



**TESTIMONY OF JODI SMITH
COMMISSIONER
North Dakota Department of Trust Lands**

House Bill 1080

**Senate Energy and Natural Resources Committee
March 12, 2021**

Chairman Kreun and members of the Senate Energy and Natural Resources Committee (Committee), I am Jodi Smith, the Commissioner and Secretary for the Board of University and School Lands (Board). I am here to testify on House Bill 1080.

The Department of Trust Lands (Department) is the administrative arm of the Board, serving under the direction and authority of the Board. The Board is comprised of the Governor, Secretary of State, Attorney General, State Treasurer, and Superintendent of Public Instruction. The Department's primary responsibility is managing the Common Schools Trust Fund (CSTF) and 12 other permanent educational trust funds. The beneficiaries of the trust funds include local school districts, various colleges and universities, and other institutions in North Dakota. The Department manages five additional funds: the Strategic Investment and Improvements Fund, the Coal Development Trust Fund, the Capitol Building Fund, the Indian Cultural Education Trust, and the Theodore Roosevelt Presidential Library and Museum Endowment.

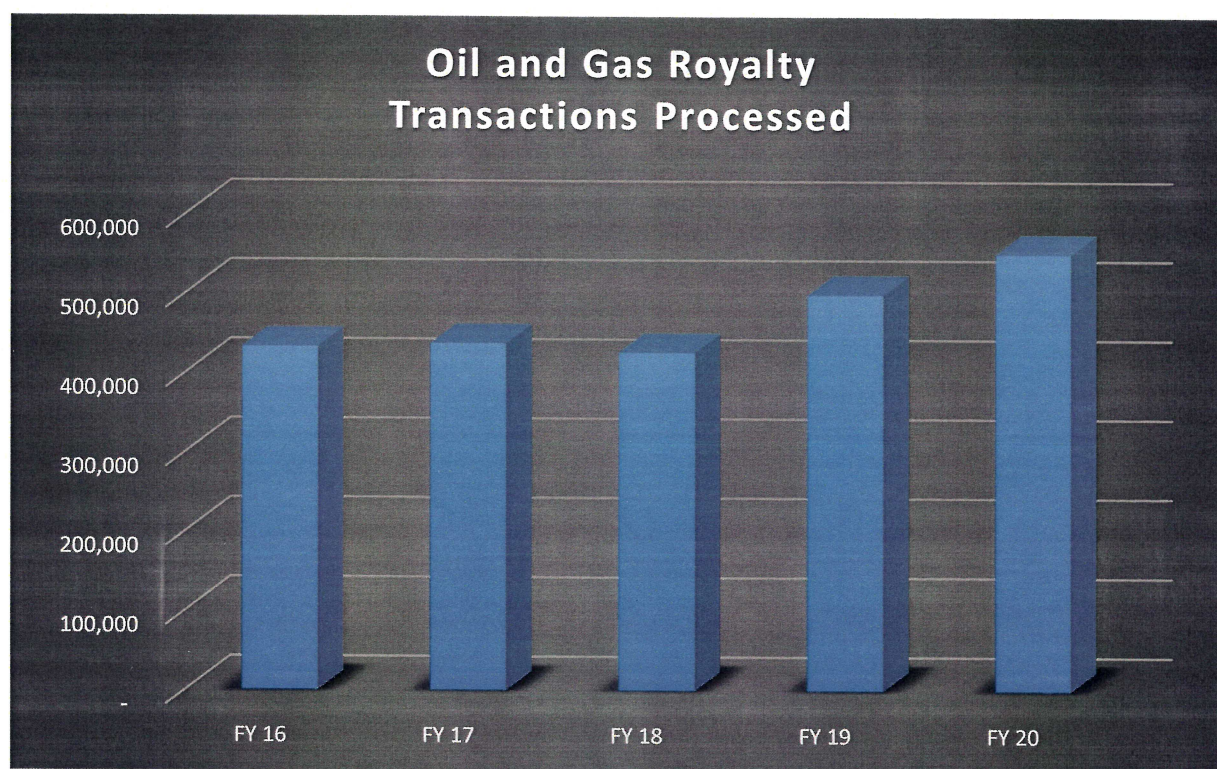
The Department also administers the responsibilities outlined in the Uniform Unclaimed Property Act, N.D.C.C. ch. 47-30.1. In this role the Department collects "unclaimed property" (uncashed checks, unused bank accounts, etc.), and processes owners' claims. This property is held in permanent trust for owners to claim, with the revenue from the investment of the property benefiting the CSTF.

