Senate Bill 2217

Testimony of R. Todd Slawson

Senate Finance and Taxation Committee

February 8, 2021

Chairman Bell and members of the Senate Finance and Taxation Committee, my name is Todd Slawson, President of Slawson Exploration Company based in Wichita, Kansas. I am a Petroleum Engineer and lived in North Dakota in the early 1980s but now reside in Denver, Colorado. Slawson Exploration, founded in 1957, is a privately held company that is self-funded with no board of directors or hedge fund investors. Slawson has drilled over 4,000 wells in 10 states in its career and has drilled and operated wells in North Dakota since 1975. We are about the 13th largest oil producer in the State. Slawson drilled its first horizontal Bakken Shale well in 1989. We are proud to have participated in the Bakken play since its beginning and to have helped advance the technology to make North Dakota the second largest oil producing state. We would like to keep it that way. I appear before you in opposition of Senate Bill 2217.

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I have had the pleasure to meet via Zoom with one of the sponsors of SB 2217 and heard him talk of the frustrations of his constituents concerning perceived excessive post-production costs that take the proceeds of the gas negative and those negative proceeds are deducted from the positive proceeds of oil sales on their monthly checks. Their belief is that the non-arm's length midstream transactions are the culprit and must be prohibited. It is also their belief that all post-production costs whether arm's length or non-arm's length for both the oil or gas products must not be deducted from the royalty calculation and the best way to do that is to introduce a bill that changes the language of well-established contracts between the lessee and lessor of an oil and gas lease. As told to me, this is all exacerbated by the unwillingness of certain oil companies to communicate with the upset royalty owners and non-operating working interest owners to explain the situation.

I know throughout my career that lack of knowledge of a situation and lack of communication leads to suspicion of wrongdoing. However, this bill is killing the fly with an atomic bomb plus it is attempting to change tens of thousands of contracts between two willing parties that have complied with the terms sometimes for decades. This is legally troubling.

I want to address the three parts of this bill that concern me most. I do not think a noncompliant party should be guilty of a Class B misdemeanor, but that is not one of the three.

1) Changing all oil and gas lease contracts to prohibit the deductions of post-production costs from both oil and gas,
2) Not allowing non-arm's length post-production costs to be deducted from the royalty calculation, and
3) Not allowing negative proceeds from the sales of either oil or gas to be deducted from the royalty check or even carried forward to be debited against a future month in which the proceeds become positive.

Post-Production Costs

A vast majority of the oil and gas leases in North Dakota state that the royalties due the mineral owners are to be calculated "at the wellhead" or "into the pipeline;" both of which are legally defined as on the leased premises which is the wellsite or location. Slawson has almost 5,000 current oil and gas leases in North Dakota and only one of those leases states post-production costs cannot be deducted for gas. It allows post-production costs for oil, however. Therefore, the intent in the negotiations with 99.98% of our lessors was that the oil and gas products are to be priced at the location and not at the tailgate of the gas processing plant or at the tailgate of the oil refinery.

Well established case law in many oil and gas producing states is clear on how royalties are to be calculated when the lease is like those in North Dakota. The law is also clear on how the post-production costs are to be handled when the oil company enhances the value of the oil or gas by selling it farther downstream rather than on the location. The lessee/oil company has the duty to deliver a marketable product at the leased premises at no cost to the royalty owner. Once done, the lessee's duties and obligations have been fulfilled and do not extend beyond that. Any sale past that location is an enhancement of the value of that product and costs to do such enhancement are shared between the lessee and the royalty owner.

> "The lessee's …duty is fulfilled by delivering a marketable product at the leased premises, and that costs incurred after this duty is fulfilled may be allocated proportionately to the royalty interest." Mittelstaedt v. Santa Fe Minerals Inc., 954 P.2d 1203 (Okla. 1998), 84977
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> "When a lease provides for royalties based on the…sale of gas at the well, and the gas is sold at the well, the operator's duty to bear the expense of making the gas marketable does not, as a matter of law, extend beyond the geographical point to post-sale expenses. In other words, the duty to make gas marketable is satisfied when the operator delivers the gas to the purchaser in a condition acceptable to the purchaser in a good faith transaction. When calculating royalty, the post-production, post-sale processing expenses deducted by the third-party purchasers are shared." Fawcett v Oil Producers, No. 108.666, 2015 WL, 4033549

This next Oklahoma ruling might say it best concerning post-production cost sharing.

