



**TESTIMONY OF JODI SMITH  
COMMISSIONER  
North Dakota Department of Trust Lands  
House Bill 1080  
Senate Appropriations Committee  
March 30, 2021**

Chairman Holmberg and members of the Senate Appropriations 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.

HB 1080 creates a separate subsection to N.D.C.C. § 15-05-10 relating to the royalties from oil and gas leases owned and managed by the Board. HB 1080 has been amended since it was first introduced in the House of Representatives to include amendments the NDPC and the Board have agreed upon. As currently drafted, version 21.0369.04000, the Board agrees to the language in the Section 1 amendment as proposed for 15-05-10(2), (3), and (4).

**Paragraph 2 – Maximum Interest**

Currently, in N.D.C.C. § 47-16-39.1, the statute states the maximum rate of interest the Board can assess to payors for late royalty payments is eighteen percent. Under HB 1080, this provision would be moved to N.D.C.C. § 15-05-10(2) and cap the late royalty payment interest rate at nine percent.

**Paragraph 3 – Maximum Penalty**

Currently, in the Board's lease and N.D.A.C. § 85-06-01-12 the maximum rate of penalty the Board can assess to payors for late royalty payments is twelve percent. Under HB 1080, this would be addressed in N.D.C.C. § 15-05-10(3), with a cap the late royalty payment penalty rate at six percent.

**Paragraph 4 – Payment Under Protest**

Currently, the Board does not allow for payment under protest for royalty disputes. Under HB 1080, the payor may submit payment under protest to stop the accrual of interest and penalties owed to the Board. Additionally, if it is determined that the payment of the disputed amount results in an overpayment, the party who made the overpayment is entitled to a refund of the overpayment amount plus interest at the rate established under N.D.C.C. § 28-20-34.

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 seven 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, 2013.

Page 2, lines 24-31.

The Section 1 amendment as proposed for 15-05-10(5) has two separate issues that potentially have a financial impact: (1) the statute of limitations set at seven years, and (2) the retroactive application of the statute of limitations to August 1, 2013.

### **Statute of Limitations**

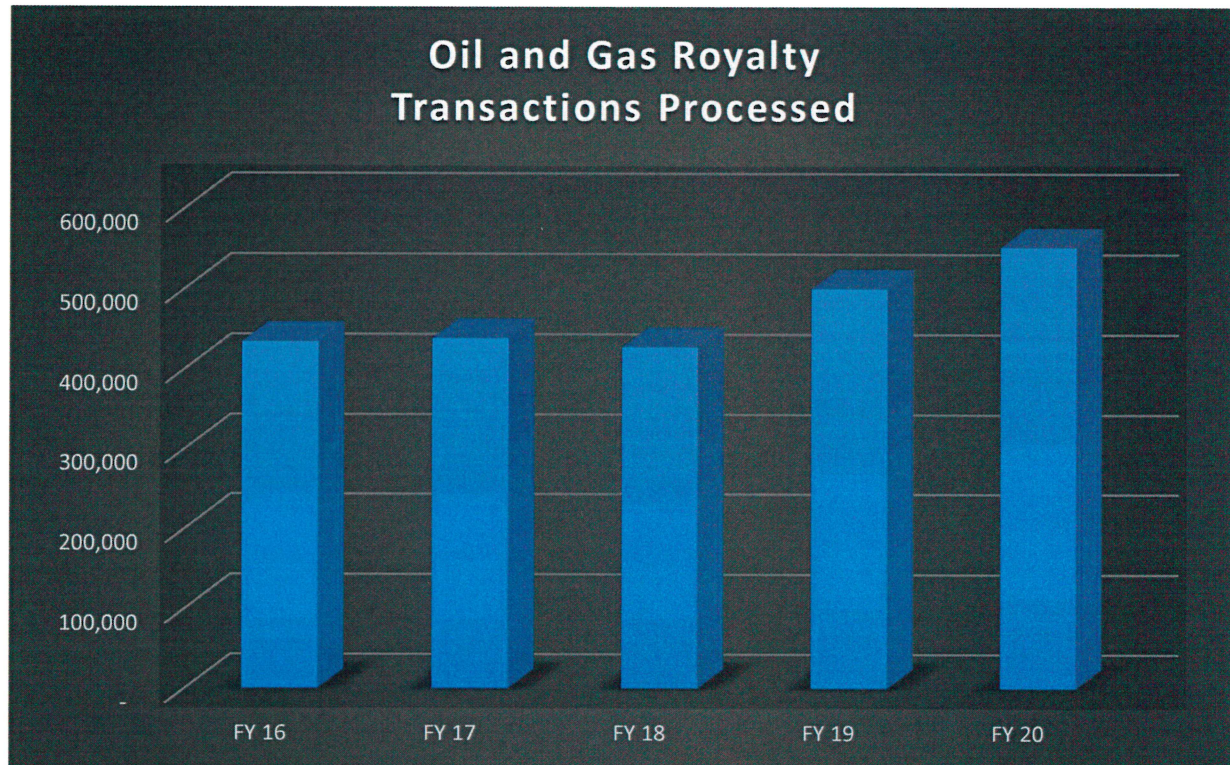
While the Department of Trust Lands (Department) has a long standing history of auditing, dating back to 1922, the Board began a concerted effort of auditing oil and gas royalties in the 1980's. Audits performed in the 1980's were primarily related to oil and gas royalties owed under leases issued prior 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 (Division) was created in March 2011 upon Legislative approval of the hiring of two staff. Today, the Division has four dedicated FTEs who are 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. Overall, the Division is responsible for:

