

W. Va.'s Legislature Giveth and Taketh Away: Two New Laws Affecting Oil and Gas Operations

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On March 9, 2018, West Virginia Governor Jim Justice signed two bills into law. The first, House Bill 4268, includes the Cotenancy Modernization and Majority Protection Act and the Unknown and Unlocatable Interest Owners Act, both of which provide long sought-after relief for oil and gas owners and operators who previously could not develop the oil or gas without all cotenants' consent. Years of negotiation and compromise produced a disjointed statutory framework, and its application will undoubtedly lead to litigation. The second, Senate Bill 360, amends W. Va. Code §22-6-8, which concerns the deduction of post-production costs from royalties under certain leases and, in large part, unwinds the legal effect of the West Virginia Supreme Court of Appeal's recent pro-industry ruling in *Leggett v. EQT Production Co.*, 239 W.Va. 264, 800 S.E.2d 850 (2017).

The Cotenancy Modernization and Majority Protection Act *(House Bill 4268)*

The Cotenancy Modernization and Majority Protection Act (the "CMMPA") allows a supermajority of cotenants to develop an oil and/or gas interest without the need for the consent of all oil or gas interest owners in some circumstances. It also provides significant protections for nonconsenting interest holders and surface owners, and creates a mechanism for surface owners to quiet title to oil and/or gas interests held by "unknown or unlocatable" owners.

Prior to the CMMPA's enactment, a cotenant owning a fractional, undivided interest in an oil or gas estate – no matter how small – could prevent the remaining cotenants from developing the oil or gas. *See Law v. Heck Oil Co.*, 106 W.Va. 296 (1928) (holding that the owner of an undivided 767/768 interest was properly enjoined from

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developing the oil and gas estate due to the principle of waste and lack of consent by the owner of 1/768 interest). The CMMPA provides that the owners of a fractional, undivided interest can develop their oil and gas interests without committing waste if:[1]

- There are seven (7) or more cotenants with a fractional, undivided interest in the oil and gas estate. W. Va. Code §37B-1-4.
- The developing party (*i.e.*, the operator) makes "reasonable efforts to negotiate with" all cotenants. *Id*.
- The developing party obtains "consent to the lawful use or development of the oil or natural gas mineral property" from the cotenants owning at least three-fourths (3/4ths) of the oil and gas estate. *Id*.

If these prerequisites are satisfied, a nonconsenting cotenant has two options. First, it can elect to receive its pro-rata share of the *highest* royalty paid to any of the leasing cotenants *without deduction for post-production costs*, and the *highest* lease bonus and delay rental payments. W. Va. Code §37B-1-4(b)(1). A nonconsenting tenant who selects this option is subject to "the lease executed by a consenting cotenant which contains terms and provisions most favorable to the nonconsenting cotenant." W. Va. Code §37B-1-4(e). Absent written agreement, however, certain lease provisions are **not** imputed to a nonconsenting cotenant even if they are contained in the "most favorable lease." *See* W.Va. Code §37B-1-4(3) (*e.g.*, choice of law provisions, arbitration provisions, storage provisions, etc.).

Alternatively, a nonconsenting cotenant can elect to receive a pro-rata working interest *after* the market value of its share of production equals double its share of costs. W. Va. Code §37B-1-4(b)(2). Absent written agreement, the rights and duties of the operator and a nonconsenting cotenant who elects to proceed as a working interest owner are determined by the Oil and Gas Conservation Commission, which is tasked with crafting "just and reasonable" terms and provisions "in a manner similar to the provisions of §22C-9-7(b)(5)(B)…governing deep wells." W. Va. Code §37B-1-4(f).

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The CMMPA also provides that an operator cannot perform surface activities on a tract with a nonconsenting oil or gas owner absent the surface owner's consent, even if the surface owner does not own any oil or gas interest. W.Va. Code §37B-1-6.

Finally, the CMMPA provides a mechanism by which a surface owner may obtain title to oil and/or gas interests underlying its property, where the oil or gas interest owner is "unknown" or "unlocatable." W. Va. Code §§37B-1-3, 37B-1-4(g).

As a companion to the CMMPA, House Bill 4268 also enacted the Unknown and Unlocatable Interest Owners Act, which establishes quarterly reporting requirements for all production under the CMMPA that involves unknown or unlocatable interests, and sets forth the West Virginia State Treasury's rights and obligations regarding the funds tendered to the State on behalf of unknown or unlocatable oil or gas owners. W.Va. Code §37B-1-4(d).

The CMMPA takes effect on June 3, 2018, and the Unknown Owners Act takes effect on July 1, 2018. Both Acts contain complexities that will almost certainly lead to disputes between oil and gas owners and operators.