> "However, we conclude that the lessor must bear a proportionate share of such costs if the lessee can show (1) that the costs enhanced the value of an already marketable product, (2) that such costs are reasonable, and (3) that actual royalties revenues increased in proportion with the costs assessed against the nonworking interest."
> Mittelstaedt v Santa Fe Minerals, Inc.

This allows the oil companies to take the oil and gas as far downstream as they can to add value to both itself and the royalty owner in proportion as long as the three criteria are met – one of which is the reasonable cost test.

I have provided in Exhibit 1, a photograph of a North Dakota Bakken wellsite with production equipment labeled. This is how oil companies deliver marketable oil and gas products on location, free of costs to the royalty owners.

A stream of oil, gas and water is pumped from the well into a heater treater that uses heat and gravity to separate the oil, gas and water. The oil is stored in tanks then metered through a Lease Access Custody Transfer meter (LACT) and pumped through a series of pipelines to a refinery for processing into gasoline, diesel, jet fuel, lubricants, asphalts etc. The oil is sold and the transfer of custody occurs at this LACT, which is owned by the pipeline company.

Exhibit 3 shows how far those refineries are from North Dakota and why our oil transportation cost is so high compared to oil produced in Texas.

The heater treater also separates and dehydrates the gas which is then immediately sold to the gas processor through its gas meter. From there it is transported via the gas processor's pipeline, to its processing plant. Custody and ownership of the gas changed hands at that sales meter.

I want to stress that gas does not need to be processed at the processing plant to have value and become "marketable." Slawson currently is selling gas on one of its locations, not to a gas processor, but rather to a crypto currency company who uses the unprocessed gas to fuel a generator to power the computer's processors. However, it would make more money to have the gas processed because the liquids such as butane and propane are valuable, but this location does not have a gas pipeline.

SB 2217 would greatly increase the percentage royalty the royalty owner would make in proportion to the oil company, who is the one that invested the money. Although this might sound like an attractive deal at first to the royalty owner, it would cause the oil company to take many drastic measures to mitigate its losses. I have looked at my actual gas statements from two different wells in December 2019 when oil and gas prices were high and calculated the results as if post-production costs were not allowed. I used a royalty interest of 20% for easy math.

Example 1 is a newer, higher volume well. The royalty owner and oil company proportionately shared 97 cents for each mcf (1000 cubic feet) of gas sold at the location. If no post-production costs were allowed in the royalty calculation, the royalty owner would now receive $3.44 for each mcf sold rather than 97 cents while the oil company would receive 36 cents versus the 97 cents. The effective royalty rate increased from 20% to 70% - 3.5x higher, while the oil company's share dropped from 80% to 30%.

Example 2 is a well several years older than well 1 and thus at a lower volume, so the gas did not receive as much value due to the costs of the processing. The royalty owner and oil company both shared 11 cents for each mcf sold on location. However, after removing the post-production costs, the royalty owner received $4.24 versus 11 cents/mcf while the oil company went from receiving 11 cents/mcf to now paying 91 cents/mcf. All the royalty owner's gains came out of the oil company's pocket while the gas processor's money stayed the same in both examples.

The oil company not only does not make money trying to enhance the value of the product, it loses a lot of money each month doing so. The enhancement only enhanced one party—the royalty owner. Now rather than the oil company and royalty owner being aligned in a win-win situation they are now in an adverse position to each other in a win – lose situation.

The oil company could do one of two things to mitigate its losses.

1) Shut in the well until the courts correct this new law or the state legislation corrects it in 2023. This would mostly hurt the State's tax base in the meantime.

2) Revise the gas purchase contract so that the gas purchaser gets the gas for free at the location. This solves the gas capture issue, solves the post-production cost issue, and would still allow the oil company to sell the oil which is by far the more lucrative product. Now the oil company, the royalty owner and the North Dakota treasury have lost and the gas purchaser has won. It is no longer a win-win situation for everyone.

The oil company cannot just flare the gas to avoid its monthly loss because North Dakota's 2014 Gas Capture Rule will not allow it. The gas contract between the gas purchaser states that the oil company must sell it all the gas it produces because the gas purchaser made the enormous investment to install the pipeline to the location and build a plant big enough to handle all the gas. Gas processors have indeed made an enormous investment in our state and everyone is glad they have. Twelve years ago, about 160 million cubic of gas per day was being processed. Now 2.6 billion cubic feet per day are. That is a 16 times increase. The investment needed was not minimal and they expect a return on their investment also.

