NOT RECOMMENDED FOR FULL-TEXT PUBLICATION

No. 12-5589

**UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT**

FILED
Aug 26, 2013
DEBORAH S. HUNT, Clerk

APPALACHIAN LAND COMPANY,	)	
	)	
Plaintiff-Appellant,	)	
	)	
v.	)	ON APPEAL FROM THE UNITED
	)	STATES DISTRICT COURT FOR THE
EQT PRODUCTION COMPANY,	)	EASTERN DISTRICT OF KENTUCKY
	)	
Defendant-Appellee.	)	

Before: DAUGHTREY, MOORE, and STRANCH, Circuit Judges.

PER CURIAM. Pursuant to the provisions of Kentucky Rule of Civil Procedure 76.37(1), we are authorized to certify to the Kentucky Supreme Court a question of Kentucky law that "may be determinative of the cause then pending before the originating court and as to which it appears . . . that there is no controlling precedent in the decisions of the Supreme Court and the Court of Appeals of" Kentucky.[1] Subsection (3) of that same rule further provides that the certification order to the Kentucky Supreme Court shall contain:

(a) The questions of law to be answered;
(b) A statement of all facts relevant to the questions certified and showing fully the nature of the controversy in which the questions arose;
(c) The names of each appellant and appellee; and
(d) The names and addresses of counsel for each appellant and appellee.

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[1] Rule 76.37(4) provides further that "[t]he certification order shall be prepared by the certifying court, signed by the judge presiding at the hearing, and forwarded to the Supreme Court by the clerk of the certifying court under its official seal."

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No. 12-5589
Appalachian Land Co. v. EQT Production Co.

QUESTION OF LAW TO BE ANSWERED

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?

STATEMENT OF RELEVANT FACTS

At its inception, this lawsuit between plaintiff Appalachian Land Company and defendant EQT Production Company, formerly known as Equitable Production Company, sought to resolve two issues. The parties first presented the district court with the question of whether a lessee of natural-gas-extraction rights could deduct gathering, compression, and treatment expenses necessary to market the natural gas before calculating the royalty payments due to the lessor pursuant to a lease agreement under which royalty payments were to be calculated based on "the market price of gas at the well." Second, the parties sought guidance on whether statutory severance-tax[2] payments also may be deducted by the lessee prior to the calculation of those royalties. We effectively decided the first issue in our opinion in *Poplar Creek Development Co. v. Chesapeake Appalachia, LLC*, 636 F.3d 235 (6th Cir. 2011), which held "that Kentucky follows the 'at-the-well' rule, which allows for

[2] Pursuant to Section 143A.020(1) of the Kentucky Revised Statutes, the Commonwealth levies a tax on the gross value of natural resources that are extracted or processed within Kentucky.

the deduction of post-production costs prior to paying appropriate royalties." *Id.* at 244. We now turn to a summary of the facts giving rise to the remaining issue.

In 1944, Robert Williams, Appalachian's predecessor-in-interest, leased certain oil and gas rights to the Kentucky West Virginia Gas Company, Inc., the predecessor-in-interest to EQT. Pursuant to that lease agreement, royalties on natural gas extracted from the land by the lessee (now EQT) are to be paid to the lessor (now Appalachian) "at the rate of one-eighth (1/8) of the market price of gas at the well."

However, "natural gas is not typically sold at the wellhead." *Schroeder v. Terra Energy, Ltd.*, 565 N.W.2d 887, 891 (Mich. Ct. App. 1997). As a result, the extractor incurs certain post-production costs prior to the sale of the gas at a site away from the well itself. We explained those gathering, compression, and treatment costs as follows in our *Poplar Creek* decision:

> "Gathering" involves gathering small amounts of gas from individual wells, then aggregating the gas into larger lines until it is in a transmission pipeline. As set forth in 30 C.F.R. § 1206.151 (2010), "[g]athering means the movement of lease production to a central accumulation and/or treatment point on the lease, unit or communitized area, or to a central accumulation or treatment point off the lease, unit or communitized area . . . ."
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> "Compression," as defined in 30 C.F.R. § 1206.151 (2010), is "the process of raising the pressure of gas." It is often used to transport low pressure gas through the pipeline to a place where it can be sold. In *Merritt v. Southwestern Electric Power Co.*, 499 So.2d 210 (La. Ct. App. 1986), the Louisiana Court of Appeals noted that: "In order to market the gas, it first had to be compressed. Thus, the gas was useless and had no market value at the wellhead until it could be moved into the gathering line by compression." *Id.* at 213.
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> Gas is treated before it is sold to remove impurities or otherwise enhance its value. *See* Randy Sutton, Annotation, *Sufficiency of "At the Well" Language in Oil and Gas Leases to Allocate Costs*, 99 A.L.R.5th 415 (2008) (describing "treatment costs" as

> arising from "the need, in some cases . . . to treat the gas to remove harmful substances or to enhance its value").

Poplar Creek, 636 F.3d at 238-39 nn.1-3.

