COMMONWEALTH OF KENTUCKY
SUPREME COURT OF KENTUCKY
CASE NO. 2013-SC-000598-CL

Question of Law from United States Court of Appeals for the Sixth Circuit, No. 12-5589

APPALACHIAN LAND COMPANY — APPELLANT

v.

EQT PRODUCTION COMPANY — APPELLEE

BRIEF FOR APPELLEE, EQT PRODUCTION COMPANY

This is to certify that a true and correct copy of this Brief for Appellee, EQT Production Company, has been served by Federal Express Overnight Mail to Hon. George E. Stigger, 236 Cardinal Circle West St., Mary's, GA 31558; Hon. John C. Whitfield, Whitfield, Bryson & Mason, LLP., 19 North Main Street, Madisonville, KY 42431; Judge Karen Caldwell, Chief Judge, United States District Court, 101 Barr Street Lexington, KY 40507; United States Court of Appeals for the Sixth Circuit, 540 Potter Stewart U.S. Courthouse, 100 East Fifth Street, Cincinnati, OH 45202-3988; and ten (10) copies to Hon. Susan Stokley Clary, Clerk, Supreme Court of Kentucky, State Capitol, Room 235, 700 Capitol Avenue, Frankfort, KY 40601, this 19th day of July, 2014.

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STATEMENT CONCERNING ORAL ARGUMENT

This Court has ordered Oral Argument in its order accepting the request for certification.

COUNTERSTATEMENT OF POINTS AND AUTHORITIES

INTRODUCTION

The Sixth Circuit Court of Appeals has certified the following question of law regarding severance taxes to this Court: Does Kentucky's "at-the-well" rule allow a natural-gas processor to deduct all severance taxes paid at market prior to calculating a contractual royalty payment based on "the market price of gas at the well," or does the resource's at-the-well price include a proportionate share of the severance taxes owed such that a processor may deduct only that portion of the severance taxes attributable to the gathering, compression and treatment of the resource prior to calculating the appropriate royalty payment?[1] In other words, this Court must determine if all of a royalty owner's proportionate share of severance taxes may be deducted as a post-production expense.

[1] In its certified question, the Sixth Circuit refers to the "processor" as the party who produces gas and pays royalties. A "processor" is the party who removes liquids and impurities from gas. This may or may not be the same entity that extracts the gas and pays royalties. It is believed that the Sixth Circuit intended to reference the "producer," which is the party who extracts gas, sells it, and pays royalties. Throughout this Brief, EQT uses the term "producer" interchangeably with the legal term, "lessee." It is meant to refer to the oil and gas company extracting the gas and selling it.

COUNTERSTATEMENT OF THE CASE

Appellant, Appalachian Land Company ("Appalachian"), is the current lessor and Appellee, EQT Production Company ("EQT"), is the current lessee of a 1944 oil and gas lease between Robert Williams and Kentucky West Virginia Gas Company for certain acreage in Pike County, Kentucky ("the Lease").[2] [Appendix 3, Record Entry No. 1-2, Lease]. The Lease contains the following royalty provision:

> Should a well or wells be found producing gas only, then the Lessor shall be paid for the gas produced from each of such gas wells at the rate of one-eighth (1/8) of the market price of gas at the well.

[Appendix 3, Record Entry No. 1-2, Lease, p. 3 (emphasis added)].

Pursuant to the terms of the Lease and existing Kentucky law, EQT calculates the wellhead royalty by deducting from the sales price of the gas at the interstate pipeline connection certain post-production expenses, including severance/processing taxes, before paying a royalty to Appalachian. Royalties are calculated this way because EQT does not sell the gas "at the wellhead," as contemplated by the lease, but sells the gas downstream at the interstate pipeline connection. Thus, Appalachian's royalty is equal to one-eighth of the sales price received less one-eighth of those post-production costs, including its proportionate share of severance/processing taxes. The goal of this payment calculation is targeted at determining the wellhead value of the gas when the sale of the gas actually takes place somewhere else. This royalty calculation practice is called the "work-back" method, and is utilized by producers throughout the oil and gas industry. *See, In re KY USA Energy, Inc.*, 448 B.R.191, 194 (W.D.Ky. 2011).

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[2] Appalachian Land is also the lessor of two other leases with EQT, but those leases were not specifically referred to in the Complaint. [Appendix 2, Record Entry No. 1, Complaint].

On July 8, 2008, Appalachian filed suit against EQT in the United States District Court for the Eastern District of Kentucky seeking class certification and an award of damages for it and similarly situated royalty owners throughout Kentucky for alleged breaches of contract associated with the deduction of post-production costs and severance/processing taxes from royalties due under "market value at the well" leases with EQT. [Appendix 2, Record Entry No. 1, Complaint].