The proposed SB 2217 does not limit post-production cost adjustments to just the downstream gas processing; so therefore, this bill would prohibit these adjustments on oil value enhancements as well. That would be a disaster. How does

the oil company even know what those oil post-production costs are and how many people touched that product each month before it reached the end user? So many products are made from Bakken oil. The gasoline from just one of our wells might end up in 100 different filling stations and it might take several months to get there but the royalty must be paid quickly. A barrel of oil originating in North Dakota might receive over $5,000 in revenue from all the end users and the costs of each downstream company transporting, processing, marketing, and profiting from the myriad of products might be $4,000. How could one justify deducting $4,000 of post-production costs from the royalty equation when the oil sold for only $50 on the North Dakota location. One might say that will never happen but there are plaintiff attorneys out there that would love to try that case on contingency with a law like this.

Beware of the unintended consequences of this bill. It would eliminate the incentive for the oil company to try to sell the product farther downstream to make more money for everyone. It will actually cause lower revenue for everyone, shorten the economic life of the well, be almost impossible to administer, and could very possibly stop the State's oil production immediately—leaving the oil in the ground. The new federal administration will be proud of what North Dakota accomplished before they could.

Non-Arm's Length Deductions

The royalty owners should want oil companies to own downstream assets versus letting them be owned by a third party.

Most oil companies operating in this basin own some downstream asset. Slawson included. Remember that one of the three criteria for a lessee to deduct post-production costs for downstream product enhancement is the reasonable test. It did not say that post-production costs could not be charged if the oil company owns the downstream assets, it just says costs must be reasonable.

In Slawson's case, we own the pipeline system that gathers oil from the locations and delivers it to a major pipeline leading to a refinery. We did not intend to own this gathering system and even took bids from many pipeline companies, but we did not like the terms they demanded such as minimum production commitments. We would have had to drill up our field at a fast pace and produce high volumes to meet their monthly production minimums for 10 years regardless of the oil price or pay hefty penalties. We could not accept those conditions. Oil companies want to maintain control and flexibility over their own oil production. Slawson built its own crude oil gathering system, charged the same tariff and did not require any production commitments.

It turned out that oil prices in years 2015, 2016, 2017 and 2020 were not good and Slawson greatly curtailed its production in those years. Slawson intentionally

had zero oil sales in May 2020 and many non-operating owners and royalty owners praised us for not selling their oil for $8/bbl.

If SB 2217 becomes law, it will force Slawson to sell its oil gathering system to a third party. That third party would probably charge more than we did and put on minimum volume commitments to ensure a quick payout of its new investment. Now the non-arm's length situation is removed, and post-production costs would be deducted from the royalty calculation. The royalty owner did not gain anything. Slawson would have forfeited its ability to curtail production during low oil price time periods, so we all lose including the State. Only the new owner of the gathering system wins.

I strongly discourage you from potentially making oil companies sell their downstream assets. If it appears an oil company is being unreasonable with their post-production costs, there are other remedies to address that. Federal and Tribal leases even allow reasonable costs for off location gas processing and non-arm's length transportation.

No Negative Proceeds

The rash of negative gas proceeds is due to recent low petroleum commodity prices plus unintended consequences of North Dakota's Gas Capture Rule. Several

operators deduct these negative gas proceeds from the positive oil proceeds at the angst of some check recipients.

In my opinion, you must take the good with the bad. You cannot make the oil company eat the loses due low commodity pricing periods but happily accept the high commodity prices. Nothing in the oil and gas leases say the royalty owners get that cherry-picking benefit and nothing says that oil companies cannot deduct negative proceeds of one product from the positive proceeds of the other.

The percent of proceeds (POP) contracts the oil companies had with gas processors for generations were changed to "fixed fee" contracts after the Gas Capture Rule was enacted which drastically limits the amount of gas an oil company can flare each month. Gas Capture took away the free market negotiations between the oil company and the gas processor forcing oil companies to have to accept "fixed fee" contracts. The oil company could not just flare the gas to avoid entering these long-term contracts. With a fixed cost fee, if the sales proceeds of the methane, propane and butane was not enough to cover the fixed fee, then the proceeds to the oil company were negative and that deficit was passed on to all parties.

The old POP contracts could not go negative since the oil company simply received a percentage of the proceeds rather than having to have the revenue be enough to exceed the fixed cost hurdle. In better pricing times this will not be a

problem and we are in higher pricing times now. This might just be a 2020 low pricing problem that no one expected.

