MARCELLUS SHALE COALITION™

What's Included:

FACT SHEET
Post-Production Costs:
Just the Facts

FACT SHEET
Post-Production Costs:
The Value for Leaseholders

TALKING POINTS
Post-Production Costs

OVERVIEW
Guaranteed Minimum Royalty Act (GMRA),
Kilmer Case and Constitutionality of HB 1391

LEGISLATIVE TRACKING & SAMPLE LETTER
Link to HB 1391
Letter to Elected Official

POWERPOINT SLIDES
Presentation on Post-Production Costs

Post-Production Costs

Just the Facts

Who owns the natural gas?

Unlike many other countries, oil and natural gas rights - along with other subsurface property rights - are typically owned by private property owners. While the surface owner often owns the subsurface oil, gas and mineral rights, that is not always the case, as it is not unusual for the subsurface rights to have been conveyed to another property owner over time. Whoever is lawfully entitled to drill for oil or natural gas owns the oil or natural gas that is produced from the well. In basic terms, this means that both the drilling operator and leaseholder(s) own the natural gas that is produced. The proportional ownership of the natural gas and other critical terms are negotiated and agreed to by the leaseholder(s) and the operator as part of the lease.

Under Pennsylvania's Oil and Gas Lease Act, any leases entered into on or after September 18, 1979 must provide at least a one-eighth (12.5%) royalty rate to be valid. Leases in existence and wells drilled prior to this date, which did not provide at least a one-eighth royalty rate, shall be escalated to this rate should the well be altered. As in other major oil and natural gas producing states, the owners of the natural gas (in this case, the operator and the leaseholder) proportionally share the expenses required to get the natural gas to market for sale, unless the parties have mutually agreed to a different arrangement.

Who bears the costs to prepare the well site, drill and construct the well?

The natural gas operator typically assumes all financial risk and bears all costs associated with constructing a well and placing it into production. It is not uncommon to incur costs between $6 - $8 million, or more, for each horizontal, unconventional shale gas well.

What costs are associated with constructing a well and placing it into production?

A multitude of costs are associated with constructing a well and placing it into production. These include costs related to researching title ownership and deed restrictions, leasing drilling rights from the property owner, surveying, engineer and design work related to the well pad, construction or preparation of access roads to the well pad, drilling and constructing the well, well stimulation and completion. Additionally, there are significant costs associated with preparing numerous environmental and other permit applications to comply with federal, state and local regulatory requirements.

What are post-production costs?

Post-production costs are the expenses incurred in order to get the gas from the wellhead to market. These costs include gathering, compression, dehydration, processing, fractionation, marketing, treating, handling and transportation. Below are descriptions of some of these costs:

Gathering	Typically include the construction of underground pipelines used to gather the natural gas from a well or series of wells in order to send it to its next destination, whether a compressor or processing facility (i.e dehydration, fractionation or other facility where the natural gas is further refined for ultimate sale).
Compression	Many of the larger interstate pipelines operate at pressures of 1,000 psig or more; wells frequently operate at much lower pressures, so gas must be compressed to enter the pipeline.
Processing	Compressing, dehydrating, fractionating and separating, treating or otherwise physically preparing the natural gas for ultimate sale. Examples may include increasing or stabilizing the pressure, removing water, or separating the natural gas into its various constituencies (i.e. ethane, propane, butane, natural gasoline, etc.)
Marketing	Finding a willing buyer and negotiating the terms of sale for gas and/or liquids.
Transportation	Transporting the natural gas from a well pad or processing facility to a point of sale. The natural gas may be transported hundreds or even thousands of miles until it reaches a customer.

How much are post-production costs?

The exact amount varies from operator to operator depending on a variety of factors, including volume, quality of the natural gas, and distance to market. However, as recently as February of 2016, the Pennsylvania Independent Fiscal Office (IFO) estimated average post-production costs in Pennsylvania to be approximately $0.82 per mcf.

MARCELLUS SHALE COALITION™

Post-Production Costs

The Value for Leaseholders

What are the benefits to the landowner?

Activities reflected in post-production expenses add significant value for both the leaseholder and operator. By processing and preparing the natural gas and delivering it for ultimate sale, both the leaseholder and operator will receive a higher payment per mcf, reflecting the value which has been added to the natural gas.

What can property owners negotiate when they lease their natural gas rights?

Natural gas cannot be extracted without the consent of the property owner, which is typically the landowner. Therefore, no lease can be executed without the consent of the property owner, meaning just about any facet of the proposed lease can be negotiated until it meets with the property owner's approval. Typical provisions include:

- The duration of the initial term of the lease (how long an operator has to drill).
- The amount of the signing bonus (typically an amount per acre leased).
- The royalty rate (provided that it is at least one-eighth, or 12.5 percent of the net value of the gas).
- Where the operator may drill on the leased property or whether the natural gas must be accessed from an adjacent property, or other considerations of importance to the property owner.