On July 17, 2009, EQT filed a motion for judgment on the pleadings, asserting that Kentucky law is clear that post-production expenses, including severance/processing taxes, are deductible from royalties pursuant to the "at the well" rule, which holds that in the absence of express language to the contrary, expenses incurred after the extraction of gas are properly shared with the royalty owner in calculating a wellhead price. [Appendix 4, Record Entry No. 45, 45-2, Motion for Judgment on the Pleadings and Memorandum]. After that motion was filed, Appalachian requested a stay pending resolution of an appeal to the Sixth Circuit on a similar motion that was granted to another producer in *Poplar Creek Dev. Co. v. Chesapeake Appalachia, L.L.C.,* 626 F.3d 235 (6th Cir. 2011). [Appendix 5, Record Entry No. 49, 49-2 Motion to Stay, and Memorandum]. The motion for stay was granted [Appendix 6, Record Entry No. 52, Order Staying Proceedings], and the case was held in abeyance until the Sixth Circuit issued an opinion on February 17, 2011, affirming the dismissal of *Poplar Creek* on the grounds that Kentucky, as an "at the well" state, permits the deduction of post-production expenses in the absence of express lease language to the contrary. The current matter was then removed from abeyance, and EQT renewed its motion for judgment on the pleadings. [Appendix 7, Record Entry No. 58, Order Removing From Abeyance;

Appendix 8, Record Entry No. 54, Motion for Judgment on the Pleadings; Appendix 9, Record Entry No. 54-1, Memorandum in Support of Motion for Judgment on the Pleadings].

On February 16, 2012, the District Court granted EQT's motion. [Appendix 10, Record Entry Nos. 59-60, Memorandum Opinion, Order and Judgment]. Pursuant to the Order, the District Court held that EQT was within its rights under Kentucky law and the Lease to deduct from royalties the lessor's share of post-production costs, including severance/processing taxes. Specifically, the District Court rejected Appalachian's invitation to adopt the "first marketable product" rule and instead acknowledged,

> The payment of severance taxes is an expense required to bring the gas to market, and the expense is included in the ultimate market price. Therefore, it is reasonable to deduct severance taxes from the market price in order to "work back" to calculate the at-the-well price.

Id. at p. 5. While Appalachian filed a motion to alter or amend the judgment on the severance/processing tax issue [Appendix 11, Record Entry No. 61, 61-1, Motion to Alter or Amend, and Memorandum], that motion was not granted [Appendix 12, Record Entry No. 64, Order Denying Motion to Alter Judgment]. Appalachian then appealed the District Court's ruling only on the deductibility of severance/processing taxes, and on August 26, 2013, the Sixth Circuit certified a question to this Court pursuant to Kentucky Rule of Civil Procedure 76.37(1) regarding whether Kentucky's "at the well" rule allows the deduction of all severance/processing taxes from the royalty owner's proportionate share in calculating royalties in the absence of lease language stating that such taxes should be the sole responsibility of the lessee. [Appendix 13, Certification to the Kentucky Supreme Court].

In accordance with the language of the applicable Lease, the rulings of the District Court in this matter, the *Poplar Creek* decision, and earlier Kentucky cases discussing the sharing of downstream post-production costs between the royalty owner and lessee, this Court should find that all such costs are deductible.

ARGUMENT

This Court should determine that a lessor's proportionate share of all severance/processing taxes is properly deductible from royalties because such a ruling is consistent with the express terms of the Lease, existing Kentucky law, and the law of other majority "at the well" states. Such a ruling would also prevent overpayment to royalty owners, who are entitled to a one-eighth royalty based on the wellhead price. There is no reason to limit the amount of severance/processing tax deductions permitted because any amount of severance/processing tax is assessed, valued and paid after production ends and is, therefore, a downstream post-production cost. Plaintiffs offer no real counter to these arguments, finding support only in cases embracing the "first marketable product" rule, which has been flatly and consistently rejected in state and federal courts throughout Kentucky. Appalachian's reliance on cases discussing statutorily imposed tax burdens rather than contractual obligations between parties is also flawed.

I. Severance/Processing Taxes Are Deductible Post-Production Expenses.

Generally, all states embrace the notion that a lessor's royalty should be free of the costs of production (costs directly incurred to extract the gas). Courts, however, are divided on whether the costs incurred after raw gas is brought to the surface are properly shared between the lessee and the lessor. Kentucky follows the majority of states in

adopting the "at the well" rule. The "at the well" rule directs that "at the well" and similar royalty language in a lease clearly sets the point at which royalties must be valued "at the wellhead;" therefore, the royalty owner must bear his proportionate share of costs incurred beyond the wellhead.[3] Only a minority of states follow the "first marketable product" rule, which holds that a producer's implied covenant to market the gas renders it completely responsible for all costs incurred to process and sell gas.[4] Severance/processing taxes are costs incurred *after* production, and because Kentucky has adopted the majority "at the well" rule, those costs are properly deductible.

