Testimony in Opposition to

SENATE BILL NO. 2217

Senate Finance and Taxation Committee

February 8, 2021

Madam Chair Bell, Senate Finance and Taxation Committee members, for the record my name is Todd D. Kranda. I am an attorney with the Kelsch Ruff Kranda Nagle & Ludwig Law Firm in Mandan. I appear before you today as a lobbyist on behalf of the North Dakota Petroleum Council (NDPC) to oppose SB 2217 which deals with mineral royalties for the production of oil and gas.

NDPC represents more than 650 companies involved in all aspects of the oil and gas industry, including oil and gas production, refining, pipelines, transportation, mineral leasing, consulting, legal work, and oilfield service activities in North Dakota, and has been representing the energy industry since 1952.

Royalties due mineral owners for the production and sale of oil and gas is governed by contract law, that is, the express oil and gas lease contract entered into between the mineral owner and the lessee. How royalties are calculated depends on the particular lease royalty clause. The royalty clause typically sets forth the point at which the value of the oil or gas is determined and what deductions may or may not be applicable. This can vary from lease to lease—and there are presently thousands of oil and gas leases in North Dakota. While there are many variations in the specific language of the royalty clauses, there are a couple clauses that are by far more prevalent than others in North Dakota, and those are described in a separate handout attached to this testimony.

First, it is important to understand that under the typical oil and gas lease, the mineral owner does not bear any costs relating to the drilling of the well, well completion including fracking, equipping the well, and operating the well. These costs are entirely borne by the operator and working interest owners. Once the product leaves the well site,

is transported, processed, enhanced or refined, these costs are considered "post-production" costs and may or may not be deducted depending upon the lease royalty clause.

Referring to the gas royalty clauses on the handout, the most common provisions provide that royalties due mineral owners are determined based upon the value of the gas "at the mouth of the well" or "the market value at the well". As will be explained by other speakers, gas is usually sold at the well to a gas processor, and then the gas is transported through its pipeline to a processing plant to separate the liquids like butane, propane and ethane from the natural gas which is methane. These separate products are sold at the tailgate of the processing plant, or downstream from the wellhead. The transportation and processing of the gas enhances the value of the gas and it has a higher value at the tailgate of a plant compared to its value at "the mouth of the well".

To determine the value of the gas "at the well", North Dakota has adopted the "work-back method", which is the majority rule in the oil and gas producing states. Under the work-back method, the lessee calculates the market value of the gas at the well "by taking the sales price that it received for its oil or gas production at a downstream point of sale and then subtracting the reasonable post-production costs" (including transportation, gathering, compressing and processing costs). Bice v. Petro-Hunt, L.L.C., 768 N.W.2d 496 (ND 2009). These post-production costs are shared proportionately by the working interest and royalty owners under the gas royalty clauses used in this example, but both the mineral owner and working interest owners likewise share proportionately in the enhanced value of the oil or gas from downstream sales.

A similar result occurs with the most common oil royalty clauses. In the attached examples, the lessor's interest is free of costs, meaning the cost of drilling, completion,

etc., but the value of the oil for royalty purposes is determined "at the wells", or at the point where the wells are connected to a pipeline, and not at some point far downstream from the wells. The long-standing law in other oil and gas states, and the practice in North Dakota, has been that post-production costs are allowed under these royalty provisions. For the committee's information, there are cases pending in the North Dakota federal courts specifically relating to the first oil royalty clause attached hereto. On November 30, 2020, the federal court certified a question to the North Dakota Supreme Court asking the Supreme Court if this oil royalty provision "is interpreted to mean the royalty is based on the value of the oil "at the well:" The case is still pending before the North Dakota Supreme Court.

Referring to the last royalty clause on the handout, the North Dakota Supreme Court held this provision prohibits the lessee from taking deductions for transporting, processing, and so forth from the mineral owner. Therefore, as previously stated, whether deductions are permitted is a matter of contract law and negotiation between the mineral owner and lessee. SB 2217, as introduced, would completely overturn the rights set forth in thousands of existing oil and gas contracts. Attempting to do so, not only would be dangerous policy and precedent, but it would implicate serious constitutional "contract clause" concerns.

In conclusion, NDPC urges your **opposition** to **SB 2217** and respectfully requests a **Do Not Pass** recommendation. Thank you and I would be happy to try to answer any questions.

Common gas royalty clauses in North Dakota

- To pay Lessor for gas produced from any oil well and used of the premises or in the manufacture of gasoline or any other product a royalty of 1/8 the proceeds, at the mouth of the well, payable monthly at the prevailing market rate.

- Lessee shall pay royalties to Lessor the market value at the wells of 1/8th of the gas produced from the land and sold.

Common oil royalty clauses in North Dakota

- To deliver to the credit of Lessor, free of cost, in the pipe line to which Lessee may connect wells on said land, the equal one eighth part of all oil produced and saved from the leased premises.

- Lessee shall pay royalties to Lessor (a) 1/8th of the oil produced and saved from said land, to be delivered at the wells or to the credit of Lessor into the pipeline to which the wells may be connected; Lessee may, at any time or times, purchase any royalty oil, paying the market value in the field on the day it is run to the storage tanks or pipelines.

- On oil, 1/8 of the produced and saved from said land, same to be delivered free of cost at the wells or to the credit of lessor in the pipeline in which the wells may be connected.

Royalty clause – No deductions permitted

Lessee shall pay Lessor the market value at the well for all gas (including all substances contained in such gas) produced from the leased premises and sold by lessee . . .; provided however, that there shall be no deductions from the value of Lessor's royalty of any required processing, cost of dehydration, compression, transportation, or other matter to market such gas. Kittleson v. Grynberg Petroleum Co., 876 N.W.2d 443 (ND 2016).