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Natural Gas Case Law Brief

Kilmer v. Elexco Land Servs., Inc.
No. 63 MAP 2009; 990 A.2d 1147 (Pa. Mar. 24, 2010)

Summary prepared by Michael Magee on June 1, 2010

This case concerned Pennsylvania's Guaranteed Minimum Royalty Act (GMRA), which provides 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." 58 P.S. § 33. The plaintiff-landowners, the Kilmers, sued Elexco Land Services, Inc. (Elexco) on the grounds that the lease they had entered into with Elexco should be invalidated because it did not comply with the GMRA's one-eighth royalty requirement. Elexco disagreed, and Elexco's motion for summary judgment was granted by the trial court. The Kilmers appealed, and the Pennsylvania Supreme Court exercised its extraordinary jurisdiction to hear the case on immediate appeal. The specific issue the Court faced on appeal was as follows: *whether the GMRA precludes parties from contracting to use the net-back method to determine the royalties payable under an oil or natural gas lease*?

Elexco argued that "royalties" are to be determined by the net-back method. Under the net-back method, the total owed to the landowner is one-eighth of the sale price of the natural gas from the landowner's acreage, minus one-eighth of the post-production costs spent treating and bringing the gas from the landowner's acreage to the place of sale. The Kilmers argued that landowners should receive a minimum payment of one-eighth of the sales price with no deductions for post-production costs, as that would fall below the one-eighth minimum requirement.

The Pennsylvania Supreme Court held that *royalties are calculated under the Guaranteed Minimum Royalty Act using the net-back method, meaning that a proportionate share of the post-production costs may be subtracted from the sales price when calculating the landowner's royalty*. Under Pennsylvania law, "Words or phrases shall be construed according to rules of grammar and according to their common and approved usage; but technical words and phrases and such others as have acquired a peculiar and appropriate meaning or are defined in this part, shall be construed according to such peculiar and appropriate meaning or definition." 1 Pa.C.S. § 1903. The Court recognized that "royalty" has such a "peculiar and appropriate" meaning in the oil and gas industry, and that meaning complies with the net-back method of calculation. Parties in oil and natural gas leases may agree to a royalty rate greater than one-eighth, but they may not prepare leases with less than a one-eighth royalty payment determined by net-back calculation.

Summary judgment was upheld in favor of the defendant.