It is common knowledge that the oil revenue is about 95% of the total revenue with gas making up the remaining 5%. The oil company's view is that selling the gas for nothing or at a small loss is an acceptable practice to keep the oil flowing. So, in low commodity pricing times, everyone just must grin and bear it to keep the oil flowing and hope for better pricing.

I think all parties involved should share in the unintended consequences due to the State's Gas Capture Rule to help the State's environment. The royalty owners and non-operating working interest owners cannot throw 100% of the consequences on the operator who did not cause it.

Oil companies operating in this State who also have assets in Texas are already voting with their feet and increasing their drilling activities there and not here. The rig count in North Dakota is not increasing. There is too much uncertainty in this state with the ND Trust lands issue, the lack of case law, federal lands issues with the new administration and potential DAPL pipeline issues.

Please do not drop an atomic bomb to kill a fly.

I urge a Do Not Pass on Senate Bill 2217.

I hope my testimony has been helpful. I would be happy to answer any questions.

Exhibit 1

Typical North Dakota Bakken Well Pad

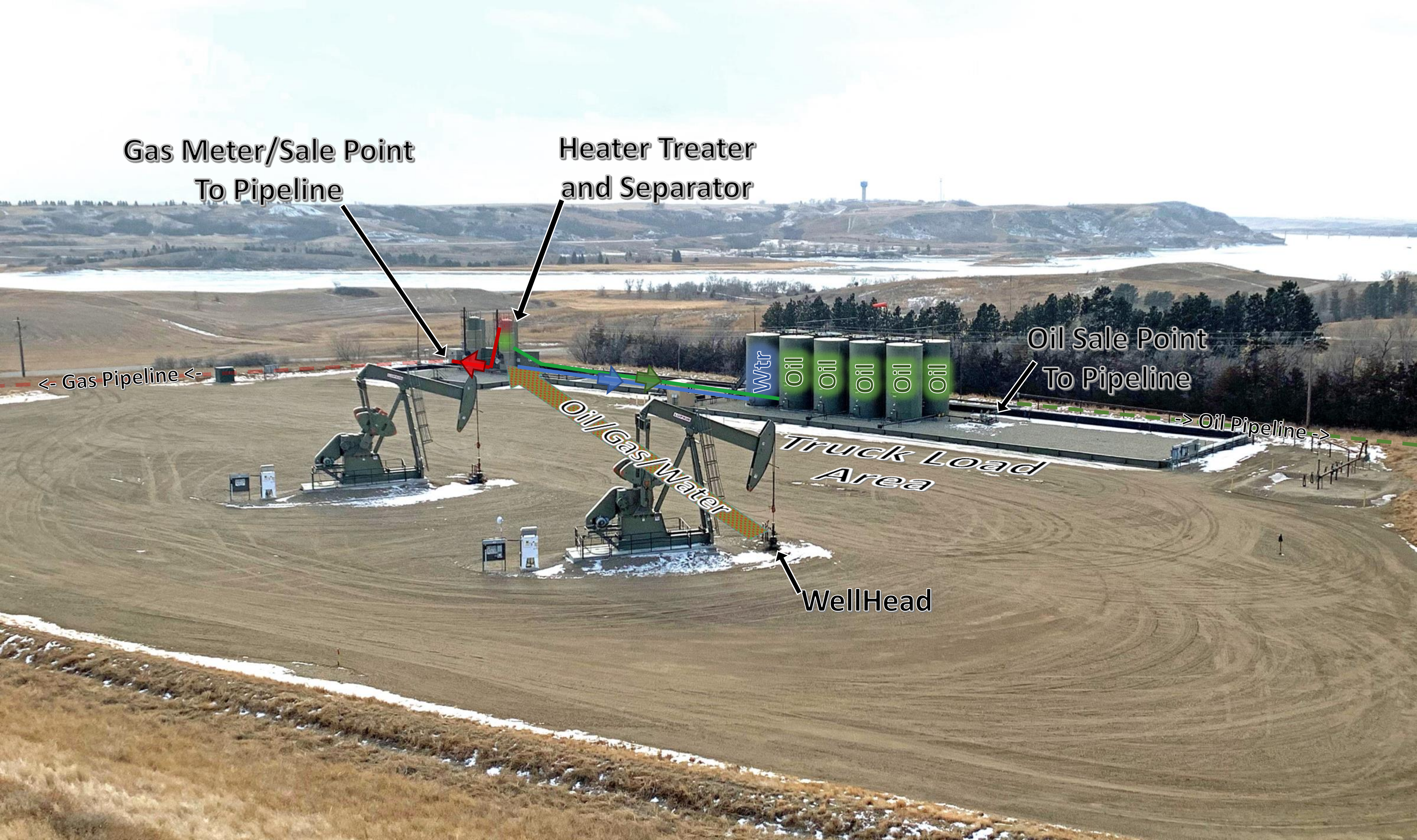

Exhibit 2

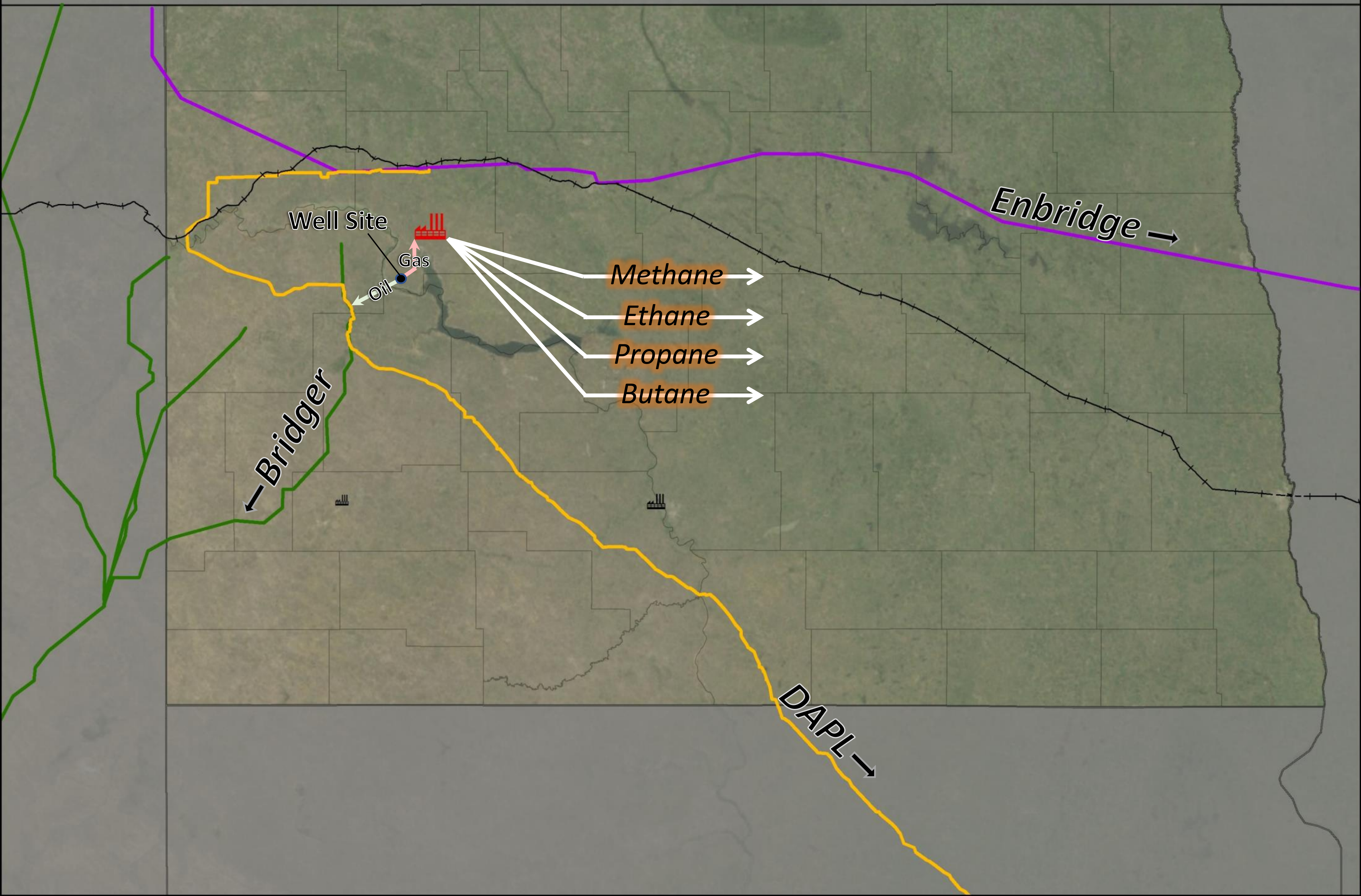

Exhibit 3
Enbridge
Bridger
DAPL
Cushing, OK
Oil Tanker Shipment
Esri, Garmin, GEBCO, NOAA NGDC, and other contributors