CERTIFIED QUESTION: WILL WEST VIRGINIA TAKE ANOTHER BITE AT THE TAWNEY APPLE?

Date: 20 September 2021

U.S. Energy, Infrastructure, and Resources Alert

By: Ryan W. Steyer, Travis L. Brannon, Thomas C. Ryan, Katherine M. Gafner

Post-production deductions are a hot topic in the Appalachian Basin. If you practice or operate in West Virginia, you know that the last 20 years have seen West Virginia forge its own path and deviate from the majority of states when it comes to the law governing royalty payments and, specifically, post-production deductions. However, that could all change. On 13 September, 2021, in the case *Kellam v. SWN Production Co.,*[1] the U.S. District Court for the Northern District of West Virginia certified questions to the Supreme Court of Appeals of West Virginia (the "Supreme Court") that could have a sweeping impact on royalty payments and related disputes in the state. In particular, the Supreme Court may finally and directly consider whether *Estate of Tawney v. Columbia Natural Resources, L.L.C.*[2] is still good law in West Virginia. The certified questions are:

- Is Tawney still good law in West Virginia?
- What is meant by the "method of calculating" the amount of post-production costs to be deducted?
- Is a simple listing of the types of costs which may be deducted sufficient to satisfy Tawney?
- If post-production costs are to be deducted, are they limited to direct costs or may indirect costs be deducted as well?

Under *Tawney*, a lessee must generally bear "all costs incurred in exploring for, producing, marketing, and transporting" oil and gas to its point of sale.[3] In other words, post-production deductions were not permitted unless (1) expressly authorized by the lease and (2) actually incurred by the lessee.[4] *Tawney* recognized that parties may contractually agree to deviate from the general rule that the lessee bears post-production costs, but held that to allow deductions, a lease must (1) "expressly provide that the lessor shall bear some part of the costs," (2) "identify with particularity the specific deductions the lessee intends to take," and (3) "indicate the method of calculating the amount to be deducted."[5]

In the aftermath of *Tawney*, state and federal courts have grappled with how the *Tawney* factors should be applied and questioned whether current West Virginia law is workable when considering the realities of the modern oil and gas industry.[6] In *Leggett v. EQT Production Co.,* the Supreme Court went out of its way to discuss "the faulty legs upon which [*Tawney*] and its iteration of the marketable product rule purports to stand,"[7] and noted instead that "the most logical way to ascertain the wellhead price is, in fact, to deduct the post-production costs from the 'value-added' downstream price,"[8] although the court stopped short of overturning Tawney. Following the Supreme Court's lead, the Fourth Circuit, in *Young v. Equinor USA Onshore Properties, Inc.,* held that West Virginia "doesn't demand that an oil and gas lease set out an Einsteinian proof for calculating post-production costs"[9] and instead, the "work-back method" is sufficient, so long as the post-production deductions are "reasonable" and "actually incurred."[10] It now appears that *Kellam* presents the Supreme Court an opportunity to revisit its decision in *Tawney*. *Kellam* is a putative class action, in which the plaintiffs allege that their leases do not allow for post-production deductions and, accordingly, various lessees improperly deducted post-production costs when calculating royalties. The *Kellam* Court acknowledged that "the Supreme Court cast a pall on *Tawney* when it criticized it's [sic] own holding in *Leggett*,"[11] and, therefore, the state of the law is "so uncertain that this Court cannot accurately and reliably predict how these questions of law would be decided under West Virginia law."[12] If the Supreme Court accepts the case, it has the potential to clarify existing West Virginia law or turn West Virginia's post-production deduction law on its head.

K&L Gates continues to monitor the evolving state of the law regarding royalties in West Virginia and will provide a full alert pending the outcome of this or other related cases.

FOOTNOTES

[1]No. 5:20-CV-85 (N.D.W. Va.).

[2]633 S.E.2d 22 (W. Va. 2006).

[3]Syl. Pt. 1, Tawney, 633 S.E. 2d at 23 (quoting Syl. Pt. 4, Wellman v. Energy Res., Inc., 557 S.E.2d 254, 256 (W. Va. 2001)).

[4]Syl. Pt. 2, Tawney, 633 S.E. 2d at 23 (quoting Syl. Pt. 5, Wellman, 557 S.E.2d at 256). [5]Tawney, 633 S.E.2d at 24.

[6]See Leggett v. EQT Prod. Co., 800 S.E.2d 850, 863, 867 (W. Va. 2017); Young v. Equinor USA Onshore Properties, Inc., 982 F.3d 201, 207 (4th Cir. 2020).

[7]Leggett v. EQT Prod. Co., 800 S.E.2d at 862.

[8]Id. at 866.

[9]Young, 982 F.3d at 208.

[10]Id. at 209.

[11]Kellam, No. 5:20-CV-85, at 25.

[12]Id. at 1.

KEY CONTACTS

RYAN W. STEYER
ASSOCIATE

PITTSBURGH
+1.412.355.8673
RYAN.STEYER@KLGATES.COM

TRAVIS L. BRANNON
PARTNER

PITTSBURGH
+1.412.355.7443
TRAVIS.BRANNON@KLGATES.COM

THOMAS C. RYAN
PARTNER

PITTSBURGH
+1.412.355.8335
THOMAS.RYAN@KLGATES.COM