Additionally, the Department operates the Energy Infrastructure and Impact Office (EIIO), which provides financial support to political subdivisions that are affected by energy development. Assistance is provided through both the oil and gas impact grant program and the coal impact loan program.

While the Department has a long standing history of auditing, dating back to 1922, the Board began a concerted effort of auditing oil and gas royalties in the 1980's. Audits performed in the 1980's were primarily related to oil and gas royalties owed under leases issued prior to 1979, which have different terms than leases issued after 1979. These audits resulted in the Board collecting additional royalties dating back to as early as the 1950's. Through the decades, the Board has persistently worked with industry partners to collect payment or establish escrow accounts for royalties from the production of minerals, in accordance with the North Dakota Century Code, the Board's lease, rules, and policies.

Between 2006 and 2011, the Board saw a 240% increase in the number of producing wells, which tripled the number of royalty records that needed to be processed. A formal Revenue Compliance Division was created in March 2011 upon Legislative approval of the hiring of necessary staff. The Department's Revenue Compliance Division (Division) is responsible for developing and implementing procedures to assure the timely and accurate accounting of all royalties, bonuses, rentals, and other revenues received, with a significant amount of time being dedicated to evaluating the accounting and collection of oil and gas royalties.

Royalty transactions include prior period adjustments and current period payments. Often, multiple transactions will occur on the same statement for the same property due to multiple tracts in the same spacing unit, reporting of various products, and prior period adjustments.



Royalty data is reviewed for ownership, valuation, and discrepancies in volume. Reported volume data is compared with the North Dakota Industrial Commission's data to identify variances. Additionally, division orders and submitted royalty reports are reviewed to identify potential issues. These audit efforts have brought additional royalties due to the trusts that may not have otherwise been collected.

Starting in 2012, the Department began issuing notices of improper deductions to companies that reported deductions on royalty statements submitted for both oil and gas. The table below details

the results of these efforts.

Royalty Activity FY 12 - FY 20

	FY 12	FY 13	FY 14	FY 15	FY 16
Oil & Gas Royalties	\$ 203,791,379	\$ 275,822,135	\$ 371,629,760	\$ 317,194,842	\$ 179,086,533
Additional Royalties Collected	5,033,003	4,511,386	8,052,757	2,467,181	915,778
Repaid Taxes & Deductions	541,319	743,283	248,958	471,200	353,256
Penalties & Interest Collected	437,279	225,346	224,201	339,525	486,998
	FY 17	FY 18	FY 19	FY 20	9 YR Average
Oil & Gas Royalties	\$ 192,039,448	\$ 293,350,591	\$ 321,908,210	\$ 238,441,014	\$ 269,504,930
Additional Royalties Collected	295,678	81,436	460,829	427,517	4,196,021
Repaid Taxes & Deductions	42,580	797,882	-	710,011	471,603
Penalties & Interest Collected	306,473	293,365	564,617	636,898	342,670

The table above details the actual dollars collected over the past nine fiscal years. The penalties and interest collected has not been substantial when compared to the royalty revenues that were assessed. Penalties and interest collected, when viewed as a percentage of the royalty revenues collected over the past nine fiscal years, was 0.13%.

HB 1080 was introduced at the request of the North Dakota Petroleum Council (NDPC) and was originally drafted to address its concerns with the Board's penalties and interest for late royalty payments.

The Board authorized the Commissioner to meet with the NDPC to work on drafting an amendment to HB 1080 agreeable to both parties. The parties were unable to agree on an amendment.

As currently drafted, version 21.0369.03000, the Board agrees to the language in the Section 1 amendment as proposed for 15-05-10(2), (3), and (4). Page 1, lines 19-24; Page 2, lines 1-23.

However, the Board is opposed to the Section 1 amendment as proposed for 15-05-10(5) which states:

If a lessee or the lessee's representative or assignee fails or refuses to comply with demands by the board to pay royalties, interest, or penalties under this chapter, the board may file an action to cancel the lease, recover unpaid royalties, and recover interest and penalties on the unpaid royalties. Notwithstanding chapter 28-01, an action under this subsection must be commenced within six years of the date oil or gas was produced under a lease. An action to cancel a lease, recover unpaid royalties, or recover interest or penalties on unpaid royalties may not be filed for production that occurred under a lease before August 1, 2015.

The Section 1 amendment as proposed for 15-05-10(5) has two separate issues that need to be addressed: (1) the statute of limitations set at six years, and (2) the retroactive application of the statute of limitations to August 1, 2015.