However, no lease provisions can be in conflict with applicable federal, state or local laws. For example, no lease provisions can ease the environmental protection and permitting standards required of the operator to extract the natural gas.

If Pennsylvania has a minimum royalty act, why is my royalty rate less than 12.5 percent?

Pennsylvania's minimum royalty act specifies that leases entered into after September 18, 1979 must provide a royalty rate of at least 12.5 percent to the leaseholder (property owner). Under the law, operators and leaseholders also share proportionally in post-production costs in order to get product in a marketable state and to an ultimate point of sale. Once these costs are deducted from the gross value of the natural gas, the leaseholder receives at least 12.5 percent - or more, if agreed to in the lease - of the net sale proceeds. It is important to remember that the post-production costs are shared proportionally, unless otherwise specified in the lease, meaning that the operator's proceeds are also based upon the net sale proceeds.

What other leaseholder protections are included in the Oil & Gas Lease Act?

Act 66 of 2013 amended the Oil and Gas Lease Act to require that an operator provide, at a minimum, the following information: month, year and amount of natural gas produced; price received per mcf; severance tax and other production taxes and deductions permitted under the lease; net value of total sales received; the leaseholder's interest, expressed as a decimal or fraction; gross and net amount of the leaseholder's share of the proceeds; and contact information for the producer. The required information shall be provided to the leaseholder as part of the royalty check stub or in some other appropriate manner furnished to the leaseholder on a regular basis.

Further, Act 66 states that if a conflict arises between the operator's division order and an oil or gas lease, then the terms and conditions of the lease shall control. A division order may not amend or supplement the terms and conditions of a lease.

Additionally, under the Pennsylvania Constitution's impairment of contracts clause, no ex post facto law may be enacted which alters or impairs the obligations, terms and conditions of a lease.

MARCELLUS SHALE COALITION™

TALKING POINTS

Post-Production Costs

- Post-production costs are the expenses incurred in order to get the gas from the wellhead to market.
- These costs include expenses to gather, compress, dehydrate, process, market and transport the gas.
- Such costs add value to the gas for both the producer and the leaseholder; without them, the gas would derive significantly lower value.
- Whether a lease permits deductions for post-production costs is a contractual issue between the landowner and the operator.
- PA law guarantees that leaseholders shall receive at least 12.5% of the net sale proceeds of the oil or gas.

MARCELLUS SHALE COALITION™

OVERVIEW

Guaranteed Minimum Royalty Act (GMRA), Kilmer Case and Constitutionality of HB 1391

- The proportionate sharing among the producer and royalty owner (i.e. lessee and lessor) of the cost of getting gas from the wellhead to market (i.e. post-production costs) is both supported by law, as upheld by the Pennsylvania Supreme Court, and is directly provided for in many existing leases across the Commonwealth.

Guaranteed Minimum Royalty Act (GMRA)

- The term royalty has traditionally- since the inception of conventional production in Pennsylvania- been defined as a share of production, free of the costs of production. Historically, a 1/8th royalty has been the industry standard. In 1979, the GMRA codified that standard by providing that:

> *A lease or other such agreement conveying the right to remove or recover oil, natural gas or gas of any other designation from lessor to lessee shall not be valid if such lease does not guarantee the lessor at least one-eighth royalty of all oil, natural gas or gas of other designations removed or recovered from the subject real property.*

- Also historically, industry has calculated royalty at the wellhead by using the point of sale value of the gas minus the lessor's proportionate share of post-production. This is known as the "net-back" method, which the Pennsylvania Supreme Court upheld in *Kilmer vs. Elexco Land Services, Inc.* (Kilmer).

Kilmer vs. Elexco Land Services, Inc.

- The lessors litigating *Kilmer* contractually agreed to "receive as its royalty one eighth (1/8th) of the sales proceeds actually received by Lessee from the sale of such production, <u>less this same percentage share of all Post Production Costs</u>." They sought to invalidate their lease, however, by asserting that it violated the GMRA because the net-back method of calculating a royalty resulted in less than 1/8th the gross value of the gas. Further, they claimed that their royalty should be calculated at point of sale and that they should not be required to share in their proportionate costs of getting the gas to market.

