals decision upholding the valuation method.

In *Appalachian Land Co. v. EQT Production Co.*, the court held that, absent language to the contrary, severance taxes cannot be deducted from royalties as a post-production cost and the producer severing natural gas from the earth is solely responsible for the payment of the severance tax; however, the rule may be altered through agreement.[4] In this case, a natural gas lessor brought a class action against the lessee for the underpayment of royalties after the lessee deducted all post-extraction processing costs, including transportation and all severance taxes, from the sales price, and then paid the lessor one-eighth of the remainder. KRS 143A.020(1) states that "for the privilege of severing or processing natural resources in this state, a tax is hereby levied at the rate of four and one-half percent (4.5%) on natural gas…to apply to the gross value of the natural

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2. Randy Sutton, *Sufficiency of "At the Well" Language in Oil and Gas Leases to Allocate Costs*, 99 A.L.R. 5th 415 (2002).
3. *Baker*, 473 S.W.3d at 597.
4. 468 S.W.3d 841 (Ky. 2015).

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resource." This tax applies to "all taxpayers severing and/or processing natural resources in this state…"[5] "Severing" is defined as "the physical removal of the natural resource from the earth or waters of this state by any means."[6] "'Processing' includes but is not limited to breaking, crushing, cleaning, drying, sizing or loading or unloading for any purpose."[7] The court cited *Burbank v. Sinclair Prairie Oil Co.*, which addressed the identical issue as it applies to oil severance taxes, whereby the Court held that the royalty owner was not liable for the tax or any portion thereof because "[t]he tax in its essence is . . . an occupation tax. It is not laid on the land containing the ore, nor on the ore after removal, but on the business of mining the ore…"[8] The Supreme Court of Kentucky concluded by stating that the severance tax was intended to be a levy for the privilege of severing or processing the gas. Absent statutory or contractual apportionment, the tax is assessed exclusively to the producer/lessee.[9]

Switching gears to the issue of eminent domain, in a ruling by the Kentucky Court of Appeals on May 22, 2015, in *Bluegrass Pipeline Company, LLC v. Kentuckians United to Restrain Eminent Domain, Inc.*, the non-profit organization filed an action seeking a declaration of rights under KRS 278.502 as to the validity of the pipeline company's claim that it had the power of eminent domain for the construction of the underground pipeline.[10] Kentuckians United to Restrain Eminent Domain, Inc., is a non-profit, incorporated under the laws of the Commonwealth of Kentucky, whose sole purpose is "to protect Kentuckians from the threat of and attempts to exercise eminent domain by entities not in the public service to Kentuckians."[11] The Defendant, Bluegrass Pipeline Company, LLC, is a joint venture proposing a 24-inch pressurized underground pipeline for transporting natural gas liquids from the Marcellus and Utica shale formations to the Gulf of Mexico. KRS 278.502 states:

> Any corporation or partnership organized for the purpose of, and any individual engaged in or proposing to engage in, constructing, maintaining or operating oil or gas wells or pipelines for transporting or delivering oil or gas, including oil

5. KY. REV. STAT. ANN. § 143A.020(2) (West 2016).
6. *Id.* § 143A.010(3).
7. *Id.* § 143A.010(6).
8. Appalachian Land Co. v. EQT Prod., 468 S.W.3d 841, 844 (Ky. 2015) (citing Burbank v. Sinclair Prairie Oil Co., 202 S.W.2d 420 (Ky. 1946)).
9. *Id.* at 848.
10. 478 S.W.3d 386 (Ky. Ct. App. 2015).
11. *Id.* at 388.

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> and gas products, *in public service* may, if it is unable to contract or agree with the owner after a good faith effort to do so, condemn the lands and material or use and occupation of the lands that are necessary for constructing, maintaining, drilling, utilizing and operating pipelines, underground oil or gas storage fields, and wells giving access thereto and all necessary machinery, equipment, pumping stations, appliances, and fixtures, including tanks and telephone lines, and other communication facilities, for use in connection therewith…[12]

In affirming the judgment of the Franklin Circuit Court, the Court of Appeals stated that KRS Chapter 278 is dedicated to the Public Service Commission (hereinafter "PSC") and public utilities, whereas Bluegrass Pipeline Company is not regulated by the PSC, and that the legislature only intended to delegate the state's power of eminent domain to those pipeline companies that are, or will be, regulated by the PSC.[13] In addition, the natural gas liquids in Bluegrass's pipeline are being transported to a facility in the Gulf of Mexico. Because these natural gas liquids are not reaching Kentucky consumers, then Bluegrass Pipeline Company and its pipeline cannot be said to be in the public service of Kentucky, and subsequently, Bluegrass does not possess the ability to condemn property through eminent domain.[14]

On March 10, 2016, in *K. Petroleum, Inc. v. Property Tax Map Number 7 Parcel 12, Knox County, Kentucky, et al.*, the United States District Court for the Eastern District of Kentucky, Southern Division, considered whether K. Petroleum ("KPI"), a private company that constructs, maintains and operates natural gas pipelines, could assert eminent domain to demand a right of way over the defendants' property under Kentucky law.[15] In this case, KPI began constructing the T-632 gas transmission pipeline on the defendants' property and, because KPI incorrectly believed that it was constructing the pipeline on property over which it had already obtained rights, it did not seek condemnation of the property prior to construction.[16] As a result, KPI filed a condemnation action under the Kentucky eminent domain power granted in Ky. Rev. Stat. §278.502, whereby every exercise

12. KY. REV. STAT. ANN. § 278.502 (West 2016).
13. *Bluegrass Pipeline Co., LLC*, 478 S.W.3d at 392.
14. *Id.*
15. Civil Action No. 6: 14-201-DCR, 2016 WL 937329 (E.D.Ky. Mar. 10, 2016).
16. *Id.* at *1.

of the power of eminent domain must be based on "public use" of the condemned property.[17]

"Public Use" includes ownership or occupation by the Commonwealth or its entities . . . and "[t]he use of the property for the creation or operation of public utilities or common carriers."[18] In addition, "no property may be condemned primarily for the purpose of facilitating an incidental private use."[19] Under Ky. Rev. Stat. §278.470, "every company receiving, transporting or delivering a supply of oil or natural gas for public consumption is declared to be a common carrier, and the receipt, transportation and delivery of natural gas into, through and from a pipeline operated by any such company is declared to be a public use." However, Bluegrass Pipeline held that only pipeline companies "regulated by the PSC" may exercise Kentucky's power of eminent domain.[20] KPI demonstrated that is regulated by the PSC, as required by Bluegrass Pipeline, and, in addition, the pipeline actually serves Kentucky consumers, so it is distinguishable from the pipeline in Bluegrass Pipeline, which transported natural gas to the Gulf of Mexico.[21] The court held that KPI established its ability to exercise eminent domain because it is regulated by the Public Service Commission and conveys natural gas to Kentucky consumers.

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17. KY. REV. STAT. ANN. §§ 416.675(1), 278.502 (West 2016).

18. *Id*. § 416.675(2).

19. *Id*. § 416.675(3).

20. Bluegrass Pipeline Company, LLC v. Kentuckians United to Restrain Eminent Domain, Inc., 478 S.W.3d 386, 392 (Ky. Ct. App. 2015).

21. K. Petroleum, Inc. v. Property Tax Map Number 7 Parcel 12, Knox County, Kentucky, et al., 2016 WL 937329, at *5 (E.D.Ky. Mar. 10, 2016).

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