WYOMING DISALLOWS DEDUCTIONS FOR TRANSPORTATION BETWEEN WELLHEAD AND MARKET PIPELINE: *CABOT OIL & GAS CORP. V. FOLLOWILL*

by
Amy Seneshen and
Will Stenzel[1]

Welborn Sullivan Meck & Tooley, P.C. - Denver, Colorado

I. Introduction

In *Cabot Oil & Gas Corp. v. Followill*,[2] the Wyoming Supreme Court more clearly defined what expenses must be shared by royalty owners. The 2004 decision adopts a broad definition of "gathering" for production costs under the Wyoming Royalty Payment Act that disallows royalty deductions for transportation charges between the wellhead and the market pipeline.

II. Wyoming Royalty Payment Act

The Wyoming Royalty Payment Act[3] (the "Act") regulates the distribution of oil and gas proceeds. The Act was amended in 1989 to more clearly allocate transportation and other expenses between lessees and royalty owners.[4] Royalty owners hold their interests free of production expenses, but must share in post-production transportation costs to a point of sale or for processing.[5] Conflicts develop because royalty owners want as few expenses as possible deducted from their royalties while lessees want to share many expenses as possible. These conflicts continued even after the 1989 amendments to the Act.[6] The *Cabot Oil* case was the product of one such dispute.

The Act specifically provides that "costs of production" (which are not deductible from royalty owners' interests) are "all costs incurred for exploration, development, primary or enhanced recovery and abandonment operations including…gathering…or transporting...the gas into the market pipeline… and does not include the reasonable and actual direct costs associated with transporting…the gas from the point of entry into the market pipeline…"[7]

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[1] Amy Seneshen is a partner at Welborn Sullivan Meck & Tooley, P.C. and specializes in oil and gas law. Will Stenzel is a third-year law student at the University of Colorado Law School and will join Welborn Sullivan Meck & Tooley, P.C. as an associate upon graduation.
[2] 93 P.3d 238 (Wyo. 2004).
[3] Wyo. Stat. Ann. §30-5-301 et seq.
[4] *See* Wyo. Stat. Ann. § 30-5-304.
[5] *Id.*
[6] *See Wold v. Hunt*, 52 F.Supp.2d 1330, 1334 (D. Wyo. 1999).
[7] Wyo. Stat. Ann. §30-5-304(vi).

III. The Facts in *Cabot Oil*

The plaintiffs in *Cabot Oil* held overriding royalty interests in 96 natural gas wells located on 13 oil and gas leases. Defendant Cabot Oil & Gas Corporation ("Cabot") was the successor in interest to the original lessors and assumed responsibility for paying the plaintiffs' royalties. Cabot arranged for unrelated third parties to transport gas from the wells to delivery points at interconnections with interstate transmission systems where the gas was sold. These companies invoiced Cabot for their services, and Cabot in turn deducted these costs from royalties paid to the plaintiffs. The overriding royalty interest owners sued Cabot, claiming that these charges were nondeductible production costs as defined by the Wyoming legislature. Cabot claimed in turn that royalty owners historically shared the cost of transporting gas from the place of production. Cabot also contended that all enumerated production costs under the Act occur on the lease or unit, and therefore all costs incurred off the lease are deductible from royalty payments.

The case was filed in the Federal District Court for the District of Wyoming, who certified two questions to the Wyoming Supreme Court: (1) what is meant by the term "gathering" in the Act; and (2) when do the penalties under the Act accrue?

IV. The Court's Analysis

While the Act is clear about the types of costs that may be deducted from royalty payments, it is unclear as to when nondeductible gathering costs end and deductible transportation costs begin. In a 1999 case, the Federal District Court for the District of Wyoming frowned upon attempts to construe gathering charges as transportation charges, but refused to draw a specific line between the two.[8] In *Cabot Oil*, the Wyoming Supreme Court more precisely defined "gathering" as all costs "to collect gas and move it to a point where it can be processed or transported to the user."[9] Under this definition, the transportation costs incurred by Cabot were deemed "gathering" and were therefore not deductible.

The Court's analysis was surprisingly brief. The Court stated that it relied on the "on the precise statutory language demarcating production from postproduction by entry to the market pipeline and the definition of market pipeline must be gleaned from the statutory language."[10] The Court held there was no authority for Cabot's contention that the Act limits gathering to those transportation costs occurring on the lease, finding that "subjecting royalties to deductions based on Cabot's determination that postproduction costs have begun at an offsite point would inject the arbitrariness that the legislature intended to defeat by enactment of the Act."[11]

V. The Significance of the Court's Decision

The *Cabot Oil* decision shifts Wyoming toward the "marketable product" approach to ascertaining deductible production costs, which essentially requires the lessee to absorb the costs

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[8] *See Wold*, 52 F.Supp.2d at 1334.
[9] *Cabot Oil & Gas Corp. v. Followill*, 93 P.3d 238, 239 (Wyo. 2004).
[10] *Id.* at 242.
[11] *Id.* at 242.

necessary to convert the gas to a marketable product. In Kansas, Oklahoma, and Colorado, which have all also adopted the marketable product approach, production costs include transportation to the point of sale and are deemed to be part of the implied duty to market. As such, these costs are borne by the lessee.[12] Texas and Louisiana courts, on the other hand, have found that nonoperating interests such as overriding royalty interests bear costs incurred after the gas has been severed from the ground and reduced to possession at the wellhead.[13]

Lessees, royalty owners and operators should be aware of the *Cabot Oil* decision when making decisions about the possible value of oil and gas interests. While a nonoperating interest will now escape certain deductions, a lessee may now think twice about the commercial viability of a particular lease or unit. At least one commentator calls the Court's interpretation of the Act "erroneous."[14]

<u>VI. Penalties</u>

The Act provides for penalties against parties who fail to provide royalty information to the nonworking interest owner and against parties who improperly deduct costs of production.[15] In *Cabot Oil*, the Court held that the statute of limitations for a violation of the Act runs for one year after a royalty owner knows or has reason to know of the violation.[16] The Court reasoned that a fixed statute of limitations would allow a lessee to avoid suit by hiding underreporting of royalties for a period of time.

[12] *Garman v. Conoco*, 886 P.2d 652, 658 (Colo. 1994).
[13] *See discussion in Garman*, 886 P.2d at 652; *and see Martin v. Glass*, 571 F. Supp. 1406, 1415 (N.D. Tex. 1983).
[14] *See* Note, Rickey Turner, *Royalty Dethroned: Wyoming's Approach to Gathering Costs*, Cabot Oil & Gas Corp. v. Followill, 5 WYO. L. REV. 665, 692 (2005).
[15] *See* Wyo. Stat. Ann. §30-5-305(b) and §30-5-304(a)(vi).
[16] *Cabot Oil*, 93 P.3d at 243.