Buyer's Remorse over Your Pennsylvania Gas Lease - The Pennsylvania Supreme Court Upholds Meager Royalty Payments and Protects the Profitability of Marcellus Gas Drilling in Kilmer v. Elexco Land Services, Inc.

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BUYER'S REMORSE OVER YOUR PENNSYLVANIA GAS LEASE?
THE PENNSYLVANIA SUPREME COURT UPHOLDS MEAGER ROYALTY PAYMENTS AND PROTECTS THE PROFITABILITY OF MARCELLUS GAS DRILLING IN KILMER V. ELEXCO LAND SERVICES, INC.

I. INTRODUCTION

The Marcellus Shale is the largest unconventional reserve of natural gas in the world, containing at least 489 trillion cubic feet of natural gas—enough fuel to meet current domestic demand for natural gas for fourteen years.¹ The Marcellus Shale is a formation of sedimentary rock below much of the Appalachian Mountains from New York to West Virginia.² The organic material trapped inside the sedimentary rock formation, commonly referred to as "source rock," has formed natural gas over millions of years.³ Since the discovery of the Marcellus Shale nearly 190 years ago, the Marcellus Shale was considered an economically unviable source of energy since the pockets of gas were surrounded by nearly impermeable rock.⁴ Recent technological developments, however, transformed the previously thought uneconomic resource into a marketable source of energy.⁵ In 2008, a boom in exploration and

² Id. at 2 (locating Marcellus shale in strata of rock beneath Pennsylvania topography).
³ See id. at 4 (describing brief history of Marcellus gas mining); see also GOVERNOR'S MARCELLUS SHALE ADVISORY COMM'N, GOVERNOR'S MARCELLUS SHALE ADVISORY COMMISSION REPORT 19 (July 22, 2011), available at http://files.dep.state.pa.us/PublicParticipation/MarcellusShaleAdvisoryCommission/MarcellusShaleAdvisoryPortalFiles/MSAC_Final_Report.pdf (describing geologic formation of Marcellus shale gas deposits over time).
⁴ See CONSIDINE ET AL., supra note 1, at 1-6 (describing how advancements in horizontal fracturing technology increase gas production and value of mineral rights).
mining of the Marcellus Shale gas began, which some commentators equate to a modern-day gold rush or oil fever.\(^6\)

For over a century, gas-mining companies have relied upon oil and gas leases, otherwise known as mineral rights leases, to secure subsurface oil and gas from privately-owned lands without actually purchasing the land.\(^7\) Leasing operations in Pennsylvania were well established long before the Marcellus Shale mining boom gained steam in 2008.\(^8\) The gas-mining business in Pennsylvania was slow through 2007 compared to the large boom in gas mining activity that began in 2008.\(^9\) Leases signed prior to 2007 compensating Marcellus Shale landowners for their mineral rights paid minimum production royalties because of minimal demand for the seemingly unviable shale gas.\(^10\) The 2008 shale boom drastically changed the dynamics of royalty payments, as gas companies were increasingly willing to pay landowners larger royalties to access the shale lying beneath their properties.\(^11\) The swell in gas lease values forced landowners, who already leased their gas rights, to desperately seek a way out of their pre-existing, undervalued leases—thus creating the source of conflict between landowners and gas companies at issue in Kilmer v. Elexco Land Services, Inc. (Kilmer).\(^12\)

\section*{II. FACTS}

In Kilmer, the plaintiff landowners signed gas leases with the defendant Elexco Land Services in 2007 for a comparatively \textit{de minimis} sum, and now sought to have their leases invalidated by the Pennsylvania courts.\(^13\) The landowners exchanged with Elexco the right to extract natural gas from beneath their property for a royalty

\begin{itemize}
\item \(^6\) George A. Bibkos & Jeffrey C. King, \textit{A Primer on Oil and Gas Law in the Marcellus Shale States}, 4 \textit{Tex. J. Oil Gas & Energy L.} 155, 156 (2008-2009) (describing "gold-rush mentality" among gas extractors in Marcellus states).
\item \(^7\) See e.g., \textit{id.} at 171-75 (discussing history of Pennsylvania gas leases).
\item \(^8\) See Considine et al., \textit{supra} note 1, at 19 (depicting 2008 expansion of Marcellus drilling in Pennsylvania).
\item \(^9\) See Governor's Marcellus Shale Advisory Comm'N, \textit{supra} note 3, at 33-34 (reporting massive increase in well permit applications beginning in 2008 and continuing through present day).
\item \(^10\) See Reeder, \textit{supra} note 5, at 1006 (noting statistics reflecting surge in royalty percentages following 2008 boom in gas drilling).
\item \(^11\) \textit{Id.} at 1006-07 (discussing rationale behind landlords' uncertainty towards entering into leases).
\item \(^12\) Kilmer v. Elexco Land Servs., Inc., 990 A.2d 1147, 1149 (Pa. 2010) (describing underlying motivation of plaintiff landowners to break gas leases signed pre-2008 when values for gas leases were significantly lower than time of litigation).
\item \(^13\) \textit{Id.} at 1150 (reviewing basis for original January 2008 suit).
\end{itemize}
of one-eighth of the value of the natural gas removed or recovered, as well as a "signing bonus" of $100 per acre leased. Recently, post-2008 lease agreements include royalties in excess of twenty percent, and bonus payments as high as $2,800 per acre. As the basis for their claim, the plaintiff landowners asserted their lease provisions violated the Pennsylvania Guaranteed Minimum Royalty Act (GMRA), which guarantees landowners a "one-eighth royalty of all oil, natural gas or gas of other designations removed or recovered from the subject real property."16

As the plaintiffs signed a lease guaranteeing a royalty for the precise amount dictated by the GMRA and using language mirroring that of the GMRA, a layperson might inquire what grounds the landowners have for claiming their leases are untenable.17 The answer, and fundamental issue here decided by the Pennsylvania Supreme Court, is how to define the term "royalty" and precisely what Pennsylvania law requires in the calculation of such payments. Pennsylvania trial courts heard seventy similar claims from landowners seeking to renegotiate their gas leases at the time Kilmer was appealed to the Pennsylvania Supreme Court. The claims raised a substantive legal issue not yet addressed by the Pennsylvania courts; thus the Pennsylvania Supreme Court exercised extraordinary jurisdiction to resolve the issue.20

A. Plaintiff Landowners' Argument

The landowners in Kilmer argued Pennsylvania should adopt the "First Marketable Product Doctrine" for defining and calculating natural gas royalties.21 The landowners alleged the natural gas royalties should be calculated as a percentage of the total proceeds

14. Id. at 1150 n.5 (reciting royalty provision from landowner's lease and citing bonus $100 per acre payment paid to landowners in present case and current bonus payments paid of $2,800 per acre).

15. See Reeder, supra note 5, at 1006 (nothing surge in royalties following 2008 gas drilling boom); see also Kilmer, 990 A.2d at 1150, n.5 (citing current bonus payments paid of $2,800 per acre).


17. Kilmer, 990 A.2d at 1150-51 (presenting court with absolute question of law as to what GMRA guaranteed to landowners in royalty interests).