- Ultimately, the Supreme Court rejected the lessors' claims and upheld the net-back method for calculating royalties as consistent with the GMRA. Further, the Supreme Court affirmed the general fairness of the net-back method, stating that:

> *The natural gas can be sold at different degrees of processing for different prices and at different prices based upon proximity of the market to high demand cities. If one company sells it at a point halfway to fully processed (or half-way to New York City), the landowner will get dramatically lower royalties than a neighbor whose gas is sold after it is fully processed. The use of the net-back method eliminates the chance that lessors would obtain different royalties on the same quality and quantity of gas coming out of the well depending on when and where in the value-added production process the gas was sold.*

- The Supreme Court firmly upheld the net-back method of calculating royalty- thus affirming the industry standard of calculating the value at the wellhead and proportionately sharing post-production costs with the lessor. The Court also provided a *footnote* that indicated that the General Assembly was, "the branch of government best suited to weigh the public policies underlying the determination of the proper point of royalty valuation." In this footnote, the court did not suggest that the legislature could retroactively change the terms of current leases.

MARCELLUS SHALE COALITION™

OVERVIEW

Guaranteed Minimum Royalty Act (GMRA), Kilmer Case and Constitutionality of HB 1391

Constitutionality of HB 1391- Impairment of Contracts

- Thousands of leases across the Commonwealth have provisions that allow for royalty payments that deduct the lessor's pro-rata share of post-production costs. This is the net-back method of calculation that was affirmed by the Supreme Court as consistent with the GMRA. Yet HB 1391 would seek to modify and therefore invalidate these current, lawful leases that include these royalty provisions.

- The Contracts Clause in both the U.S. (Art. I § 10, cl. 1) and Pennsylvania (Art. 1 § 17) Constitutions prohibit laws impairing "the obligations of contracts." Under both Constitutions, private contract rights and obligations are binding, and the parties are entitled to rely on them. HB 1391, as applied to existing oil and gas leases, would impair lawful royalty provisions of these existing leases.

Fundamentally, without investing in the cost of delivering the gas to a point of sale, the lessor's gas has little value.

- For example, if the gas were sold at the wellhead, the price paid would reflect the *purchaser's* cost of getting the gas to market. Thus, the price paid would be less than the "market price," and the lessor would receive his share (e.g. 1/8) of that lesser price. If, however, the gas were sold downstream from the wellhead, it would sell for a higher price, but there would be costs to get it downstream (i.e. post-production costs).

- In order to receive a higher value for the commodity, both parties to the contract (i.e. lessee & lessor) have a vested interest in undertaking the necessary expenditures to prepare and transport that gas for sale and likewise- inasmuch as the lease provides for it- share proportionately in these costs in order to derive the highest value for the gas.

- Despite any suggestion to the contrary, it is not the role of the legislature to alter retroactively existing contracts that provide for the deduction of post-production costs, a practice that is supported by the Pennsylvania Supreme Court and memorialized in leases throughout the state.

HB 1391 would substantively alter existing contracts, and therefore it is unconstitutional.

- The only result from enactment of this bill would be the entrenchment of thousands of Pennsylvanians across the Commonwealth in protracted litigation.

MARCELLUS SHALE COALITION™

SAMPLE LETTER
Letter to Elected Official

LINK: About HB 1391

Dear Senator/State Representative:

I opposes HB 1391 because this legislation seeks to alter the economic terms of privately-negotiated leases, which is an unconstitutional impairment of contracts under both the Pennsylvania and U.S. Constitutions.

The proportionate sharing among the producer and royalty owner of the cost of getting gas from the wellhead to market (i.e. post-production costs) is both supported by law, as upheld by the Pennsylvania Supreme Court, and is directly provided for in many existing leases across the Commonwealth. There is nothing improper about the proportionate sharing of post-production costs and certainly nothing that should warrant government to rewrite the contract language that the Supreme Court declared valid.

The term royalty historically- since conventional drilling in the Commonwealth- refers to the share of production, free of the costs of production, paid by a producer (or lessee) to a mineral owner (lessor) pursuant to a lease. The producer bears all the expense and risk to bring the gas to the surface, which typically costs several million dollars per well pad.

The cost of preparing and delivering the gas to market, however, is collectively and proportionately borne by the lessor and the lessee pursuant to the negotiated terms of the lease. Without this investment (e.g. if the gas were sold at the wellhead) the purchaser would bear those costs and thus would pay less for the gas, and that lower price would result in a lower royalty. Therefore, both the lessor and lessee have a common interest in preparing and delivering the natural gas in the most cost-efficient way possible to a downstream market where it can fetch the highest price possible.

The deduction of post-production costs remains a fair, legitimate and common business practice and one upheld by the Pennsylvania Supreme Court. HB 1391 infringes upon free market contract negotiations and unconstitutionally impairs existing contracts and therefore is unconstitutional. As your constituent, I urge you to vote against HB 1391.

Thank you for your consideration.

Sincerely,

<<Your Name>>