

TESTIMONY OF JEFF ENGLESON
Deputy State Land Commissioner
North Dakota State Land Department

Government Services Committee
August 17, 2010

As most of you know, the Land Department manages the lands, minerals and financial assets of the various trust funds under the control of the Board of University and School Lands. I am here today to give you a brief explanation of some of the major terms and conditions found in our oil and gas leases today.

The Land Department uses a standard lease form, which has been approved by the Land Board. This form is used for all oil and gas leases issued by the Department, regardless of which trust fund owns the minerals. I have attached a copy of our current lease form for your reference. Listed below are a few of the major terms and conditions found in most oil and gas leases, including the Land Department's:

Term of Lease: All Land Department oil and gas leases are issued for a term of 5 years and will continue in effect as long as oil and gas are produced thereon in commercial quantities.

Lease Bonus: All Land Department oil and gas leases are subject to the public auction process at one of the Department's quarterly oil and gas lease sales. At those auctions, companies and individuals bid a on the amount of bonus they are willing to pay, per acre, to have the right to drill for oil on state minerals for a 5-year period. Board policy states that the lease bonus shall not be less than \$1/acre. Our record bonus is \$12,500/acre for a small Stark County tract in May, 2010.

Delay Rental: This is the amount that must be paid annually to hold a lease that is not yet producing. If a lease does not produce oil within the first year of the lease, a delay rental of \$1/acre is due if the lessee wants to keep the right to drill for oil for the remaining 4 years. Delay rentals are due each year of the lease as long as there is no commercial production.

Royalty Rate: At the present time, all Land Department leases are issued with 1/6th royalty rate (16.667%). When a well is drilled, and production is established, the Land Department's lessee is required to pay the state a royalty on all of the oil and gas produced from the lease. The royalty rate is stated as a percentage of gross production and is applied to the value of oil and gas produced and sold from the lease.

All of the above lease terms and conditions are a result of Land Board policy, not law.

Although there are many other terms and conditions in the Land Department's oil and gas lease, these are probably the most significant in determining the amount of revenue a given lease will generate.

This concludes my planned testimony for today. However, I will gladly do my best to answer any questions the committee may have.

OIL AND GAS LEASE

Lease Number
OG-«lm_lease»

«paidup»

This lease, executed «lm_effective», between the State of North Dakota acting by and through the Board of University and School Lands and its agent, the Commissioner of University and School Lands, 1707 North 9th Street, Bismarck, ND 58501, hereinafter called "lessor," and

«na_last»

«na_addr1»

«na_city» «na_state» «na_zip»

hereinafter called "lessee."

1. Lessor, in consideration of \$ «lm_bonus», and the initial annual delay rental of \$ «mt_ognetb», the receipt of which is acknowledged, and of the royalties, covenants, and conditions contained herein to be kept and performed by the lessee, does lease exclusively to lessee the property described below, for the purpose of exploring for drilling for, and producing oil and/or gas from the leased premises; for a primary term of five years and as long thereafter as oil and/or gas may be produced in commercial quantities and subject to other provisions as provided herein; and with the right of ingress and egress and the right to use as much of the leased premises as shall be reasonably necessary to the purpose of this lease including but not limited to constructing and maintaining wellpads, roads, pipelines, communication lines, and other structures, appliances, and equipment. When the surface is owned by Lessor, the construction of a well pad and appurtenances thereto, such as a separate tank battery, roads, pipelines, communication lines, and electrical lines, shall be subject to review and approval by Lessor before construction begins.

«mt_county» COUNTY, NORTH DAKOTA

TOWNSHIP «mt_twp» NORTH, RANGE «mt_rng» WEST

SECTION «mt_sec»: «mt_subdv»

2. If lessor owns an interest less than the whole and undivided fee in the leased premises, the royalties under paragraph 4 and payments under paragraphs 8 and 10 shall be paid lessor in the proportion which lessor's interest bears to the whole and undivided fee. Lessor neither warrants nor agrees to defend title to the leased premises, except that all bonuses and rentals will be returned to the lessee in the event lessor does not have a lawful right to lease the leased premises for oil and/or gas exploration and production.