A. Post-Production Costs Are Costs Incurred *After* Gas Is Captured.

It is generally accepted that a "royalty" is "the landowner's share of production, free of the expenses of production." *Kilmer v. Elexco Land Services, Inc.*, 990 A.2d 1147, 1157 (Pa. 2010)(citing Howard R. Williams & Charles J. Meyers, Manual of Oil and Gas Terms §R (Patrick H. Martin & Bruce M. Kramer eds., 2009). *See also, Heritage Resources v. NationsBank,* 939 S.W.2d 118, 121-122 (Tex. Sup. Ct. 1996); *CIG Exploration, Inc. v. Hill,* 824 F. Supp. 1532, 1539 (D. Utah 1993). Thus, in an "at the well" state like Kentucky, it is essential to identify what costs are production costs (which are the sole responsibility of the lessee) and what costs are post-production costs (which are properly allocated between the lessor and lessee). Courts in states like Kentucky have acknowledged that "production costs" include costs of drilling, equipping and operating the well, and overhead expenses. *Swiss Oil Corporation v. Hupp,* 253 Ky. 552, 69 S.W.2d 1037, 1045 (Ky. App. 1934)(also expressly rejecting the notion that income taxes

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[3] Majority states include California, Kentucky, Louisiana, Michigan, Mississippi, New Mexico, North Dakota, Pennsylvania, Texas and Utah.

[4] Minority states include Colorado, Kansas, Oklahoma and West Virginia.

could be considered a cost of production). Generally, production costs are all costs directly incurred to capture the gas.

Post-production costs, on the other hand, are "costs incurred after production, *e.g.*, production or gathering taxes, costs of treatment of the product ..., costs/or transportation to market." *Kilmer,* 990 A.2d at 1157 (quoting *Manual of Oil and Gas Terms,* §R, *supra*)(emphasis added). *See also Poplar Creek* 636 F.3d at 239 (stating that post-production costs are those "expenses ... incurred after the gas leaves the wellhead"). Based on these definitions of what activities constitute production and what activities constitute post-production, it is evident that the dividing time for purposes of cost-sharing is the point in time when the gas is extracted.

B. Producers May Deduct Post-Production Costs From Royalties.

As recognized and affirmed by the Sixth Circuit in *Poplar Creek*, Kentucky has long acknowledged that a producer's implied duty to market gas does not require it to bear all of the costs associated with marketing produced, raw gas. Rather, the duty to market merely "requires the lessee to use due diligence and good faith to market the gas." *Hiroc Programs, Inc. v. Robertson,* 40 S.W.3d 373, 37 (Ky. App. 2000). The *Poplar Creek* Court acknowledged that the implied duty to market is at the heart of any post-production expense evaluation:

> The dispositive issue in this case is the meaning of "wholesale market value of such gas at the well" in the parties' royalty clause and the propriety, under Kentucky law, of deducting post-production costs from the lessor's royalties. A number of courts in gas-producing states across the country have considered the meaning of similar royalty clauses in deciding which marketing or post-production costs, if any, are to be borne by the royalty owner. The decisions of these courts, however, have not been uniform. There are two diverse viewpoints, with some decisions

> picking and choosing between the two, depending on the specific cost under consideration. At one end of the spectrum is the view that, because the operator has an implied duty or an implied covenant to market the gas, all post-production costs must be borne by the operator. *See, e.g., Garman v. Conoco, Inc.,* 886 P.2d 652, 653–54 (Colo.1994) (holding that where a lease is silent with regard to how costs incurred post-production are to be borne, a lessee may not deduct costs required to make the mineral marketable). Poplar Creek advocates for this view, which the parties term the "marketable product" rule.
>
> At the other end of the spectrum, several courts have held that while there is an implied duty or covenant to market the gas, this duty does not extend to expenses incurred in sales not at the wellhead; post-production costs are to be shared proportionately by the working interest and royalty owners. *See, e.g., Schroeder,* 565 N.W.2d at 894 ("gross proceeds at the wellhead" contemplates the deduction of post-production costs from the sale price of the gas, based on the view that "at the wellhead" refers to location for royalty valuation purposes).

Poplar Creek, 636 F.3d at 240-241. Thereafter, the Court confirmed Kentucky's stance that the producer's implied duty to market does not carry with it the obligation to bear responsibility for all downstream costs:

> Kentucky follows the at-the-well rule, which allows for the deduction of post-production costs prior to paying appropriate royalties. We further hold that "at the well" refers to gas in its natural state, before the gas has been processed or transported from the well.

Id. at 244.

Long before the *Poplar Creek* decision Kentucky courts recognized that the duty to market does not require a producer to pay more than a wellhead royalty in the absence of express language to the contrary. *See, e.g., Rains v. Kentucky Oil Co.,* 255 S.W.121 (Ky. 1923); *Warfield Natural Gas Co. v. Allen,* 88 S.W.2d 989 (Ky. 1935); *Reed v. Hackworth,* 287 S.W.2d 912 (Ky. 1956). This rule is known as the "at the well" rule

because "at the well" is the point at which royalties are typically valued. This majority rule directs when gas is sold downstream instead of at the well, the deduction of post-production expenses from royalties is necessary to calculate a wellhead price for the gas. By deducting post-production costs from the downstream sales price, the producer "works back" to the wellhead value of the gas. *See generally, Poplar Creek,* 636 F.3d 235; *In Re Ky USA Energy, Inc.,* 448 B.R. 191 (Bankr. W.D. Ky. 2011).