Statute of Limitations

The six-year statute of limitations going forward would be difficult for the Board to conduct timely audits of all the royalty payers with current Department staffing levels. There are approximately 80 companies that pay royalties to the Board on over 8,200 oil and gas leases covering over 7,500 producing properties. In addition to auditing royalties, the Division is responsible for auditing bonuses, rents, and other revenues received by the Department, together with developing, implementing, and monitoring the managerial and system controls used by the Department to detect and prevent misappropriation of assets and revenues.

Texas and New Mexico, two states who conduct audits of oil and gas royalties, do not have a statute of limitations for royalties owed on state owned minerals. Recently, New Mexico experienced gas royalty payment issues. They executed settlement agreements to resolve affiliated gas contracts covering periods as far back as the 1980's. This is important to note as it is not uncommon for other states to have similar royalty issues and to make corrections going back decades.

The North Dakota Supreme Court has not yet ruled on the statute of limitations that applies to oil and gas royalties owed to the Board; however, it has ruled on a 10-year statute of limitations for private mineral owners. The Board believes the decision in Newfield v. State of North Dakota, Civil No. 27-2018-CV-00143 (McKenzie County District Court), will resolve the statute of limitations dispute.

Retroactive Application

The Section 1 amendment as proposed for 15-05-10(5), as currently amended, creates a retroactive limitation for the collection of oil and gas royalties to August 1, 2015, or six years.

As will be discussed, the Board believes the bill as presently drafted raises constitutional issues.

The Board's concern with this section is similar to the NDPC's concern with SB 2217. NDPC's attorney Todd Kranda testified before this committee on February 8, 2021, stating "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." Senator Scott Meyer similarly expressed this at the February 19, 2021 Senate floor debate when discussing Senate Bill 2217 and stated "it's not the legislature's role to be fighting private contract disputes"

The Board manages 13 permanent trusts created under Article IX of the North Dakota Constitution. The Board has entered into oil and gas lease contracts from which it has earned and is owed royalty payments upon the sale of the extracted minerals owned by these trusts. North Dakota Constitution Article IX, Section 1, requires "Revenues earned by a perpetual trust fund must be deposited in the fund." North Dakota Constitution Article IX, Section 2 goes on to state "no part of the fund must ever be diverted, even temporarily, from this purpose or used for any purpose other than the maintenance of common schools as provided by law." Passing a law limiting the collection of royalty payments owed to the permanent trusts conflicts with Article IX of North Dakota Constitution.

Assistant Attorney General Dave Garner is available to provide testimony regarding the constitutionality of this bill.

Communication History

The topic of deductions, specifically gas deductions has been communicated to royalty payors as early as 1979. In response to receiving a draft version of the current lease in early 1979, payors expressed concern with the new royalty provisions, specifically, the deductibility of expenses. Many payors expressed the opinion that the new version of the lease did not allow for the deduction of expenses payors had historically taken. After the adoption of the new lease form in 1979, the Department conducted numerous audits during the late 1980's and early 1990's.

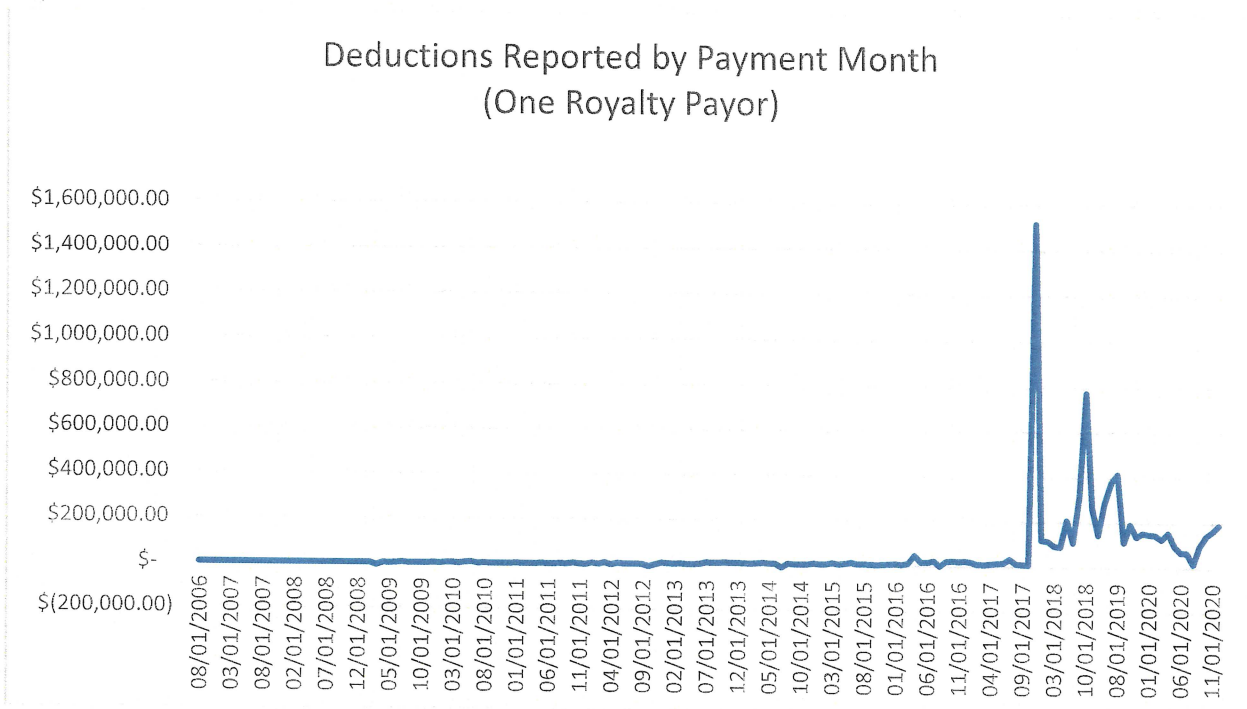
Many of the audits conducted by the Department throughout the years covered production periods for many years prior to the date of audit notification. For example, one audit completed in 1998 covered production from 1984 through 1991. After working through numerous issues with the operator, the Department resolved these issues and received payment in 2001. This is one instance where a company acknowledged inaccurate payments dating back many years and complied with correcting payment, evidencing the Board's long-standing practice of conducting audits and collecting royalty payments for time periods exceeding six years.