18. Id. at 1151 (noting ultimate issue at dispute in Kilmer).

19. Id. (acknowledging upwards of seventy suits on hold when litigation was pending).

20. Id. (describing basis for supreme court exercising extraordinary jurisdiction over appeal in case).

21. Id. at 1152 (introducing landowners' claim under first marketable product doctrine).
from the market sale of the gas.\textsuperscript{22} Under the construction of their current lease, the landowners received a one-eighth royalty calculated using the "net back" method, which subtracts the gas company's post-production costs from the sale revenue when calculating the royalty payments.\textsuperscript{23}

The landowners point to Pennsylvania law which includes an implied duty to market in gas leases, such that a gas company is under an obligation to sell the gas to which it leased the rights in order to ensure the lessor receives just compensation for his lease.\textsuperscript{24} The landowners claim this recognized duty indicates that royalties, as conceived by the state legislature when passing the GMRA, must be based on the price of gas when sold.\textsuperscript{25} The landowners argue Pennsylvania should adopt the precedent set by federal law, as well as Kansas, Oklahoma, and Wyoming state law, which implies calculation of royalties based on the first marketable product doctrine.\textsuperscript{26} According to the landowners, this interpretation of the GMRA matches the Pennsylvania legislature's intent at the time of passage in 1979.\textsuperscript{27} Finally, the landowners rely upon the Pennsylvania rules of statutory construction, which mandate statutes must be interpreted to remediate the problems they were intended to address.\textsuperscript{28}

B. Gas Companies' Argument

Elexco Land Services and Southwest Energy Corporation refute the landowners' argument that gas royalties should be calculated according to the first marketable product doctrine; instead, they assert the net back calculation complies with the terms of the lease at issue and the GMRA.\textsuperscript{29} The net back method approximates

\begin{itemize}
\item \textsuperscript{22} See Kilmer, 990 A.2d at 1152 (explaining first marketable product doctrine requires gas companies to pay share of gross revenue received from sale of gas, without subtracting post-production expenses).
\item \textsuperscript{23} Id. at 1149 (stating lease in question, and many other gas leases in Pennsylvania, use net back methodology, which subtracts post-production costs from royalty paid to landowners).
\item \textsuperscript{24} Id. at 1152 (discussing connection between implied duty to market previously established in Pennsylvania and potential corresponding mandate to follow first marketable product doctrine).
\item \textsuperscript{25} Id. (noting other states that recognize implied duty to market follow first marketable product doctrine).
\item \textsuperscript{26} Id. (citing survey of gas lease law of other gas-producing states).
\item \textsuperscript{27} Kilmer, 990 A.2d at 1153 (discussing legislative intent claims).
\item \textsuperscript{28} See id. (describing purpose of Pennsylvania rules of statutory construction is to "remed[y] the perceived mischief addressed therein").
\item \textsuperscript{29} Id. at 1154 (outlining gas companies' core arguments).
\end{itemize}
the value of the raw gas when it is extracted from the earth.30 The gas companies argue a plain reading of the GMRA indicates the Pennsylvania legislature implicitly contemplated that the calculation of royalties is based on the value of the gas "removed or recovered" from the real property in question.31

Gas drillers such as Southwestern Energy add considerable value to natural gas by the time it is brought to market by bearing all post-production costs.32 Post-production costs include: the expense of processing, transporting, and storing all product extracted from the wellhead.33 These costs, which are never borne by landowners, account for the majority of a gas company’s operational expenses and constitute significant value added to the extracted gas by turning it into a marketable product.34 According to the gas companies, the only fair mechanism to approximate the value of the natural gas at the point “removed or recovered” is by subtracting the post-production costs from the revenue received at the market.35 The gas companies assert the term royalty has developed a technical implied meaning in the natural gas extraction industry that relies on calculations according to the net back method.36

III. BACKGROUND

A. The Guaranteed Minimum Royalty Act

Pennsylvania is the only state to guarantee lessors receive a minimum percentage of oil and gas revenue derived from extraction on leased land.37 Thus, the Pennsylvania Supreme Court’s decision as to which royalty calculation method will be read into both outstanding gas leases and the GMRA itself greatly impacts both

31. See Kilmer, 990 A.2d at 1154 (asserting plain reading of GMRA language indicates legislature intended royalties are calculated on value of gas at moment removed or recovered from ground).
32. See WILLIAMS & MEYERS, supra note 30 (listing additional value-added services provided by gas extractors after production).
33. See Kilmer, 990 A.2d at 1150 n.3 (noting relevant provision of landowners’ 2007 lease interpreted post-production costs).
34. Id. at 1154 (explaining value added by post-production costs incurred by gas companies in shale gas production).
35. See Kilmer, 990 A.2d at 1154 (describing gas companies’ claim that net back is fair approximation of gas value at wellhead).
36. Id. at 1154-55 (summarizing assertion that technical interpretation of royalty is required by Pennsylvania rules of statutory construction).
37. See Bibikos & King, supra note 6, at 181 (indicating uniqueness of Pennsylvania’s GMRA).
present and future leases.\textsuperscript{38} In 1979, following extensive debate upon the constitutionality of such a law, and without any mention in the legislative record as to how to define the term royalty, the Pennsylvania legislature passed the controversial provision guaranteeing a one-eighth royalty share to lessors.\textsuperscript{39}

Absent an authoritative legislative history or formal definition, the landowners in Kilmer appealed to other methods of statutory interpretation to yield a definition of royalty excluding post-production costs.\textsuperscript{40} The landowners believe the definition of royalty should be imported from an earlier Pennsylvania gas law, which defines “royalty owner” as “any owner of an interest in oil or gas lease which entitles him to share in the production . . . without obligating him to pay any costs under such lease.”\textsuperscript{41} If read in concert with the GMRA, a court could potentially conclude the definition of royalty owner excludes both production and post-production costs from royalty calculations.\textsuperscript{42}

In further support of the landowners’ proposed interpretation, they claim the Pennsylvania rules of statutory construction require courts to interpret the GMRA in a manner favorable to their disposition.\textsuperscript{43} Pennsylvania law requires courts to effectuate the intent of the General Assembly, and the intent should be discerned from a list of factors, including: “(1) [t]he occasion and necessity for the statute[,] (2) [t]he circumstances under which it was enacted[, and] (3) [t]he mischief to be remedied.”\textsuperscript{44} Yet, as the gas companies counter, the same law also prohibits an interpretation of the law that is “impossible of execution or unreasonable.”\textsuperscript{45} The absence of a clear definition of royalty, as guaranteed to landowners

\textsuperscript{38} For a discussion of the impact of court-approved net back method on Pennsylvania gas industry, see infra notes 182-207.

\textsuperscript{39} See S.B. 568, 163rd Gen. Assemb. (Pa. 1979) (failing to properly define royalty interest).

\textsuperscript{40} See Kilmer, 990 A.2d at 1153 (stating different ways to define royalty interest).


\textsuperscript{42} See Brief for Appellant at 12, Kilmer v. Elexco Land Servs., Inc., 990 A.2d 1147 (Pa. 2010) (No. 63 MAP 2009), 2009 WL 6346618, at *12-13 (arguing GMRA should be read pari materia with Pennsylvania Oil and Gas Conservation Law).

\textsuperscript{43} Kilmer, 990 A.2d at 1153 (recounting plaintiff landowners’ argument that GMRA constitutes remedial statute, and therefore it must be interpreted to effectuate its remedial purpose).

\textsuperscript{44} 1 Pa. Const. Stat. Ann. § 1921(c) (West 1972) (listing factors General Assembly may consider when words of statute are not explicit).