Kentucky is not alone in its adoption of the "at the well" rule. In fact, a majority of natural gas producing states also permit the deduction of post-production expenses in calculating royalties. In addition to Kentucky, other states that follow the "at the well" rule include California, Louisiana, Michigan, Mississippi, New Mexico, North Dakota, Pennsylvania, Texas and Utah. These jurisdictions have consistently held that lessees may deduct post-production costs when calculating royalties to be paid to a lessor. *See, e.g., Piney Woods Country Life School v. Shell Oil Co.,* 726 F.2d 225 (5th Cir. 1984)(construing Mississippi law); *Martin v. Glass*, 571 F.Supp. 1406 (N.D.Tex. 1983); *Emery Resource Holdings, LLC v. Coastal Plains Energy, Inc.*, 915 F.Supp.2d 1231 (D. Utah 2012); *Atlantic Richfield Co. v. California*, 214 Cal.App.3d 533 (Cal.App. 1989); *Merritt v. Southwestern Electric Power Co.,* 499 So.2d 210 (La.App. 1986); *Schroeder v. Terra Energy, Ltd.*, 565 N.W.2d 887 (Mich.App. 1997); *Concoco Phillips Co. v. Lyons*, 299 P.3d 844 (N.M. 2009); *Bice v. Petro-Hunt, L.L.C.,* 768 N.W.2d 496 (N.D. 2009); *Kilmer v. Elexco Land Services, Inc.,* 990 A2d 1147 (Penn. 2010); *Judice v. Mewborne Oil Co.,* 939 S.W.2d 133 (Tex. 1996).

In light of the established law in Kentucky regarding the duty to market and the deductibility of certain expenses incurred by a producer after production,

severance/processing taxes are deductible from a lessor's royalty if such taxes are properly classified as post-production expenses. As discussed below, they are.

C. Severance Taxes Are Deductible Post-Production Expenses.

While Kentucky courts have not yet expressly held that severance taxes are properly included in those post-production expenses that may be deducted to determine a wellhead royalty, the nature of Kentucky's severance/processing tax in light of the "at the well" rule confirms that such costs are deductible post-production expenses. Moreover, the majority of "at the well" states have considered the issue and have uniformly upheld the deduction of severance taxes as a cost incurred after production ends.

The tax imposed pursuant to K.R.S. § 143A.020 (1980), is one assessed after production of natural gas. Pursuant to K.R.S. § 143A.020, a 4.5% tax is assessed "[f]or the privilege of severing or processing natural resources." While characterized as a tax on the privilege of severing and processing, the tax is, in fact, assessed based on the value of the natural gas that has already been "severed." "Severed" is defined as the "physical removal of the [gas] from the earth." K.R.S. § 143A.010 (2013). As suggested by the definition of "severed," gas cannot be considered severed until extraction (*i.e.*, production) has been completed.

Also, "processing" is an industry term used to describe post-production activities to remove liquids or other impurities from the raw gas. *See, e.g., Forest Oil Corp. v. Eagle Rock Field Services, LP,* 349 S.W.3d 696 (Tex. 2011); *Williams Production RMT Co. v. State Dept. of Revenue,* 2005 Wyo. 28, 107 P.3d 179 (2005); *Western Gas Resources, Inc. v. Heitkamp,* 489 N.W.2d 869, 873 (N.D. 1992). Because the tax is assessed, in part or in whole, for the privilege of engaging in this post-production

activity, there can hardly be any argument that the tax itself should not be deductible as a post-production cost. Thus, the statutory language clearly evidences the intent to tax the gas (1) after it has been extracted, and (2) on activities that take place post-production.

To be sure, the statute states that the tax is calculated based on the "gross value" of the gas severed or processed, which is set by the sales price received for the gas at the ultimate sales point. K.R.S. §143A.010-020. Lessees like EQT may – and do – deduct from the sales value the cost of transportation expenses in calculating the "gross value" for severance/processing tax purposes *Id.*; however, the tax is clearly valued downstream. Because the values cannot be set until after extraction has been completed, the tax is undoubtedly a post-production cost.

Although the Kentucky Supreme Court has not yet confirmed that a severance tax is a post-production expense deductible from the lessor's royalty, other majority "at the well" states have examined the severance/processing tax issue and have reached the conclusion that they are deductible. For example, in *Cartwright v. Cologne Production Co.*, 182 S.W.3d 438 (Tex. App. 2006), the Texas Court of Appeals stated:

> Whatever costs are incurred after production of the gas or minerals are normally proportionately borne by both the operator and the royalty interest owners. These post-production costs **include taxes**, treatment costs to render the gas marketable, compression costs to make it deliverable into a purchaser's pipeline, and transportation costs.

Id. at 444-445 (emphasis added). In *Chesapeake Exploration, LLC v. Hyder*, 427 S.W.3d 472 (Tex. App. 2014), the court explained that a royalty, although not subject to the costs of production, "is normally subject to post-production costs, **including taxes**, treatment costs to render it marketable and transportation costs," but the parties may modify this

general rule by agreement. *Id.* at 476 (emphasis added). Thus, permitting the deduction is the default rule, only to be modified by express contractual language to the contrary.