3. If no well be commenced on the leased premises on or before the anniversary date of the lease during the primary term, this lease shall terminate unless lessee by said date shall pay lessor, the annual delay rental specified in paragraph 1, payment of such sum shall cover the privilege of deferring the commencement of a well for one year from said date.

4. ROYALTIES:

A. Lessee agrees to pay lessor a royalty of one sixth.

B. Lessee agrees to pay lessor the royalty on oil based upon gross production or the market value thereof, at the option of lessor, such value to be determined by 1) the highest posted price, plus premium, if any, paid for oil, condensate, distillate, or other liquid hydrocarbons, respectively, of a like type and gravity for the field where produced and when run, or 2) the highest market price thereof paid for the area where produced and when run, or 3) the gross proceeds of sale, whichever is greater. Lessee agrees that before any gas produced from the land hereby leased is sold, used or processed in a plant, it will be run free of cost to lessor through an adequate oil and gas separator of conventional type or other equipment at least as efficient to the end that all liquid hydrocarbons recoverable from the gas by such means will be recovered. Upon written consent of lessor, the requirement that such gas be run through such a separator or other equipment may be waived upon such terms and conditions as prescribed by lessor.

C. Lessee agrees to pay lessor the royalty on any gas, produced and marketed, based on gross production or the market value thereof, at the option of the lessor, such value to be based on gross proceeds of sale where such sale constitutes an arm's length transaction.

D. Lessee agrees to pay lessor the royalty on carbon black, sulphur or any other products produced or manufactured from gas (excepting liquid hydrocarbons) whether said gas be "casinghead", "dry" or any other gas, by fractionating, burning or any other processing, based on gross production of such products, or the market value thereof, at the option of lessor, such market value to be the lessee's share of the average gross proceeds of sale for each of the products where such sale constitutes an arm's length transaction.

E. If a sale of gas, carbon black, sulphur, or any other products produced or manufactured from gas, including liquid hydrocarbons recovered from gas processed in a plant, does not constitute an arm's length transaction the payment of royalties not taken in kind shall be governed by the rules and regulations of the Board of University and School Lands in effect on the date of this lease.

F. All royalties on oil, gas, carbon black, sulphur, or any other products shall be payable on an amount equal to the full value of all consideration for such products in whatever form or forms, which directly or indirectly compensates, credits, or benefits lessee.

G. Notwithstanding anything contained herein to the contrary, lessor may, at its option, upon not less than sixty (60) days notice to lessee, require at any time or from time to time that payment of all or any royalties accruing to lessor under this lease be made in kind at the well without deduction for the cost of producing, gathering, storing, separating, treating, dehydrating, vapor recovery, compressing, processing, transporting, conditioning, removing impurities, depreciation, risk capital, and otherwise making the oil, gas and other products hereunder ready for sale or use; in such event lessor will provide its own tankage when necessary and will indemnify lessee against all tort claims arising from the taking of royalty in kind.

H. No royalty shall be payable on any oil and/or gas unavoidably lost or on any gas as may represent this lease's proportionate share of any fuel used to process gas produced hereunder in any processing plant. Notwithstanding anything contained herein to the contrary, lessee may recycle gas for gas lift purposes on the leased premises or for injection into any oil or gas producing formation underlying the leased premises after the liquid hydrocarbons contained in the gas have been removed and no royalties shall be payable on the gas so recycled until such time as the same may thereafter be produced and sold or used by lessee in such manner as to entitle lessor to a royalty thereon under the royalty provisions of this lease. Lessee shall have the free use of oil, gas, saltwater, and other products produced from the leased premises where the same are reasonably used by lessee to produce oil and/or gas in commercial quantities from the leased premises.

I. Notwithstanding anything contained herein to the contrary, royalties due under this lease shall be subject to any lawful price controls governing the oil and/or gas produced from the leased premises.

5. All royalties not taken in kind and other payments under this lease shall be paid to the Commissioner of University and School Lands, State Land Department, 1707 North 9th Street, PO Box 5523, Bismarck, ND 58506-5523, in accordance with the rules and regulations of the Board of University and School Lands in effect on the date of this lease.