\textsuperscript{45} Id. at § 1922 (stating General Assembly is not to reach absurd results in interpretation of non-explicit language of statute).
in gas leases by the Pennsylvania GMRA, is the source of the controversy in the Pennsylvania Supreme Court’s Kilmer decision.46

B. Net Back Is the Federal Methodology for Gas Royalty Calculation

A majority of state jurisdictions use the net back method to calculate gas royalties, and federal courts recognize net back for extraction lease agreements from federal lands.47 These jurisdictions are known as “at-the-well” because the royalty approximates a percentage of the value of the gas at the time it reaches the wellhead.48 This method, grounded in property rights, allows the lessor to retain a fractional property interest in the gas at the time it is extracted, and all subsequent expenditures by the lessee to add value to the gas must be compensated.49

In the current marketplace, natural gas is not monetized at the point of extraction.50 Due to a shift in the market structure toward vertical integration, a gas company, such as Southwest, may not only extract the gas, but also process, store, and transport it to end users in markets such as New York, Pittsburgh, and Philadelphia (the largest consumption centers surrounding the Marcellus Shale).51 To determine the fair market value of gas at the wellhead, the net back method subtracts all of the post-extraction costs incurred by the gas company from the sale price at the end market.52 This calculation method is defined in the Code of Federal Regulations to exclude the “costs of transportation, processing, or manufacturing” from the value of the gas extracted and sold at the market.53 Unlike most gas-producing jurisdictions, Pennsylvania courts have, un-

46. See Kilmer, 990 A.2d at 1149 (indicating case at bar concerns proper construction of term royalty within GMRA).
47. See Bibikos & King, supra note 6, at 169 (describing legal background for states following net back methodology, known as “at-the-well” jurisdictions).
48. Id. at 169-70 (describing method for calculating royalty percentage at the-well jurisdictions).
49. Id. (describing rationale behind net back methodology).
50. See Considine et al., supra note 1, at 16 (explaining gas produced from well heads is not ready for sale because gas must go through several processes become marketable).
51. See id. at 11-16 (presenting most significant consumption markets for Marcellus shale gas, and tracing process for bringing gas to market).
52. See Bibikos & King, supra note 6, at 169-70 (describing royalty calculation using net back methodology).
til now, remained curiously silent on whether or not net back is an implied component of gas leases.54

C. The Implied Duty to Market and the First Marketable Product Doctrine

Pennsylvania, like most states with a substantial body of oil and gas law, recognizes an “implied duty to market” oil and gas.55 The duty applies to any lessee who contracts with a landowning lessor for the right to extract minerals from the lessor’s land in exchange for a royalty share of the extracting lessee’s proceeds.56 The implied duty to market obligates a lessee gas extractor to market any gas capable of extraction from the land so long as sufficient quantities can be produced to justify the expense of bringing the gas to the market.57 The implied duty protects a lessor landowner by creating an obligation “to operate for the common good of both parties.”58 In Pennsylvania, the existence of such a duty stems from a long-standing precedent in *Iams v. Carnegie Natural Gas Co.* (*Iams*),59 in which the plaintiff landowner leased his mineral rights to the defendant gas company in exchange for the first $500 of annual revenue from the sale of gas.60 Although the gas company found significant subterranean gas reserves, it chose not to move forward with extraction.61 This inaction deprived the landowners of due compensation for their lease or the alternative ability to lease the mineral rights to another party.62 The unjust nature of

54. See Bibikos & King, supra note 6, at 181 (indicating relative silence of Pennsylvania courts on gas lease royalty issues since enactment of 1979 Minimum Royalty Act).
55. See Kilmer, 990 A.2d at 1152 (acknowledging existence of implied duty to market under Pennsylvania law).
56. Bruce M. Kramer & Chris Pearson, *The Implied Marketing Covenant in Oil and Gas Leases: Some Needed Changes for the 80’s*, 46 LA. L. REV. 787, 792 (1986) (stating *Iams* clarifies basic principles of implied covenant to market); see also Howard R. Williams & Charles J. Meyers, *Vol. 5 Oil and Gas Law* 3 (2007) (noting implied covenants in gas leases were “launched” by Pennsylvania Supreme Court in Stoddard v. Emery, 128 Pa. 436, 18 A. 339 (1889)).
57. See Kilmer, 990 A.2d at 1152 (describing current state of implied duty to market).
59. *See Iams*, 45 A. at 54-55 (determining whether lessee is bound by duty to market gas and other mineral products capable of extraction from leased land where lease agreement expressly contemplates such activity).
60. *See id.* at 54 (relating facts of case and terms of lease).
61. *See id.* (describing gas companies’ decision not to extract gas and bring it to market).
62. *Id.* at 55 (holding lessor of gas rights must make reasonable efforts to monetize gas available for extraction).
this arrangement led to the establishment of then implied duty to market.63

In Kilmer, the plaintiff landowners asserted the implied duty to market created a legal basis known as the first marketable product doctrine.64 The Kilmer landowners, as well as several states, derive a secondary duty from the doctrine that compels lessee gas extractors to "bear all the costs necessary to market the natural gas obtained from the Plaintiffs’ property to the point of sale."65 Under the first marketable product doctrine, a gas company is obligated to market any gas extracted from leased land and absorb the costs of bringing it to the market.66 Without such a duty, a situation could exist in which a gas company is required to extract and sell the gas, but the landowner receives nothing because the post-production costs exceed the value of the gas extracted.67

Other states without a statute similar to Pennsylvania’s GMRA, have recognized a derivative first marketable product doctrine stemming from the implied duty to market.68 In Kilmer, the plaintiffs drew from the Kansas Supreme Court, which found: "If it is the lessee’s obligation to market the product, it seems necessary to follow that his is the task also to prepare it for market, if it is unmerchantable in its natural form."69 The plaintiffs also cited the Oklahoma Supreme Court, which found: "We interpret the lessees duty to market to include the cost of preparing the gas for market."70 Finally, the plaintiffs cited the Colorado Supreme Court as stating: "In our view the implied covenant to market obligates the lessee to incur those post-production costs necessary to place gas in a condition acceptable for market.”71

63. See Kilmer, 990 A.2d at 1152 (describing rationale for implied duty to market).
64. See Brief for Appellant, supra note 42, at *9-10 (outlining claim for first marketable product doctrine in Pennsylvania).
65. Id. at *10 (describing basis for first marketable product doctrine).
66. See id. (describing inherent duty of lessee to absorb all costs necessary to market natural gas).
67. Id. (describing consequences of not following first marketable product doctrine).
68. See Kilmer, 990 A.2d at 1152, 1155 (indicating courts of other states have recognized utilization of first marketable product doctrine).
70. Id. (quoting Wood v. TXO Production Corp., 854 P.2d 880 (Okla. 1993)) (stating oil and gas lessor should be required to pay portion of oil and gas compression costs).
71. Id. (quoting Garman v. Conoco, Inc., 886 P.2d 652 (Colo. 1994)) (asserting owner of overriding royalty interest in gas production is required to bear pro-
Ultimately, the plaintiffs in Kilmer wanted the Pennsylvania Supreme Court to conclude the Pennsylvania legislature, in adopting the GMRA while cognizant of the common law “implied duty to market precedent,” explicitly adopted a first marketable product approach to gas royalty calculation.72 If this were the legislature’s intent, then the practices undertaken by the defendants in the course of performance with the specific gas lease at issue here would be distinctly violative of the GMRA.73 Pennsylvania, however, has never explicitly adopted the above-cited doctrine.74 Professor Bruce Kramer of the Texas Tech School of Law, the principal supporter of the first marketable product doctrine, filed an amicus curiae brief against Pennsylvania law and in favor of the alternative net back method.75

D. Recent Case Law Developments in the Battle Between Net Back and First Marketable Product Doctrine

The Pennsylvania Supreme Court and the lower state courts were not the first courts to confront the issue of the validity of the net back gas royalty calculation method under Pennsylvania law.76 The Middle District of Pennsylvania heard two cases with fact patterns nearly identical to Kilmer, and the court addressed the validity of a gas lease operating under the net back method.77 In both Kropa v. Cabot Oil and Gas Corp. (Kropa) and Stone v. Elexco Land Services (Stone), the plaintiffs brought suit in federal court seeking invalidation of their Marcellus Shale natural gas leases based, at

portionate share of postproduction costs incurred to convert raw gas into marketable product, absent contrary provision in the assignment creating overriding royalty interest).