The Fifth Circuit has also long approved these deductions. *See Arkansas Natural Gas Co. v. Sartor*, 78 F.2d 924 (5th Cir. 1935) (finding that Louisiana severance tax was properly deducted when calculating royalty). The Louisiana state courts have agreed with the Fifth Circuit's interpretation and found that lessees are entitled to deduct severance taxes. *See, e.g., Gibbs v. Southern Carbon Co.*, 171 So. 587, 589 (La. App. 1937) ("Plaintiff was without right to claim the part of the severance tax deducted from his royalties."); *Babin v. First Energy Corp.*, 693 So.2d 813, 815 (La. App. 1st Cir. 1997) (noting that "[t]he costs of severance taxes ... are considered to be post production costs and, are therefore, borne proportionately by the lessee and the royalty owner."(citing *Costs Deductible By the Lessee in Accounting for the Production of Oil or Gas*, 46 La.L.Rev. 895, 895-911 (1986))).

Louisiana has explained at least part of its rationale for permitting the deduction of post-production expenses like severance taxes, noting that if a royalty owner took his gas in kind, there would be no question that he must bear responsibility for his share of costs incurred directly upon severance. That Court noted that "if it had been contemplated or provided in the lease contract that the gas should have been divided in kind, it would hardly be disputed that the division should be made at the well." *Wall v. United Gas Public Service Co.*, 178 La. 908, 502 So. 561 (1934). This rationale appeared again with regard to the deductibility of severance taxes in *Sartor v. United Carbon Co.*, 183 La. 287, 293; 163 So. 103, 105 (La. 1935). The *Sartor* Court, after discussing the logical application of the rule on the deductibility of post-production expenses to

severance taxes found, "It is our opinion that the defendant properly deducted the proportionate share of the severance tax due by the plaintiffs before paying the amount of the royalty." *Id.*

The Mississippi Supreme Court explained its rationale for allowing the deduction of severance taxes as follows:

> It is only by means of the activities of the lessee that the royalty holder gets anything from the oil, and being thus essentially associated with the activities and the proceeds thereof, he is not to disassociate himself from the State's exactions in the identical operations by which the proceeds are realized.

Gulf Refining Co. v. Stone, 21 So.2d 19, 21 (Miss. 1945).

As discussed in more detail below, Appalachian has little response to this overwhelming breadth of authority in support of the deductibility of severance taxes. While Appalachian has claimed in the past that the *Cartwright* and *Sartor* cases above are distinguishable because the taxing statutes are worded differently than KRS § 143A.020, in neither of those cases did the court state that its holding was based on the specific wording of the taxing statute. As discussed more fully in Section III below, the taxing statutes are largely irrelevant as to whether a party may properly deduct the taxes when calculating royalties. Moreover, the statutes addressed in *Cartwright* and *Sartor* are – contrary to Appalachian's representations – substantially similar to Kentucky's severance/processing tax statute. Notably, all calculate the amount of taxes assessed on the price received for the gas after it is produced.

Authoritative oil and gas treatises relied upon by courts around the country in evaluating oil and gas law claims acknowledge that severance taxes are post-production costs, stating that post-production costs include "gross production and severance taxes."

8 Howard R. Williams & Charles J. Meyers, *Oil and Gas Law* § 645.2, pp. 599-602 (Patrick H. Martin & Bruce M. Kramer, eds. 2012). In § 645.2, severance taxes are even listed as the first post-production expense deductible from royalties:

> A royalty or other nonoperating interest in production is usually subject to a proportionate share of the costs incurred subsequent to production where the royalty or nonoperating interest is payable "at the well." Among these "subsequent to production" costs borne by nonoperating interests as well as by operating interests are the following:
>
> (1) Gross production and severance taxes. Some leases and other agreements include an express provision concerning the location of severance and production taxes. To be distinguished, of course, are income taxes; the operator and nonoperator must respectively bear the burden of his own income tax without contribution of the other party.

Id. (quoting *McDonald v. O'Meara,* 259 F.2d 425 (5th Cir. 1958) as holding that the "[l]essee may sell Lessor's royalty oil at the best market price obtainable and pay Lessor the price received...less any severance or production tax imposed thereon.") Other oil and gas legal scholars have long agreed: "The production or severance tax attributable to the lessor's royalty interest is ordinarily deducted from the royalty unless the lease contains an express provision to the contrary." Hardwicke, *Problems Arising Out of Royalty Clauses in Oil and Gas Leases in Texas,* 29 Tex. L. Rev. 790, 800 (1951).

In accordance with this case law from other majority states and the persuasive analysis of legal experts, the Sixth Circuit's opinion in *Poplar Creek* is well-reasoned, and the facts in that case are essentially on all fours with the instant case, making application of its legal holdings to the present matter logical. As the District Court properly recognized, severance/processing taxes are a post-production expense and are deductible under the Sixth Circuit's holding in *Poplar Creek.* [Appendix 10, Record Entry

No. 59, Memorandum, Opinion and Order, p. 5]. Like the other post-production costs there, the severance/processing tax is imposed at a later time on the price received at the sales point and should be deducted in calculating royalties. There is no language in the Lease that would otherwise indicate that severance/processing taxes should be treated differently from other post-production costs. The "market price at the well" can only be accurately determined by subtracting all post-production costs including severance/production taxes paid by the lessee.