Amendment to W. Va. Code §22-6-8 – Post-Production Costs *(Senate Bill 360)*

Senate Bill 360 amends W. Va. Code §22-6-8, a statute that addresses older oil and gas leases that provide for the payment of a "flat well royalty" rather than a percentage royalty. The amendment is narrowly focused and is clearly intended to counteract the West Virginia Supreme Court of Appeal's decision in *Leggett v. EQT Production Co.*, 239 W.Va. 264, 800 S.E.2d 850 (2017).

Under §22-6-8, when an operator applies to West Virginia Department of Environmental Protection ("DEP") for a permit to drill, redrill, deepen, fracture, stimulate, pressure, convert, combine or physically change to allow the migration of fluid from one formation to another, the operator's permit application must include either: (1) a copy of each oil and gas lease or contract "by which the right to

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extract, produce or market the oil or gas" exists; or (2) a summary of each such lease or contract, including a description of its royalty provision. W. Va. Code §22-6-8(c). If any of the leases or contracts require the operator to pay a "flat well royalty" or a "similar provision for compensation…which is not…inherently related to the volume of oil and gas" extracted, produced or marketed – as opposed to a percentage royalty – DEP must deny the permit unless the application is accompanied by an affidavit certifying that the lessor will be paid at least a one-eighth royalty on oil or gas extracted, produced or marketed from the well. W. Va. Code §22-6-8(e).

The only material change to §22-6-8 is to subsection (e). In its pre-amendment form, subsection (e) required the applicant to certify that the lessor would be paid "not less than one eighth of **the total amount paid to or received by or allowed to the owner of the working interest at the wellhead** for the oil and gas so extracted, produced or marketed…" W. Va. Code §22-6-8(e) (2017) (emphasis added).

The amendments, which become effective on May 31, 2018, change §22-6-8(e) to require the permit applicant to certify that the lessor will be paid "not less than one eighth of **the gross proceeds, free from any deductions for post-production expenses, received at the first point of sale to an unaffiliated third-party purchaser in an arm's length transaction** for the oil and gas so extracted, produced or marketed…" W. Va. Code §22-6-8(e) (2018) (emphasis added).

The amendments are intended to address, and effectively nullify, the West Virginia Supreme Court of Appeal's recent decision in *Leggett v. EQT Production Co.*, 239 W.Va. 264, 800 S.E.2d 850 (2017). In *Leggett*, the Court held that a lessee was permitted to deduct post-production costs from royalties owed to a lessor with a flat well royalty lease for which a percentage royalty was required under §22-6-8(e).[2]

Importantly, the amendments to §22-6-8 do **not** abolish the practice of deducting post-production costs from oil and gas royalties in West Virginia. The amendments apply only if (1) the underlying lease or contract is a flat well royalty lease or contract;

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and (2) the operator applies for a permit after May 30, 2018. In addition, the law applies only to the specific well being permitted – it does not modify the royalty being paid on existing wells drilled under the same lease (unless and until a new permit is needed for that existing well).

The amendments to §22-6-8 take effect on May 31, 2018.

For more information, please contact Kenneth Witzel, Kara Eaton, Nicholas Koch or any other member of Frost Brown Todd's Energy and Natural Resources Industry Team.

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[1] W. Va. Code §37-7-2, amended and reenacted by House Bill 4268, provides that the "lawful use or development of oil or natural gas and their constituents in compliance with [the CMMPA] is not the commission of waste."

[2] *Leggett* represented a notable departure from the Court's earlier holdings in *Wellman v. Energy Resources, Inc.*, 210 W. Va. 200, 557 S.E.2d 254 (2001), and *Tawney v. Columbia Natural Resources, L.L.C.*, 219 W. Va. 266, 633 S.E.2d 22 (2006), in which the Court disallowed the deduction of post-production costs from certain percentage-royalty leases. In *Wellman*, applying the principles that (1) ambiguous provisions in leases are to be construed against the drafting party; and (2) lessees have an implied duty to "get the oil or gas in marketable condition and actually transport it to market[,]" the Court held that "unless a lease provides otherwise, the lessee must bear all costs incurred in exploring or, producing, marketing and transporting the product to the point of sale." *Wellman*, at 211, 557 S.E.2d at 265, Syl. Pt. 4. Likewise, in *Tawney*, the Court applied the same rational to leases that provide that royalties are to be calculated "at the wellhead." *Tawney*, 219 W. Va. at 268, 633 S.E.2d at 24. The *Tawney* Court concluded that the term, "at the wellhead," was ambiguous, and that post-production costs could not be deducted from the lessors' royalty under a lease requiring royalties to be calculated "at the wellhead" absent other language in the lease expressly allowing post-production costs to be deducted from royalties. *Id.* at 273, 633 S.E.2d at 29, Syl. Pt. 10.

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