72. See Kilmer, 990 A.2d at 1152-54 (describing landowner’s claims for first marketable product doctrine).

73. Id. at 1156 (summarizing court’s resolve to follow legislative intent, albeit in accordance with rules of statutory interpretation).

74. Id. at 1157-58 (dismissing landowners’ assertion that legislature intended first marketable product doctrine).

75. See Brief for Bruce Kraemer as Amicus Curiae Supporting Appellees, Kilmer v. Elexco Land Servs., Inc., 990 A.2d 1147 (Pa. 2010), 2009 WL 6346625 at *14 (rejecting landowner’s interpretation of Kraemer’s scholarship).


77. See Stone, 2009 WL 1515251, at *2 (declining to reach conclusion on royalty issue); see also Kropa, 609 F. Supp.2d at 373 (describing facts of respective cases).
least partially, on arguments that the net back royalty calculations violated the Pennsylvania GMRA.78

The federal district court in both cases explicitly recognized that Pennsylvania courts were currently considering the same issue in Kilmer at the trial court level in the Susquehanna County Court of Common Pleas.79 While the Kilmer trial court found the GMRA "does not prohibit the inclusion of 'post-production' costs to calculate the one-eighth royalty," the federal district court was "not convinced that merely because the [GMRA] is silent on whether post-production costs can be deducted means that costs can in fact be legally deducted from the royalty."80 The federal district court, in contrast to the Pennsylvania Supreme Court, found a "plain meaning" reading of the GMRA does not allow post-production costs be netted out of a landowner's royalty.81

Contrary to the defendant gas companies' argument in Kilmer, however, a plain meaning statutory interpretation is not conclusory.82 The Pennsylvania rules of statutory interpretation indicate "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."83 The defendant gas companies in Kilmer claim the term royalty takes on a specific meaning as a technical term within the natural gas industry, and thus courts should define or interpret it in accordance with this technical meaning.84 Of course the technical definition of royalty proposed by the gas company is one that specifically removes all post-production costs from the market sale price of the gas in question.85 In both Kropa and Stone, however, the federal district court interpreted terms and the

78. See Stone, 2009 WL 1515251 at *1 (stating plaintiff’s claims of fraudulent inducement and invalidity of lease because failed to provide royalty payment minimum); Kropa, 609 F. Supp.2d at 373-74 (summarizing respective plaintiffs' claims).
79. See Kropa, 609 F. Supp.2d at 380 n.7 (establishing federal court awaited Kilmer decision for interpretation of state law).
81. See Kropa, 609 F. Supp.2d at 381 (holding case cannot be dismissed based on theory that GMRA permits net back).
82. See Kilmer, 990 A.2d at 1157 (delineating differences between statutory interpretation of technical terms and ordinary terms).
83. 1 PA. CONS. STAT. ANN. § 1903(a) (West 1972) (stating rule on interpretation of technical terms in Pennsylvania statutes).
84. See Kilmer, 990 A.2d at 1155 (summarizing gas companies' argument on distinction between technical terms and those defined by common usage).
85. Id. (quoting industry manual definition proposed by gas companies).
implied duty to market as potentially prohibiting the gas companies’ preferred net-back method and requiring the calculation of royalties as a raw one-eighth share of the sale price of gas at the market.\textsuperscript{86}

In the absence of a GMRA-like statute, many states struggle to interpret gas lease royalty provisions that are silent on calculation methodology.\textsuperscript{87} In facing this issue, the Colorado Supreme Court issued an opinion in 1994 that included a comprehensive survey of various states’ common law on the issue.\textsuperscript{88} In \textit{Garman v. Conoco, Inc. (Garman)},\textsuperscript{89} Conoco, a major U.S. based oil and gas producer, referred to the plaintiff landowners’ assertion of a first marketable product doctrine as a “desire to get a ‘free-ride’ on certain costs incurred after the gas is brought to the surface.”\textsuperscript{90} Upon hearing this certified question of law from the federal district court, the court ultimately decided the relationship between landowner and lessee “specifically provides for a ‘free-ride’ on costs incurred to establish marketable production.”\textsuperscript{91}

After surveying law in Texas, Louisiana, Oklahoma, Kansas, Arkansas, and North Dakota, the Colorado Supreme Court found Conoco’s argument that industry practice has taken on a specific technical meaning for royalty inclusive of net back unpersuasive.\textsuperscript{92} The court reasoned that before common landowners must have full understanding of a term before being bound by the meaning of a

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\textsuperscript{86} See generally \textit{Kropa}, 609 F. Supp.2d at 381-83 (denying defendant’s motion to dismiss and acknowledging merit of plaintiff’s argument with regard to royalty definition); see also \textit{Stone}, 2009 WL 1515251, at *7-8 (stating holding).

\textsuperscript{87} See \textit{Garman v. Conoco, Inc.}, 886 P.2d 652, 653 (Colo. 1994) (attempting to interpret Colorado lease provisions). The court posited whether:

Under Colorado law, . . . the owner of an overriding royalty interest in gas production [is] required to bear a proportionate share of post-production costs, such as processing, transportation, and compression, when the assignment creating the overriding royalty interest is silent as to how post-production costs are to be borne?

\textit{Id.}

\textsuperscript{88} \textit{Id.} at 652-58 (surveying results of other states’ litigation over validity of net back royalty calculation).

\textsuperscript{89} \textit{Garman}, 886 P.2d at 661 (explaining holding). Under Colorado law, “overriding royalty interest owners are not obligated to bear any share of post-production expenses, such as compressing, transporting and processing, undertaken to transform raw gas produced at the surface into a marketable product.” \textit{Id.}

\textsuperscript{90} \textit{Id.} at 657 (stating gas companies’ assertion of invalidity of landowners’ argument).

\textsuperscript{91} \textit{Id.} (leading to conclusion of validity of first marketable product doctrine).