1. Managing collections of royalties and surface payments
2. Monitoring and developing internal controls
3. Ensuring accurate setup and transfers of funds for investment purposes
4. Tracking of escrowed funds
5. Assisting with the drafting of leases, rules, easements, or any other financial agreements
6. Participating in the drafting legal pleadings
7. Reviewing unclaimed property claims over \$2,500

A significant portion of the Divisions efforts are dedicated auditing royalty transactions. 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 owed to the trusts that may not have otherwise been collected.

The seven-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 order to conduct audits in a timely manner within the seven-year statute of limitations, the Department will need an additional auditor. It is estimated this will cost approximately \$300,000 per biennium.

The State Auditor's Office currently has four auditing FTEs in the Federal Mineral Audit Division who are dedicated to just auditing Federal oil and gas royalties' reporting revenues of \$168 million during 2020 on roughly 5,000 properties. Comparatively during the same time period, the Department received \$193 million in oil and gas royalties on 7,500 properties with only three auditing FTEs.

#### **Retroactive Application**

The Section 1 amendment as proposed for 15-05-10(5), creates a retroactive limitation for the collection of oil and gas royalties to August 1, 2013, or eight years. The potential lost revenue due to this section is estimated to be \$69.4 million during the 2021-2023 biennium. Additionally, by not collecting the revenue owed the impacted trusts/funds investment earnings will also be reduced. The compounding interest not earned on lost revenue of \$69.4 million is estimated at \$9 million for the 2023-2025 biennium. By 2031, the amount of lost revenue, with compounding



interest, is estimated to be \$130 million. By 2038, this will be over \$200 million lost revenue for the trusts.

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

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 may ever be diverted, even temporarily, from this purpose or used for any purpose other than the maintenance of the institution, as provided by law." Passing a law limiting the collection of royalty payments owed to the permanent trusts conflicts with Article IX of the North Dakota Constitution.

Supporting this position on the legislative website there is a PDF file containing the Enabling Act (<https://www.legis.nd.gov/constit/theenablingact.pdf>) paragraph four on page six of this document cites to *State ex rel. Sathre v. Board of University & School Lands*, 262 N.W. 60 (N.D. 1935), states "The assembly cannot divert nor authorize diversion of any part of the principal or interest or income from the investment of funds under the control of the board of university and school lands arising from the rental or sale of lands granted by the United States to any purposes other than those for which grants were made and any diversion to other purposes or any donation thereof in aid of an individual, by the assembly directly, or by the board of university and school lands by legislative enactment is unconstitutional."

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 seven 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.