II. There Is No Reason To Limit The Amount of Severance/Processing Tax Deductions Where Such Deductions Are Permitted.

The entire amount of the severance/processing tax must be subject to deduction pursuant to the "at the well" rule and the clear terms of the Lease. The Sixth Circuit's certified question asks this Court to consider whether severance/processing taxes should only be deducted for the portion of the gas sales price that is attributable to value added downstream by undertaking post-production activities. It would contradict the majority "at the well" rule to limit the amount of severance/processing taxes deducted to only the amount by which the gas's value was enhanced downstream. It would go against the express terms of the Lease and result in an unfair allocation of royalties to the lessor at the expense of the lessee.

First, limiting permissible severance/processing tax deductions to the amount of the sales price shown to be attributable to the downstream value enhancements would directly contradict the majority "at the well" rule, which calls for the use of a "work back" method to calculate the wellhead value. Under the "work back" methodology, downstream costs are deducted from the ultimate sales price to estimate what the wellhead price would have been had a sale taken place there. *See, e.g., In re KY USA*

Energy, Inc., 448 B.R. at 194. Limiting the portion of severance taxes deductible would instead require the adoption of the minority "marketable product" rule analysis that assumes only proven value-enhancing costs may be deducted.

Under the minority "marketable product" rule, an analysis is undertaken to determine whether a cost is deductible by evaluating whether the cost was incurred *after* a marketable product was achieved which enhanced the value of the gas. *See Coulter v. Anadarko Petroleum Corp.*, 296 Kan. 336, 292 P.3d 289 (Kan. 2013). It is only a value-enhancing cost incurred after gas has been made marketable that is deductible. Such an analysis is simply contrary to the law of Kentucky and other majority states and must be rejected.

While EQT agrees with the District Court's conclusion in the current case that severance/processing taxes are necessarily reflected in the downstream price (and that this supports the notion that such costs should be deductible), analyzing what portions of a post-production cost is a value-enhancing portion is not necessary in the majority "at the well" analysis. There is nothing in the Lease to suggest that the parties agreed to limit the amount that severance/processing taxes are deductible. Under the "at the well" analysis, the phrase "at the well" in a royalty clause clearly and unambiguously authorizes the deduction of a royalty owner's proportionate share of all post-production costs. *See, e.g., Culpepper v. EOG Resources, Inc.*, 92 So.3d 1141, 1144 (La.App. 2012)(holding that "[t]he computation of a royalty 'at the well' has been long-held by our courts to include deductions for post-production costs.")

Incorporating into the severance tax deduction a limitation of the deductibility of the tax only to those amounts by which the gas's value is enhanced is tantamount to

applying the "marketable product" rule to severances taxes only, while flatly rejecting its applicability to all other post-production expenses. It would essentially separate Kentucky from the majority-rule states and render it a hybrid "at the well"/"marketable product" state. No other state in the country has adopted such directly contradicting analyses, and such a methodology cannot be logically reconciled with Kentucky's prior case law on the duty to market.

Moreover, permitting the deduction of only a portion of severance/processing taxes assessed ignores the specific meaning given to the phrase "market value at the well" in "at the well" states and would result in a windfall to lessors, who would ultimately receive more than their one-eighth share of the value of the gas at the expense of the producer. At the same time, the producer's seven-eighths share of the proceeds would be reduced by eight-eighths of the severance/processing tax assessment (which is assessed on a privilege the benefit of which both the producer and royalty owner receive), the royalty owner would be unburdened by that post-production cost and would actually receive more than a one-eighth share of the ultimate price. In the absence of lease language to the contrary, this hybrid rule should be rejected as inequitable.

Because permitting the deduction of only a portion of severance/processing taxes would contradict adherence to the "at the well" rule and would result in an inflated payment to royalty owners at the expense of the producer, the deduction of a royalty owner's proportionate share of <u>all</u> severance/processing taxes assessed should be permitted by this Court.

III. Kentucky's Tax Statute Is Not Controlling But Supports the Deduction of Severance/Processing Taxes.

Appalachian has asserted that the Kentucky taxing statutes, KRS § 143A.010 *et seq.*, were not discussed in the District Court's Memorandum Opinion. [Appendix 10, Record Entry 59-60, Memorandum Opinion, Order and Judgment]. The taxing statutes provide authority for collection of severance/processing taxes by taxing authorities, but they are not controlling as to the issues in the current dispute between private parties to a lease. The taxing statutes, like many other Kentucky taxing statutes, identify only who must remit severance/processing taxes to the Commonwealth. EQT does not dispute that it has responsibility to remit the tax to the Commonwealth when the gas is sold. However, the statutes do not dictate how taxes are treated to calculate royalties owed under a lease. Similarly, when buying a new car in Kentucky, many times the car dealer actually has the responsibility to remit the applicable sales tax to the Commonwealth, but the dealer customarily charges the tax to another party. As such, a discussion of the taxing statutes is not helpful in the analysis of the "at the well" rule.