\textsuperscript{92} See \textit{id.} at 660 (finding many states upheld landowner-friendly interpretation of lease provisions guaranteeing royalties by rejecting net back).
technical term.\textsuperscript{93} Often, a landowner who enters into such a lease agreement will be dealing with the gas industry for the first and only time, and will have no reason to be aware of the "intricacies of mineral development."\textsuperscript{94} The Pennsylvania Supreme Court in \textit{Kilmer}, however, ultimately found differently, and reasoned a landowner should be required to abide by the technical meaning of royalty.\textsuperscript{95}

E. Proposed Legislative Solutions to the \textit{Kilmer} Controversy

Following the \textit{Kilmer} decision, the Pennsylvania General Assembly considered a bill, entitled "An act regulating the terms and conditions of certain leases regarding natural gas and oil," which would have statutorily mandated gas royalty payments not deduct post–production costs incurred by gas companies.\textsuperscript{96} The bill specifically forbade the net back methodology and increased the guaranteed minimum royalty to fifteen percent.\textsuperscript{97} The measure passed the House Environmental Resources and Energy Committee on a purely party-line vote, but never received an up-or-down vote in the House Appropriations Committee.\textsuperscript{98} Rather than take such an extreme protective measure in favor of Pennsylvania landowners over gas companies, the Pennsylvania legislature has currently shifted its focus to a possible severance tax on gas drillers of the Marcellus Shale in an attempt to capture some of their revenue for the benefit of Pennsylvania taxpayers.\textsuperscript{99}

IV. Narrative Analysis

The Pennsylvania Supreme Court began in \textit{Kilmer} by stating the underlying motive behind the plaintiff landowners' claim is to

\begin{itemize}
\item \textsuperscript{93} \textit{Id.} (reasoning landowner cannot be bound to lease term without understanding the term).
\item \textsuperscript{94} \textit{Garman}, 886 P.2d at 660 (recognizing Conoco is more sophisticated in lease negotiations than landowner and possesses unfair upper-hand).
\item \textsuperscript{95} See \textit{Kilmer} v. Eleco Land Servs., Inc., 990 A.2d 1147, 1157 (Pa. 2010) (concluding term royalty is to be interpreted in accordance with technical meaning).
\item \textsuperscript{96} H.B. 2214, 193rd Leg. 2d Sess. (Pa. 2010) (introducing amendments to GMRA).
\item \textsuperscript{97} \textit{Id.} (stating terms of amendment to GMRA and proposing substantially increased minimum royalties).
\item \textsuperscript{98} \textit{Bill Information: House Bill 2214, Pennsylvania General Assembly}, http://www.legis.state.pa.us/cfdocs/billinfo/billinfo.cfm?year=2009&sind=0&body=H&type=B&bn=2214 (last accessed Oct. 27, 2010) (indicating bill has been re-committed to Appropriation Committee since May 26, 2010).
\end{itemize}
garner more attractive gas lease terms and higher royalty payments.\textsuperscript{100} The Court cites the 2007 surge in interest in gas drilling, the spike in value of gas leases, and the relative inexpensiveness of landowner royalties in current leases as the reasons why the landowners sought a court to invalidate their leases.\textsuperscript{101} By placing these motives at the front of the opinion, it is evident the court did not sympathize with the landowner’s unfavorable contractual standing with the lessee gas companies.\textsuperscript{102}

The court recognized the novelty of the issue before it.\textsuperscript{103} The Susquehanna Court of Common Pleas, upon issuing its initial decision at trial, determined that no Pennsylvania appellate court previously addressed the issue of royalty calculation.\textsuperscript{104} Thus, because of the enormous number of cases on the state court dockets depending on the gas royalty resolution, the Pennsylvania Supreme Court exercised extraordinary jurisdiction on the purely legal question of how to effectively define royalty within the context of gas leases and the GMRA.\textsuperscript{105} The court stated the standard of review on this purely legal issue was de novo.\textsuperscript{106}

A. Legislative Intent of the Pennsylvania General Assembly in 1979

Ultimately, the fundamental issue of law in \textit{Kilmer} was the Pennsylvania General Assembly’s intended definition of royalty when it constructed and passed the GMRA in 1979.\textsuperscript{107} The GMRA is silent on the issue, and the court refused to accept either party’s argument that definitions from outside statutes should be read into the GMRA as indicative of the intent behind this specific provi-

\textsuperscript{100} See \textit{Kilmer}, 990 A.2d at 1149-50 (describing effect of upsurge in interest in Marcellus gas drilling on landowners).

\textsuperscript{101} Id. at 1150 (explaining landowners desire to invalidate gas leases).

\textsuperscript{102} See id. at 1158 (holding landowners are not entitled to invalidate their leases).

\textsuperscript{103} Id. at 1151 (citing trial court’s conclusion that no Pennsylvania appellate court previously ruled on issue of royalty calculation under GMRA).

\textsuperscript{104} Id. (recognizing trial court’s inability to effectively decide case based on precedent).

\textsuperscript{105} \textit{Kilmer}, 990 A.2d at 1151 (describing backlog of cases that developed while awaiting definitive word from supreme court on validity of net back royalty calculations).

\textsuperscript{106} Id. (exercising extraordinary jurisdiction over purely legal issue led to de novo standard of review).

\textsuperscript{107} Id. at 1156-58 (finding most relevant arguments to pertain to statutory interpretation and legislative intent for definition of term royalty).
sion. The court states, "the GMRA does not use any of the terms suggested by the parties, such as 'at the wellhead,' 'post-production costs,' or 'point of sale.'" The court instead believed there was good reason for the absence of any further details expounding upon how and where to calculate royalties as a percentage of sale.

Drawing from the detailed histories of the Pennsylvania oil and gas industries provided by the parties, the court recognized that in 1979 the sale of natural gas at the wellhead and at the market were one in the same. Prior to the modernization of the gas industry, drillers and extractors were separate from the pipeline companies. In 1979, gas-extracting companies such as Southwestern would sell the extracted gas directly to the pipeline company, literally at the wellhead, for federally regulated prices. In the three decades since the GMRA was enacted, gas companies have become vertically integrated, and now own the pipelines. Additionally, gas prices are no longer federally regulated. Yet the court found that in 1979 there was only one conceivable price from which to calculate the one-eighth royalty share—the price paid by the extractor to the pipeline company. The court, therefore, recognized that in light of industrial development, it needed to provide its own definition of royalty.

B. The Court's Definition of Royalty

The Pennsylvania Supreme Court recognized the stark contrast between the landowner's conception of the term royalty and the

108. Id. at 1157 (noting silence of Pennsylvania General Assembly on definition of royalty, and rejecting conclusive arguments of both parties).
109. Id. (rejecting proposed definitions set forth by litigating parties).
110. Kilmer, 990 A.2d at 1157 (noting reasons for absence of statutory definition).
111. Id. (concluding there was no reason to differentiate at-the-wellhead price when GMRA was passed in 1979).
112. Id. (stating background history of Pennsylvania gas industry in 1979).
113. Id. (explaining gas industry operations in 1979 utilized separate pipeline companies).
114. See id. at 1157 (concluding gas industry underwent substantial structural changes in three decades since GMRA was passed).
115. Kilmer, 990 A.2d at 1157 (noting absence of federal regulation of gas price).
116. Id. (interpreting legislative intent in 1979 was based upon system of gas transactions that no longer exists).
117. Id. (concluding absence of relevant and conclusive legislative intent leaves interpretation to judiciary).
defendant gas companies’ conception. The landowners sought a
definition derived from common meaning and standard dictionary
definitions. The gas companies wanted to define royalty according
to a technical meaning. The court knew it had to make an
initial determination between common and technical usage, and
the Pennsylvania rules of statutory construction delineate two sepa-
rate methods for arriving at a definition. The court indicated it
viewed the term as technical—having acquired a “peculiar and ap-
propriate meaning.” The court, therefore, launched into an
analysis of the technical meaning, and thereby rejected the land-
owners’ plain meaning argument.