Shortly after the creation of the Division in 2011, the Department began issuing notices of improper deductions for both oil and gas royalties to companies that reported deductions as required by N.D.C.C. § 38-08-06.3. These notices covered periods back to January 2007 and clearly stated there should not be any deductions taken from either oil or gas royalties. If a royalty payor did not report deductions, they did not receive a notice.

The majority of royalty payors currently disputing deductions were most recently audited for production occurring from 2012-2014. During these audits it was discovered that many royalty payors were taking deductions that were not reported on their royalty statements. The Department and Board have had numerous communications with royalty payors regarding deduction concerns for both oil and gas royalties. Most of these royalty payors are not parties to litigation with the Board. If the proposed bill passes in its current form, the Board may only be able to collect underpaid royalties from production occurring after July 31, 2015, even though most royalty payors received notices and audit findings for periods prior to 2015. This could potentially cost the funds manage by the Board \$110 Million.

While working with industry to develop a new royalty reporting form in late 2014 and early 2015, the question of deductions was raised by many royalty payors. In conjunction with the issuance of its then new royalty reporting form in July 2015, Frequently Asked Questions (FAQs) were added to the Department's website. The FAQ's clearly state "Gross proceeds of sale means income before deduction of expenses . . . you may NOT deduct or 'net out' the expenses"

It is important to note, that in July 2017 letters were sent to all royalty payors and lessees regarding the proper method to calculate gas royalties. Some royalty payors, after receiving this letter, increased their reported gas deductions on a go forward basis and adjusted prior periods rather than working with the Department to resolve the issue. For example, the chart shown below, illustrates one royalty payor's gas deductions as reported to the Department. Through October 2017 this payor reported taking total cumulative deductions of \$678,712 for gas. Since then this payor has reported an average of \$228,643 each month.



With consistent and continuous messaging to royalty payors, the Board continues to have royalty payors who are out of compliance. Currently, the Board has authorized a waiver of penalty and an interest of prime plus 4%. Even with this offer, there are royalty payors who are out of compliance. Additionally, there are operators who have communicated with the Department they do not intend to work with the Department to enter into compliance until the Newfield case is resolved.

In addition to the Newfield litigation regarding payment of gas royalties, the Board is also party to litigation with Continental Resources. That case relates to the proper payment of both oil and gas royalty payments.

The Board is only in litigation with Continental and Newfield. There are currently 30 gas royalty payors and 10 oil royalty payors out of compliance with the Board (these numbers include Continental and Newfield). Again, the Board and the Department have attempted to work with these companies to resolve any dispute for nearly a decade.

In summary, the Board does not support HB 1080 in its current form, specifically the Section 1 amendment as proposed for 15-05-10(5). The Board recommends removal of any reference to retroactive application and a statute of limitations as to the collection of funds owed. The Board believes the Court's decision in Newfield will address special defenses governing past due royalty payments including the applicable statute of limitations.

We look forward to working with the Committee on these issues and would be happy to answer any questions.