The taxing statutes support EQT's position that severance/processing taxes are deductible when calculating royalties since they do not allow taxes to be deducted from the sales price when computing the tax owed. The tax is owed on the gross amount received by the lessee, which logically must include a sufficient value to pay costs and taxes. The severance/processing tax statute is set forth at KRS 143A.020:

> (1) 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 and four and one-half percent (4.5%) on all other natural resources, such rates to apply to the gross value of the natural resource severed or processed except that no tax shall be imposed on the processing of ball clay.

> (2) The tax shall apply to all taxpayers severing and/or processing natural resources in this state, and shall be in addition to all other taxes imposed by law.

(emphasis added). Clearly, this is a tax incurred post-production on the gross value of the resource. KRS 143A.010 provides definitions for a number of terms used in the taxing statute, KRS 143A.020:

> (4) (a) "Taxpayer" means any individual, partnership, joint venture, association, corporation, receiver, trustee, guardian, executor, administrator, fiduciary, or representative of any kind engaged in the business of severing and/or processing natural resources in this state for sale or use. In instances where contracts, either oral or written, are entered into whereby persons, organizations or businesses are engaged in the business of severing and/or processing a natural resource but do not obtain title to or do not have an economic interest therein, the party who owns the natural resource or has an economic interest is the taxpayer.
>
> (5) "Gross value" is defined as follows: (a) For natural resources severed and/or processed and sold during a reporting period, gross value is the amount received or receivable by the taxpayer...(g) in all instances, the gross value shall not be reduced by any taxes including the tax levied in KRS 143A.020, royalties, sales commissions, or any other expense.

Before the statute was amended, effective July 1, 2013, the statute provided:

> (5) "Gross value" is synonymous with gross income from property as defined in section 613 of the Internal Revenue Code and regulations 1.613-3 and 1.613-4 in effect on December 31, 1977, with the exception that in all instances transportation expense, as defined in subsection (9) of this section incurred in transporting a natural resource shall not be considered as gross income from the property. . . .
>
> ***
>
> (8) "Economic interest" for the purpose of this chapter is synonymous with the economic interest ownership required

> by Internal Revenue Code, Section 611 in effect on December 31, 1977, entitling the taxpayer to a depletion deduction for income tax purposes with the exception that a party who only receives an arm's length royalty shall not be considered as having an economic interest.

Notably, Section 611(b)(1) of the Internal Revenue Code, 26 U.S.C. § 611(b)(1), provides that "[i]n the case of a lease, the deduction under this section shall be equitably apportioned between the lessor and lessee." It is entirely proper to deduct these added taxes. This was precisely the point made by the District Court in its Order overruling Appalachian's motion to alter or amend. [Appendix 12, Record Entry No. 64, Order Denying Motion to Alter Judgment p. 2]. The tax is paid after production. Thus, it is a post-production expense, and it is proper to deduct the taxes.

While a natural gas producer may be the eventual taxpayer, this simply means that the producer is responsible for remitting the taxes to the Commonwealth. The taxing statutes do not control whether the gas producer may rightfully deduct a proportionate share of the taxes as a post-production expense because the royalty owner has a fractional interest in the production. In Kentucky, the value of the gas "at the well" is not the value of the gas, plus taxes, unless the lease expressly states that it is. The Lease at issue here does not, and the leases at issue in applying the "at the well" rule do not.

IV. Appalachian's Arguments For Treating Severance/Processing Taxes Differently Than Other Post-Production Costs Are Unconvincing.

Appalachian previously incorrectly argued that the severance/processing tax is an expense of production, that the term "market value" is exclusive of severance/processing tax obligations, and that other rulings of the deductibility of severance/processing taxes are inapplicable due to the language of other severance/processing tax statutes. All of these arguments are unconvincing.

A. The *Enron* Case Is Not Instructive or Binding.

Appalachian argues in its briefs to the District Court and the Sixth Circuit that severances taxes are, in fact, production costs. Specifically, Appalachian has argued that a 1994 Utah case lends support to the notion that severance taxes are production costs rather than post-production costs. However, that case did not address the issue. Instead, the Utah Supreme Court determined only whether a severance tax reimbursement paid to the producer by the purchaser of the gas was properly shared with the royalty owner pursuant to the particular terms of the lease between the parties. *Enron Oil and Gas Co. v. State of Utah,* 871 P.2d 508 (Utah 1994). The *Enron* Court never addressed whether severance taxes are a production or a post-production cost as those terms are used to evaluate royalty obligations. Appalachian clings to *dicta* in the opinion that generically calls severance taxes a "cost of production." "Production" was used generally by the *Enron* Court to mean the realization of a product which is sold and upon which sales price the producer is taxed (meaning, "production" generically meant all activities of a producer prior to sale).

Moreover, while the oil and gas lease in *Enron* provided for a royalty based on the "reasonable market value at the well," this term was later defined in the lease as "the price at which the [gas] was sold, provided that in no event shall the price for the gas be less than that received by the United States of America for its royalties from gas of like grade and quality from the same field." *Id.* at 509. Importantly, pursuant to its gas purchase agreement, Enron was receiving a price plus tax reimbursements, which is not the case here. In a later Utah case, a federal district court did consider "at the well" language and concluded that the royalty provision, which called for the gas to be valued

at the market rate at the wellhead, permitted the deduction of taxes. *Emery Resources Holdings, LLC,* 915 F.Supp. 2d at 1242.