The court cited the Manual of Oil and Gas Terms to define roy-
alty as “[t]he landowner’s share of production, free of expenses of
production.” Based on this industry-specific definition, the court
distinguished between “expenses of production” and “post-produc-
tion costs.” The court stated the expenses of production include
the costs associated with drilling the gas wells and extracting the gas
to the surface of the land. These costs were not in question, and
under any interpretation of the gas lease at issue, were borne exclu-
sively by the gas company. The court reasoned the inclusion of
the term “free of production costs” specifically excluded post-pro-
duction costs from the above-cited technical definition of royalty.
The court cited support for this analysis from a treatise written by
George Bibikos, a K&L Gates attorney representing Southwestern

118. Id. at 1150-56 (summarizing divergent arguments of parties on definition
of royalty).
119. See id. at 1151-53 (summarizing landowners’ arguments).
120. Kilmer, 990 A.2d at 1153-56 (summarizing gas companies’ arguments).
121. Id. at 1157 (discussing whether royalty should be construed in accord
with common usage or technical meaning adopted by industry).
122. Id. (concluding term royalty has “peculiar and appropriate” meaning
within Pennsylvania gas industry, and rules of statutory construction advise to fol-
low such technical definition).
123. Id. (moving to next steps of statutory construction without addressing
argument for common usage).
124. See id. (quoting Williams and Meyers, supra note 30) (providing technical
definition of royalty).
125. Kilmer, 990 A.2d at 1157 (explaining distinction between production and
post-production costs). Production costs, which must always be borne fully by the
lessee extractor, encompasses those costs incurred before the gas reaches the sur-
face of the property. Id.
126. Id. (noting production expenses are not subtracted from royalty
calculations).
127. Id. (noting production costs are not at issue in present case).
128. Id. (concluding technical definition of royalty allows exclusion of post-
production costs). Post-production costs are borne pro rata by royalty holders in
accordance with the royalty share percentage. Id.
in Kilmer. The court additionally cited Williston on Contracts for the notion that "generally the royalty is not payable from the gross profit but from the net amount remaining after the deduction of certain production and development costs."

C. Issues of Competitive Fairness Among Landowners

The Pennsylvania Supreme Court accepted the gas companies’ assertion that even in the modern-day gas industry, gas royalties can be accepted in-kind, as well as in the form of cash proceeds from the sale of the gas. A landowner taking a royalty in-kind physically collects the raw gas extracted and captures it for his own uses. Thus, the court reasoned a royalty taken in-kind should be of equivalent value to one taken as cash proceeds from a sale. The value of the gas sold as a marketable product to an end user would far exceed the value of gas in raw form collected and stored by the landowner at the site of the wellhead. The court reasoned the Pennsylvania General Assembly “would not intend to create a situation where one landowner would receive a dramatically increased royalty . . . [than] a neighbor who took the royalty in-kind.”

The court recognized a second issue of fairness among landowners: the potential for divergent values of gas leases depending on the specific sales practices of the gas company with whom they enter a lease agreement. If a gas company chooses to handle the processing and delivery of gas all the way to the terminal end user, the first marketable product doctrine creates an outsized royalty payment to that company’s lessor landowners relative to others.

129. See id. (deriving analysis of relationship between definition of royalty and net back calculations from George A. Bibikos and Jeffrey C. King). For a discussion of the Bibikos and King approach, see supra note 6 at 168-69.


131. Id. at 1158 (observing gas royalties can still be taken in-kind).

132. Id. at 1154 (recognizing landowners can take in-kind royalties, though impractical).

133. Id. at 1158 (giving credence to gas companies’ argument that royalties in cash and in-kind should be equivalent).

134. See id. (indicating severe discrepancies would result between two types of royalties if first marketable product doctrine was adopted).

135. Kilmer, 990 A.2d at 1158 (reasoning legislature would not have intended such discrepancy).

136. Id. (finding leasehold values would be different since lessor gas extractor’s practices are out of lessee’s control).

137. Id. (explaining gas company business operations have greatest effect on royalties under first marketable product doctrine).
Many gas companies may sell the gas in a lesser processed form at regional collection sites that are further from large markets such as New York, which would result in a lower royalty payment if following the first marketable product doctrine. Different gas company trade practices could create a situation in which two Pennsylvania neighbors with equivalent gas reserves beneath their land receive drastically different royalty compensation based on the trade practice of their respective gas company lessees. The court found this potential inequity to be inherently undesirable, and noted that following a net back calculation methodology would arrive at similar royalties for similarly-situated landowners.

The last major landowners’ concern rejected by the court is that the net back methodology created an incentive for gas companies to inflate their post-production costs, thereby driving down royalty payments to landowners. The court dismisses this concern as baseless because the royalty is calculated as a one-eighth share, and the gas company accordingly bears the remaining seven-eighths of the post-production costs. Basic economic logic indicated artificially inflating such costs would hurt the lessee gas company’s profits more than it would save the company on royalty distributions. If landowners are genuinely concerned about possible improprieties in the calculation of deducted post-production costs, they have a right to seek a court-ordered accounting—not the right to invalidate their leases.

The Pennsylvania Supreme Court unanimously concluded the GMRA permits the use of net back calculations to arrive at the value of gas “at the wellhead.” The court affirmed the Susquehanna County Court of Common Pleas grant of summary judgment to the gas companies.

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138. See id. (explaining geographic distance from consumption centers severely impacts royalty amounts).
139. See id. (highlighting equity among landowners as benefit of net-back method).
140. Kilmer, 990 A.2d at 1158 (finding net back calculation resolved issues in favorable manner).
141. Id. (explaining landowners’ final contention).
142. Id. (rejecting landowners’ logic because gas companies bear greater burden of potentially inflated costs than landowners, thereby defeating motivation to inflate costs).
143. Id. (explaining consequences of inflating post-production costs).
144. Id. (noting landowners’ retain right to seek court accountings).
145. Kilmer, 990 A.2d at 1158 (concluding net back calculations are included in value calculation).
146. Id. (affirming trial court holding).
V. CRITICAL ANALYSIS

The underlying question of law in Kilmer is a matter of statutory interpretation: specifically, what was the Pennsylvania General Assembly's intended definition of royalty when creating the GMRA?147 The Pennsylvania Supreme Court, three decades after the Act's passage, follows the mandated process for statutory interpretation.148 The court's conclusion at each step of the process proved critical to arrive at the ultimate decision to permit the net back methodology.149 At each step, however, the court failed to either acknowledge or give adequate treatment to opposing facts or arguments persuasive toward an alternative decision.150 Aside from initial treatment of the parties' briefed arguments, the court's final opinion on the question in Kilmer is short in both verbiage and citation to precedent.151 It therefore seems the court knew the ultimate decision it sought to reach, and made a conclusion with relatively limited legal analysis.152

A. The Court's Decision to Utilize a Technical Definition

At the outset, the Pennsylvania Supreme Court's opinion in Kilmer recognized the first question was whether the term royalty had "acquired a peculiar and appropriate meaning."153 Terms in Pennsylvania statutes are construed in accordance with their common usage unless they are deemed technical according to the above test.154 The majority in Kilmer cites a definition of royalty from a technical source.155 The court used this technical definition moving forward, therefore asserting royalty is a technical term and dispelling any possibility of analyzing the term in accordance with

147. See id. at 1149 (stating question presented to Pennsylvania Supreme Court).
148. See id. at 1156-57 (applying laws of statutory construction to definition of royalty).
149. See Kilmer, 990 A.2d at 1156-58 (applying statutorily mandated process for Pennsylvania statutory interpretation).
150. See id. (excluding consideration of plaintiffs' argument beyond summation in beginning of opinion).
151. See id. (spanning only three pages in Pennsylvania Reports and citing only two prior cases in process of statutory interpretation).
152. See id. (concluding technical definition of royalty according to defendants' preferred literature is binding upon parties).
153. See Kilmer, 990 A.2d at 1157 (citing 1 PA. CONS. STAT. ANN. § 1903 (West 1972) for rules of statutory interpretation) (determining whether royalty is technical term under rules for Pennsylvania statutory interpretation).
154. Id. (restating rules of statutory interpretation).
155. Id. (citing WILLIAMS & MEYERS, supra note 30) (giving technical definition of royalty).
its plain dictionary meaning. The Kilmer opinion does not grant the same treatment to common and technical usages of the term royalty as other seminal opinions on gas leasing issues such as Garman chose to do.