As previously noted, in *Poplar Creek*, "we h[e]ld that Kentucky follows the 'at-the-well' rule." *Id.* at 244. "'At the well' means that the gas has not been increased in value by processing or transportation[,]" thus entitling the lessor to royalties based only upon "the value or price of unprocessed, untransported gas." *Piney Woods Country Life Sch. v. Shell Oil Co.*, 726 F.2d 225, 240 (5th Cir. 1984) (applying Mississippi law). Stated differently, the lessor must bear "its proportionate share of processing costs incurred downstream of the well" by accepting royalty payments "determined by working back from the price at the point of sale, deducting the cost of processing and transportation to the wellhead." *Schroeder*, 565 N.W.2d at 893 (quoting *Atl. Richfield Co. v. Cal.*, 262 Cal. Rptr. 683, 688 (Cal. Ct. App. 1989)). Thus, under applicable Kentucky law, post-production costs that improved the quality or marketability of the natural resource must be deducted from the ultimate selling price of the natural gas before any royalties due a lessor based upon the "market price of gas at the well" are calculated.

Despite challenging just such a conclusion in its complaint in this litigation, Appalachian now concedes that *Poplar Creek* is the law of the circuit and recognizes that we are not at liberty to arrive at a conclusion in this case that differs from that in our earlier published decision. *See, e.g.*, *Salmi v. Sec'y of Health & Human Servs.*, 774 F.2d 685, 689 (6th Cir. 1985) (prior decision of this court "remains controlling authority unless an inconsistent decision of the United States Supreme Court requires modification of the decision or this Court sitting en banc overrules the prior

decision"). Consequently, Appalachian no longer seeks to recover from EQT that portion of royalties that would be owed simply because of the increase in the market price of the natural gas due to refinements and treatments that occurred *after* the defendant extracted the gas from the wells. Nevertheless, Appalachian continues to assert that the royalty payments due to it should have been based upon the value of the gas after deducting the post-production costs but *before* deducting the severance taxes paid pursuant to Kentucky statutes.[3] Thus, Appalachian argues that it is entitled to royalty payments in an amount greater than it has heretofore received from EQT.

The district court rejected this argument. Relying upon the rationale used by appellate courts in Texas and Michigan when addressing similar issues in *Cartwright v. Cologne Production Co.*, 182 S.W.3d 438, 444-45 (Tex. Ct. App. 2006), and *Schroeder*, 565 N.W.2d at 895, respectively, the district court reasoned:

> The Kentucky severance tax is simply another post-production cost that leads to a market price that is higher than the at-the-well price. Therefore, it is appropriate for EQT to deduct taxes, in addition to post-production costs, from the market price to determine the at-the-well price – and then pay [Appalachian] royalties based [on] that price.
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> * * * * *
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> 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.

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[3] In accordance with Kentucky's revenue and taxation statutes, "[f]or the privilege of severing or processing natural resources in [Kentucky], a tax is . . . levied at the rate of four and one-half percent (4.5%) on natural gas . . . , such rates to apply to the gross value of the natural resource severed or processed . . . ." Ky. Rev. Stat. § 143A.020(1). The "gross value" of natural resources severed and/or processed is further defined in the Commonwealth's statutes as "the amount received or receivable by the taxpayer," or "the fair market value for that grade and quality of the natural resource." Ky. Rev. Stat. §§ 143A.010(5)(a) & (b).

Appalachian Land Co. v. EQT Prod. Co., No. 7:08-139-KKC, 2012 WL 523749, at *3 (E.D. Ky. Feb. 16, 2012).

Appalachian moved in a timely manner to alter or amend the judgment. In its motion, the plaintiff contended that the deduction of severance taxes from the sales price of the natural gas, prior to calculating the royalty payments, improperly transferred the responsibility of paying those taxes from the owner of the natural resource (EQT) to the owner of the royalty interest (Appalachian). The district court denied the motion to alter or amend its judgment, however, explaining that "the issue in this case is not whether Kentucky law requires [Appalachian] to pay a portion of the severance taxes. The issue here is whether the contract between EQT and [Appalachian] allows EQT to deduct a portion of the severance taxes it pays from the ultimate sales price in order to calculate the market price at-the-well." As stated by the district court:

> Under the lease, EQT would be prohibited from deducting severance taxes if EQT paid those severance taxes based on the price of the gas "at the well." But, the taxes are paid at the market price, which is higher than the at-the-well price. Therefore, it is permissible to deduct severance taxes, as well as other postproduction costs, from the market price in order to "work back" to calculate the at-the-well price.

Our opinion in *Poplar Creek* did not address directly the question of whether Kentucky severance taxes also can be deducted from the sale price of natural gas at the market before determining the royalty payment due a lessor like Appalachian. Consequently, we now certify the question of law stated above to the Kentucky Supreme Court regarding the intent and the reach of the Kentucky severance-tax statute.

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PARTIES AND COUNSEL

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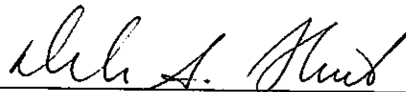
Karen Nelson Moore
Circuit Judge, Presiding

PROOF OF SERVICE

True copies of the foregoing Certification Order were sent this 26th day of August, 2013, by ordinary United States Mail to George E. Stigger, Appalachian Land Company, 236 Cardinal Circle West, St. Marys, Georgia 31558 and John C. Whitfield, Whitfield, Bryson & Mason, LLP, 19 North Main Street, Madisonville, Kentucky 42431, counsel for plaintiff-appellant; and Kimberly S. McCann, Gregory L. Monge and Keri E. Lucas, VanAntwerp, Monge, Jones, Edwards & McCann, LLP, 1544 Winchester Avenue, 5th Floor, P.O. Box 1111, Ashland, Kentucky 41105-1111, counsel for defendant-appellee.



Deborah S. Hunt, Clerk