Because the term "production" means those activities undertaken to physically extract gas as opposed to those activities and costs incurred after extraction is achieved, severance taxes assessed on a product sold after extraction are properly classified as post-production expenses.

B. "Market Price At The Well" Is Recognized As Having A Particular Meaning In Majority States.

Appalachian originally asserted and presumably will argue again that "market price" includes all production and severance/processing taxes. For this premise, Appalachian has cited *Commonwealth v. R.J. Corman Railroad Co./Memphis Line*, 116 S.W.3d 488 (Ky. 2003), which merely sets forth the general definition of "fair market value" as:

> [T]he price that a willing seller will take and a willing buyer will pay for property, neither being under any compulsion to sell or buy and both being in possession of all relevant information regarding the property.

Id. at 491 (internal citations omitted). Noticeably absent is <u>any</u> mention of production or severance/processing taxes. To the contrary, "at the well" states, as discussed above, consider the phrase "market value at the well" to mean that said value is net of any costs incurred after the time when the gas is captured. *See, e.g., Heritage Resources, Inc.*, 939 S.W. 2d at 129 (stating that the lower court's assessment that "'market value at the well' ... meant that the royalty interests were subject to costs incurred after production, including taxes" was correct).

C. *Burbank* and Other Cases Relied Upon By Appalachian Can Be Distinguished.

The only other Kentucky case Appalachian has cited is *Burbank v. Sinclair Prairie Oil Co.*, 202 S.W.2d 420 (Ky. 1946). This case involved the declaration of rights under an oil lease relating to a Kentucky license tax on oil producers, and did not address whether Kentucky's "at the well" rule would allow the deduction of severance/processing taxes. In fact, there is no mention of the contractual obligations regarding the assessment of royalties between the lessor and the lessee. The court was simply addressing the obligation to pay the license tax as an occupational tax and did not adjudicate the contractual obligations between the parties relating to the present Kentucky severance/processing tax statute. There was also no mention in that particular lease of "market value at the well." Instead, the *Burbank* lease provided the royalty was to be calculated on the actual sales price of the oil sold at the leased premises. Clearly, this case is not authoritative for the question being asked of this Court, and the Sixth Circuit must not have found it to be instructive.

Appalachian may also attempt to rely on a series of cases involving Peabody Coal Company to support its claim that the severance/processing taxes are not deductible.[5] However, the language of the leases in each of those cases is different than this one. The *Reis* lease provided that royalties would be calculated on the "average gross sales realization," which was defined in the lease as "the sales price without deduction of sales commission or expenses." *Reis*, 997 S.W.2d at 54. In the *Willits* lease, royalties were to be paid on the "gross-realization" of coal. "Gross Realization" was defined in the

[5] *See Reis v. Peabody Coal Co.*, 997 S.W.2d 49 (Mo.App. 1999); *Willits v. Peabody Coal Co.*, 188 F.3d 510 (table)(6th Cir. 1999)(unpublished opinion); *Hemenway v. Peabody Coal Co.*, 159 F.3d 255 (7th Cir. 1998).

agreement as "the gross selling price of all merchantable coal . . . in determining the "Gross Realization" there shall be deducted from the F.O.B. barge price to the customer or buyer the reasonable cost of transporting . . . such coal . . . ." *Willits* 188 F.3d 510 at *9. Similarly, the *Hemenway* lease which involved an Indiana case, dictated that royalties were to be paid based on the actual "sales price" of the coal. *Hemenway*, 159 F.3d at 256. The use of the term "gross" in these leases clearly indicated that royalties were to be calculated on the gross sales price of the coal, before any deductions. While the various *Peabody Coal Company* leases explicitly stated that royalties were to be calculated on the sales price of the coal, without any deductions, the Appalachian Lease contains no such language prohibiting the deduction of all severance/processing taxes before calculating royalties. Instead, the Lease here requires a market price to be determined "at the well," which under the "at the well" rule adopted by Kentucky, permits the deduction of all post-production expenses.

For the reasons described above, the *Poplar Creek* Court properly disregarded the authorities relied upon by Appalachian, and the District Court correctly recognized severance/processing taxes as a post-production expense and permitted the deduction of severance/processing taxes.

The District Court was correct when it interpreted the reasoning in *Poplar Creek* as applying to severance/processing taxes and recognized all severance/processing taxes are deductible as a post-production expense. Like other post-production costs, the severance/processing taxes are incurred and imposed based on a gross sales price at a time well after production has been completed. Therefore, in Kentucky, the market

price "at the well" is the gross sales price, less all post-production costs, including all severance/processing taxes.

CONCLUSION

For all of the foregoing reasons, EQT Production Company respectfully requests that this Court hold that in Kentucky, the "at the well" rule allows a deduction for all severance/processing taxes paid before calculating a contractual royalty payment based on "the market price of gas at the well."

Respectfully submitted,

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