6. During the primary term, if prior to discovery of oil and/or gas on the leased premises, lessee should drill a dry hole or holes thereon, or if after discovery of oil and/or gas the production thereof should cease from any cause, this lease shall not terminate if lessee commences additional drilling or reworking operations within sixty (60) days thereafter or resumes the payment of the annual delay rental as provided in paragraph 3 of this lease on or before the anniversary date next ensuing after the expiration of sixty (60) days from the date of completion of the dry hole(s) or cessation of production. If lessee should drill a dry hole during the last year of the primary term, lessee's rights shall remain in full force and effect without further operations or payments of annual delay rentals until the expiration of the primary term.

7. In the event that production of oil and/or gas in commercial quantities on the leased premises, after once obtained shall cease for any cause at or after the expiration of the primary term, this lease shall not terminate if lessee commences additional drilling or reworking operations on the leased premises within sixty (60) days after such cessations, and this lease shall remain in full force and effect so long as such operations continue in good faith, without interruptions totaling more than thirty (30) days during any such operations; if any such operations result in the production of oil and/or gas, this lease shall remain in full force and effect as long as oil and/or gas is produced in commercial quantities.

8. If, at the expiration of the primary term, production of oil and/or gas has not been obtained in commercial quantities on the leased premises but drilling, testing, completion, recompletion, reworking, deepening, plugging back, or repairing operations are being conducted thereon in good faith, lessee may, on or before the expiration of the primary term, file a written application with the Commissioner of University and School Lands for a one hundred eighty (180) day extension of this lease, such application to be accompanied by a payment of ten dollars (\$10.00) per acre, and the Commissioner shall, in writing, extend this lease for a period of one hundred eighty (180) days beyond the expiration of the primary term and as long as oil and/or gas is produced in commercial quantities; lessee may, as long as such drilling, testing, or completion operations are being conducted in good faith, make written application to the Commissioner, on or before the expiration of the initial extended period of one hundred eighty (180) days for an additional extension of one hundred eighty (180) days, such application to be accompanied by a payment of twenty dollars (\$20.00) per acre, and the Commissioner shall, in writing, extend this lease for an additional one hundred eighty (180) day period from and after the expiration of the initial extended period of one hundred eighty (180) days, and as long as oil and/or gas is produced in commercial quantities; this lease shall not be extended for more than a total of three hundred sixty (360) days from and after the expiration of the primary term unless production in commercial quantities has been obtained or unless extended by some other provision hereof.

9. After a well producing, or capable of producing, oil and/or gas has been completed on the leased premises, lessee shall exercise the diligence of a reasonably prudent operator in drilling such additional well or wells as may be reasonably necessary for the proper development of the leased premises and in marketing the production therefrom. Lessee shall adequately protect the leased premises from drainage from adjacent lands or leases. Without limiting the generality of the preceding sentence, if oil and/or gas is produced in commercial quantities from adjacent state owned mineral land leased at a lesser royalty or any other adjacent mineral land where the well is within one thousand (1,000) feet of the leased premises and where the leased premises are not entitled to an interest in such well by reason of spacing, pooling, or unitization, lessee shall, within one hundred twenty (120) days after completion of such well, and subject to oil and gas conservation laws, rules, and orders, 1) diligently begin in good faith the drilling of a corresponding offset well on the leased premises, or on lands pooled therewith, and such offset well shall be drilled to such depth as may be necessary to prevent the drainage of the leased premises, 2) agree with lessor to pay a compensatory royalty in lieu of the drilling of an offset well, 3) release sufficient leased acreage (not less than a governmental quarter-quarter section or comparable legal subdivision) to avoid the offset requisites, or 4) apply to lessor for a waiver of the offset obligation the granting of which shall be subject to the sole discretion and approval of the Board of University and School Lands. If an offset well is drilled lessee shall use all means necessary in a good faith effort to make such offset well produce oil and/or gas in commercial quantities.