The Garman opinion, establishing the first marketable product doctrine in Colorado, contains a well-reasoned analysis for why royalty cannot be construed according to a technical meaning in the gas-leasing context. According to the Colorado Supreme Court, a party to a gas lease contract cannot be bound in contract to an industry custom the party cannot be expected to understand. In a gas lease situation, the landowner can be expected to be dealing with a sophisticated commercial gas company for the first and only time in their life. When the landowner agrees in contract to lease the mineral rights to the gas company, the parties agree on terms mutually understood. In this factual scenario, as envisioned by the court in Garman, it is expected the landowner understands royalty in accordance with its common usage definition rather than a highly technical interpretation available only in specialized trade manuals.

The court's citation to an article from the Texas Journal of Oil, Gas & Energy, written by Bibikos and King, for elaboration on the technical meaning of royalty raises concern. Bibikos, a K&L Gates attorney in Pennsylvania specializing in energy issues, litigated for the gas companies in Kilmer. He wrote the article detailing the meaning of gas royalties in 2008, and explicitly

156. See id. (concluding royalty should be construed according to its peculiar and appropriate meaning).
158. See Garman 886 P.2d at 658-61 (surveying other states' rationales for arriving at first marketable product doctrine in cases analogous to Kilmer).
159. Id. at 660 (explaining common law precedent that parties to lease can only be bound by terms they understand).
160. Id. (alluding that landowners do not engage in negotiations with gas companies or other sophisticated parties on regular basis).
161. Id. (describing industry practice of securing lease interests).
162. Id. (indicating landowner has no reason to be aware of technical trade-usage of term royalty).
163. See Kilmer, 990 A.2d at 1157 (citing to Bibikos and King, supra note 6, at 169) (elaborating on technical meaning of royalty).
164. Bibikos & King, supra note 6, at n.1 (providing biographical detail on authors); see also Kilmer, 990 A.2d at 1148 (providing names of attorneys representing appellants).
contemplated the impact of forthcoming litigation over GMRA interpretation.165 Yet the Pennsylvania Supreme Court cited to the subjective opinion of one of the attorneys arguing before it as definitive and authoritative.166

The court in Kilmer fails to acknowledge landowners in gas leases are less sophisticated parties who can only be expected to read the plain meaning of terms into their leases.167 While the Garman case was solely about interpreting the terms of an individual lease, as opposed to the generally applicable statute in Kilmer, the purpose of the GMRA is to protect Pennsylvania landowners and the statutory terms must be read to remediate the problem they are designed to address.168 In dispensing with a plain meaning analysis of the term royalty, the court made an initial determination preventing statutes from remediating the underlying societal problem they were intended to address.169

B. The Court's Opinion Does Not Give Treatment to Iams and the Implied Duty to Market

The federal district courts in Pennsylvania were wrestling with cases that required interpretation of the GMRA concurrently with the appeal in Kilmer.170 Judge James M. Munley of the Middle District of Pennsylvania heard the controversies in both Kropa and Stone, and recognized the potential validity of the first marketable product doctrine in both instances.171 In deciding these cases, Judge Munley found that courts recognized the tenets of the first marketable product doctrine in states where courts had long-standing common laws guaranteeing an implied duty to market.172 Both the Pennsylvania Supreme Court and Judge Munley recognized

165. See Bibkos & King, supra note 6, at 181-84 (building case to protect net back methodology by claiming it is widely used across United States).
166. Kilmer, 990 A.2d at 1157-58 (implying article co-authored by Bibkos and King is treatise, on par with Williston on Contracts as authority on subject).
167. See id. at 1156-58 (noting absent treatment of potentially using common definition).
169. Kilmer, 990 A.2d at 1157-58 (failing to interpret statute in light of "object to be attained" and instead focusing on technical definition).
170. See id. at 1152-53 (describing cases in federal district court on this issue).
172. See supra note 171 and accompanying text.
Iams and other 19th century precedents establishing the implied duty to market the extracted natural gas in Pennsylvania. The Pennsylvania Supreme Court in Kilmer, however, gave no explicit reason why it disregarded the conclusion many other state courts previously reached. The implied duty to market inherently yields the first marketable product doctrine.

C. Interpreting the GMRA to Remediate the Issue at Hand When Passed in 1979

When the Pennsylvania Supreme Court initially decided to interpret the term royalty in accordance with a technical meaning and subsequently decided the meaning included the net back method, the court remained silent on other statutory interpretation mandates. A Pennsylvania statute mandates statutory interpretation in accordance with legislative intent of the General Assembly. The pertinent statute states: “when the words of a statute are not explicit, the intention of the General Assembly may be ascertained by considering . . . the occasion and necessity for the statute.” This statute names seven other factors a court should consider, all of which lead a court to assume the legislature meant to remedy the problem in mind when passing the law in question. The intent of the General Assembly in passing the GMRA was to prevent landowners from being “exploited.” In light of that general intent, the Pennsylvania rules of statutory interpretation advise the court to interpret the law in a manner that contin-

173. Kilmer, 990 A.2d at 1152-53 (noting Iams and other 19th century precedents established implied duty to market extracted natural gas in Pennsylvania).

174. See id. at 1156-58 (giving no explanation for why Pennsylvania does not recognize connection between implied duty to market and first marketable product doctrine).

175. See id. (holding net back is appropriate default interpretation without distinguishing plaintiff’s cited precedent).


177. See id. § 1921 (describing guidance provided by rules of statutory interpretation to determine legislative intent).

178. Id. § 1921(c) (listing factors for consideration).

179. Id. (listing factors for court to consider when interpreting statute).

180. See Legislative Journal – Senate, Pennsylvania General Assembly, S.B. 568, Bill on Third Consideration and Final Passage (statements of Senators Stapleton and Hager) (June 21, 1979) (illustrating intent of General Assembly).
A. The Kilmer Case Defines the Legal Framework for Interpreting Oil and Gas Law in the Future.