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

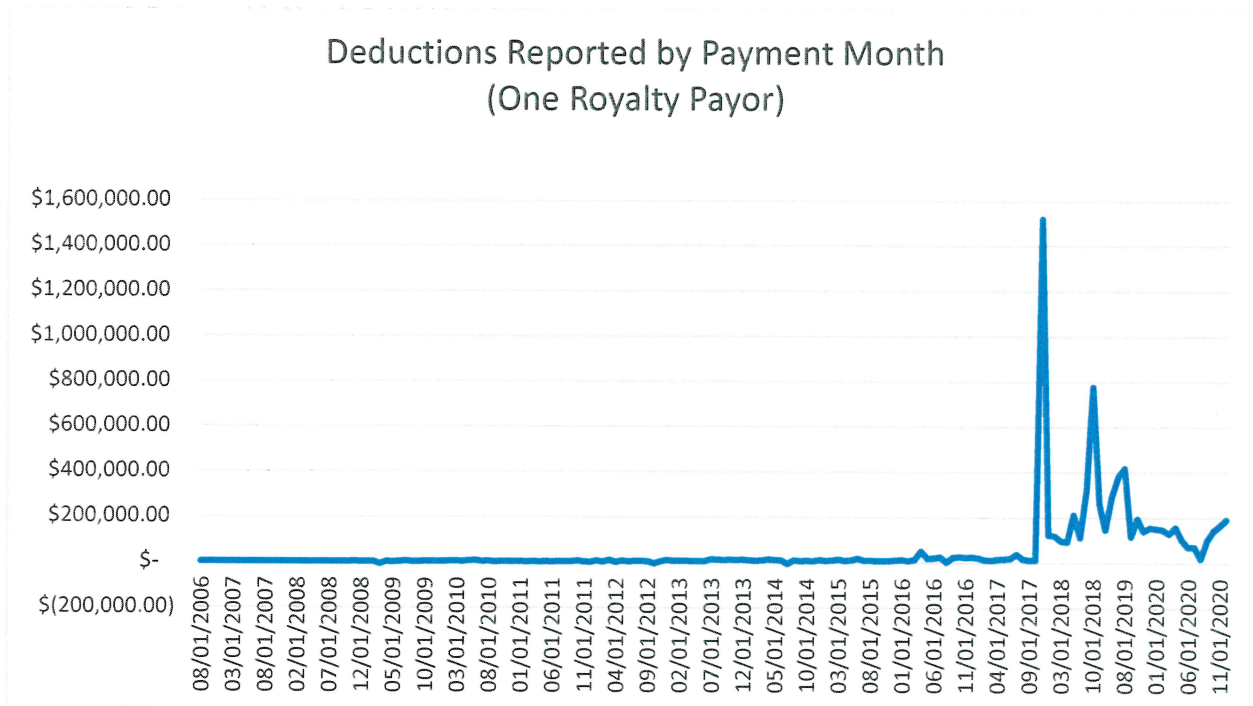
	FY 12	FY 13	FY 14	FY 15	FY 16
<b>Oil &amp; Gas Royalties</b>	\$ 203,791,379	\$ 275,822,135	\$ 371,629,760	\$ 317,194,842	\$ 179,086,533
<b>Additional Royalties Collected</b>	5,033,003	4,511,386	8,052,757	2,467,181	915,778
<b>Repaid Taxes &amp; Deductions</b>	541,319	743,283	248,958	471,200	353,256
<b>Penalties &amp; Interest Collected</b>	437,279	225,346	224,201	339,525	486,998
	FY 17	FY 18	FY 19	FY 20	9 YR Average
<b>Oil &amp; Gas Royalties</b>	\$ 192,039,448	\$ 293,350,591	\$ 321,908,210	\$ 238,441,014	\$ 269,504,930
<b>Additional Royalties Collected</b>	295,678	81,436	460,829	427,517	4,196,021
<b>Repaid Taxes &amp; Deductions</b>	42,580	797,882	-	710,011	471,603
<b>Penalties &amp; Interest Collected</b>	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 have 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, amounted to 0.13%.

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, 2013, even though most royalty payors received notices and audit findings for periods prior to 2013. This could potentially cost the funds managed by the Board \$69.4 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 rate 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, for nearly a decade, the Board and the Department have attempted to work with these companies to resolve any dispute.

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) retroactive application. As outlined in the fiscal note attached to the bill, the implementation of this section will cost the funds managed by the Board an estimated \$69.4 during the next biennium. 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. Additionally, the Department is seeking an additional FTE to meet the obligations arising from the seven year statute of limitations.

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