10. In the event lessee discovers gas in commercial quantities but is unable to market same and this lease is not otherwise being maintained in force and effect, lessee may pay the sum of \$1,600.00 per annum for each well capable of producing gas in commercial quantities; such payment shall be made prior to the expiration of the primary term of this lease or if the primary term has expired within sixty (60) days after lessee shuts in such well or ceases to produce gas therefrom or within sixty (60) days after this lease ceases to be otherwise maintained in force and effect. If such payment is made, this lease shall be considered to be a producing lease and such shut-in gas well payment shall extend the term of this lease for a period of one (1) year from the end of the primary term or, if after the primary term, from the first day of the month next succeeding the month in which such well was shut in or production ceased or this lease ceased to be otherwise maintained in force and effect. Thereafter, if no suitable market for such gas exists, lessee may extend this lease for two (2) additional and successive periods of one (1) year each by the payment of a like sum of money each year as above provided, on or before the expiration of the extended term. If, while this lease is being maintained in force and effect by payment of such shut-in gas well payments, gas should be sold from a well or wells situated within 1,000 feet of the leased premises and completed in the same producing reservoir, or in any case where drainage is occurring, the right to further extend this lease by such shut-in gas well payments shall cease and this lease shall remain in force and effect for the remainder of the current one-year period for which the shut-in gas well payment has been made and for an additional period not to exceed two (2) years from the expiration of the primary term by payment by lessee of compensatory royalty at the royalty rate provided for herein, of the value of production from the well completed in the same producing reservoir from which gas is being sold and which is situated within 1,000 feet of or draining the leased premises on which such shut-in gas well is situated; this compensatory royalty shall be paid monthly to lessor beginning on or before the last day of the month next succeeding the month in which such gas is sold, provided further that such compensatory royalties paid in any twelve-month period must be at least equal to the annual shut-in gas well payment provided for herein. Nothing herein shall relieve lessee of the obligation of reasonable development, nor of the obligation to drill offset wells as required by law or by this lease.

11. Whenever as a result of war, rebellion, riots, acts of God, or a governmental law, order, or regulation, other than a law in Title 15 or Chapter 38-09 of the North Dakota Century Code and other than an order or regulation of the Board of University and School Lands (unless such order or regulation specifically provides otherwise), lessee, despite his good faith effort, is prevented from exercising any rights or performing any obligations under this lease, and this lease is not kept in force and effect by other provisions contained herein, this lease shall remain in full force and effect for the period of such prevention provided lessee acts diligently, when possible, to legally overcome such law, order, or regulation that is preventing lessee from exercising any rights under this lease. This provision shall not operate to extend the lease for a period of more than two (2) years. The operation of this paragraph shall not release lessee from paying royalties on actual production, compensatory royalty under paragraph 9 or the continuing payment of any sum in accordance with a shut-in agreement entered into under paragraph 10. Lessee shall pay lessor the amount of the annual rental specified in paragraph 1 for each year during the period of prevention unless lessor is receiving other compensation under this lease.

12. Lessee agrees to indemnify lessor from any and all lawful claims against lessor for loss, injury or damage resulting from the activities of lessee under this lease.

13. This lease shall be subject to all rules and regulations of the Board of University and School Lands in effect on the date of this lease; such rules and regulations are herein incorporated by reference. If lessee shall fail or refuse to make the payment of any sum due under the lease or if any of the terms of this lease shall be violated, this lease may be cancelled by lessor in accordance with such rules.

14. The rights of Lessee hereunder may not be assigned or subleased in whole or in part without Lessor's prior written consent.

15. Time is of the essence; however, sufficient time allowances will be given so that a lease will not expire due to delays resulting from the failure of the Board of University and School Lands to act on a proposal under paragraph 9 of this lease.

16. The lessor hereby reserves and retains title to any and all historical, archaeological, and paleontological materials, whether such materials are found upon the surface or below the surface of the land. If the lessee discovers a historical, archaeological, or paleontological resource during its operations on the leased premises, the lessee shall immediately stop work and do nothing to disturb or alter the resource. The lessee shall notify the State Land Department and shall not resume work until the State Land Department notifies the lessee what protective measures, if any, the Commissioner may require to preserve or protect the resource.

17. The covenants, conditions, and agreements contained herein shall extend to and be binding upon the heirs, executors, administrators, successors, or assigns of the lessee.

Reserved for recording



Commissioner of University and School Lands