Kilmer not only decided the fate of the seventy landowner suits awaiting the Pennsylvania Supreme Court’s decision on net back royalty calculations, it also set the tone for future decisions in conflicts arising from mineral rights leases in Pennsylvania.181 Issues of oil and gas law surrounding the development of Marcellus Shale gas drilling are firmly on the minds of the Pennsylvania bar and bench.182 Kilmer indicated courts will interpret gas lease terms, under Pennsylvania law, in accordance with the technical meaning acquired over time within the gas industry.183 While it is unclear exactly how many leasing conflicts will turn on courts interpretation of technical lease terms, courts have already begun to broadly interpret the Kilmer holdings to affirm the validity of royalty calculations favoring the gas company when roughly similar to those at issue in Kilmer.184

The federal district court for the Middle District of Pennsylvania (the same court that questioned the validity of the net back calculation in Stone and Kropa) recently decided three cases in which landowners were bound by lease terms that calculated royal-


183. See id. at 4-15 (covering gas law extensively in training materials).


ties by deducting the post-production expenses.\textsuperscript{186} The district court interpreted \textit{Kilmer} and found that the leases, unlike those in \textit{Kilmer} that were silent on post-production expense deductions, can be reasonably interpreted to subtract post-production expenses from royalty calculations.\textsuperscript{187} Subsequent decisions after \textit{Kilmer} have established the net back royalty calculation as the default rule for questions of royalty interpretation.\textsuperscript{188}

From the perspective of Pennsylvania landowners sitting atop Marcellus Shale gas deposits, the \textit{Kilmer} decision serves as a cautionary tale.\textsuperscript{189} The Pittsburgh Post-Gazette understated the effect of \textit{Kilmer} on subsequent decisions interpreting gas leases when it stated \textit{Kilmer} "drives home the need for landowners to do some research before entering into a lease with a drilling company."\textsuperscript{190} The same news article quoted a gas company spokesman advising landowners "the best advice, no matter how poor you are, is to go see a lawyer before you sign anything."\textsuperscript{191} As legal commentators noted, courts will be interpreting gas lease provisions in accordance with a technical meaning that no layperson could reasonably be expected to comprehend, though the landowners will later be bound to the terms.\textsuperscript{192} The landowners in \textit{Kilmer} and analogous cases today suffer from a severe case of buyer's remorse.\textsuperscript{193} Without highly trained representation, Pennsylvania landowners may continue to receive relatively raw deals that minimize compensation paid for

\begin{footnotes}
\textsuperscript{186} See George A. Bibikos & David R. Fine, \textit{Oil and Gas Alert: Applying Kilmer's Holding Broadly to Other Types of Net-Back Leases: The Lausche, Beach, and Hooker Decisions}, K & L GATES 1-2 (Oct. 14, 2010), http://www.klgates.com/files/Publication/1e774111-6ac4-4ad0-b750-b3b8b97b2/Presentation/PublicationAttachment/10b66bf-33b1-4417-8c73-0cf19d2817d3/OGA_101410.pdf (explaining \textit{Kilmer} has been broadly interpreted).

\textsuperscript{187} See id. (summarizing holdings of recent federal district court cases on net back issue).

\textsuperscript{188} See id. at 2 (stating conclusion of attorneys within firm publishing paper).


\textsuperscript{190} See id. (stating need for landowners to be wary in reaching royalty agreements).

\textsuperscript{191} Id. (advising landowners to seek legal counsel when negotiating gas leases).

\textsuperscript{192} See generally Stacia A. Christman & Gregg M. Rosen, \textit{Legal Updates: Big Win for Gas Companies in Pennsylvania Marcellus Shale Royalties Case}, McGuire Woods LLP (Apr. 2, 2010), http://www.mcguirewoods.com/news-resources/item.asp?item=4572 (noting ramification of \textit{Kilmer} will be expectation of being bound to terms according to technical definition).

\textsuperscript{193} See Ove, \textit{supra} note 189 (explaining landowners in older leases are upset because they earn significantly less than counterparts who signed leases post-2008).
\end{footnotes}
the increasingly valuable shale gas reserves lying deep beneath their land.\textsuperscript{194}

B. Protected Economic Value of Marcellus Shale Drilling

This Casenote identified several faults in the Pennsylvania Supreme Court's rationale in \textit{Kilmer}.\textsuperscript{195} The court, unanimous in its approval of the gas companies' net back methodology, was greatly concerned with the potential "catastrophic" impact on the Pennsylvania oil and gas industry and the state's economy as a whole.\textsuperscript{196} In the face of the potential economic impact, the court may have forsaken a detailed analysis of the arguments supporting a first marketable product doctrine-based rule in favor of protecting a vitally important Pennsylvania industry.\textsuperscript{197} In the wake of \textit{Kilmer}, the gas industry exhaled a sigh of relief, and began seeking new mineral leases for new drilling operation that were previously shelved while the court interpreted the GMRA.\textsuperscript{198}

The court was undoubtedly aware of the total economic impact on the Marcellus gas industry in Pennsylvania.\textsuperscript{199} Marcellus gas producers collectively spent \$3.1 billion within Pennsylvania in 2008 alone.\textsuperscript{200} Based on estimated economic multipliers, the industry in 2010 is estimated to have an \$8 billion impact on the state's gross domestic product.\textsuperscript{201} The industry adds as many as 100,000 jobs to the Pennsylvania economy, and yields \$872 million in tax revenues to state and local tax collectors' coffers.\textsuperscript{202} \textit{Kilmer} put this industry in jeopardy by questioning the validity of all gas leases in the state designed to comply with the GMRA while following a net back royalty methodology.\textsuperscript{203} The primary motivator for gas companies to

\begin{footnotes}
\item[194] \textit{Id.} (advising landowners to seek legal counsel in negotiating leases).
\item[195] For a critical analysis of the \textit{Kilmer} decision, see \textit{supra} notes 147-181.
\item[196] Christman & Rosen, \textit{supra} note 192 (explaining potential economic ramifications of alternative decision).
\item[197] See infra notes 199-202 (describing economic contribution of Marcellus Shale to Pennsylvania economy).
\item[198] See Finkelson, \textit{supra} note 185 (noting reinvigoration of gas-extraction construction post-\textit{Kilmer}).
\item[200] See Considine \textit{et al.}, \textit{supra} note 1, at 21 (discussing total spending of business entities drilling gas in-state).
\item[201] \textit{Id.} at 23 (discussing impact on economy adjusted for estimate future rates of growth within natural gas industry).
\item[202] \textit{Id.} (discussing labor and tax inputs into Pennsylvania economy).
\item[203] See \textit{Kilmer}, 990 A.2d at 1148 (recognizing GMRA applies to all gas leases in Pennsylvania, and changes in interpretation of law will subsequently affect all leases).
\end{footnotes}
continue adding such enormous value to the Pennsylvania economy is a combination of high profit margins and a favorable business climate.\textsuperscript{204} An contrary holding in \textit{Kilmer} would have threatened profit margins by increasing mandatory royalty payments and destabilized the business climate by creating a massive litigation risk.\textsuperscript{205} The landowners suffering from buyers' remorse were bound by the gas companies' most profitable pre-2008 leases—leases that, if voided, could unbalance the high-profit business operations of Pennsylvania gas drillers.\textsuperscript{206} The Pennsylvania Supreme Court was especially eager to prevent such devastating tumult in the rapidly developing natural gas sector of Pennsylvania's economy.\textsuperscript{207}

\textit{Michael Morris*}

\textsuperscript{204} See Considine \textit{et al.}, \textit{supra} note 1, at 28-30 (discussing how primary business drivers for gas drilling in Pennsylvania are based on friendly business climate in-state).

\textsuperscript{205} See Kilmer, 990 A.2d at 1150-51 (recognizing GMRA is applicable to large proportion of gas leases in Pennsylvania, and over seventy cases on court dockets await interpretation).

\textsuperscript{206} See id. at 1150 (noting remedy sought by plaintiffs includes termination of current leases). With a significant number of cases awaiting the outcome of this decision, a different outcome could have forced drillers to renegotiate leases before continuing operations. \textit{Id.} at 1151.

\textsuperscript{207} See \textit{id.} at 1158 (exercising extraordinary jurisdiction in order to issue unanimous opinion affirming gas companies' preferred calculation methodology).

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