North Dakota Legislative Council
Prepared for the Energy Development and Transmission Committee
LC# 23.9039.01000
August 2021

OIL AND GAS LEASE POSTPRODUCTION DEDUCTIONS - BACKGROUND MEMORANDUM

STUDY OVERVIEW

Section 1 of Senate Bill No. 2217 (2021) directs the Legislative Management to study deductions for postproduction costs under oil and gas leases. The study must include:

- Consideration of the methods used to calculate the value of oil and gas, the point of sale used to determine the value, oil and gas sales in the absence of an arm's-length contract, any deductions or incentives applied to the value, and the methods used to report any deductions or incentives on mineral royalty statements;
- Input from representatives from the oil and gas industry, representatives from an organization representing royalty owners, the Department of Mineral Resources, the Department of Trust Lands, and the Attorney General; and
- An analysis and review of state-mandated natural gas capture targets, federal land permitting restrictions, the effectiveness of using onsite flare mitigation technologies, and the infrastructure necessary to enhancing oil and natural gas value.

The study may include consideration of the desirability and feasibility of expanding the use and market access of natural gas, including value-added energy opportunities within the state.

PRIOR STUDIES RELATED TO OIL AND GAS LEASE POSTPRODUCTION DEDUCTIONS

Tax Department

Section 21 of Senate Bill No. 2013 (2017) directed the Tax Department to study the valuation of oil and gas as used to determine mineral royalty payments and tax liability and to report the results and recommendations of the study to the Energy Development and Transmission Committee during the 2017-18 interim. The study was conducted in consultation with the Board of University and School Lands and the Industrial Commission, and included consideration of:

- The methods used to calculate the value of oil and gas, including changes in custody, the basis for the value, any deductions or incentives applied to the value, and the point at which the value is determined;
- The impact of state and federal regulations, including gas capture requirements;
- The market competition for gas processing, including the possibility of ratesetting by the Public Service Commission; and
- The reporting of any deductions or incentives applied to the value as included on mineral royalty statements and tax reporting documents.

At the conclusion of the study of private oil and gas royalty lease contracts and after having received input from various stakeholders, the Tax Department recommended no statutory changes to how natural gas or oil is valued for private party royalty purposes, how natural gas or oil is valued for tax purposes, or how natural gas gathering and processing costs are deducted from distributions to private royalty. The Tax Department based the recommendation on the following considerations:

- Oil and gas royalty contracts are agreements between two or more private parties;
- The judicial system is in place to address contractual disputes between the oil producers and the royalty owners with regards to which deductions are allowed and which deductions are prohibited; and
- The Industrial Commission made regulatory changes to improve the disclosure of deductions and adjustments on royalty statements.

Senate Concurrent Resolution No. 4010 (2019)

Senate Concurrent Resolution No. 4010 (2019) directed the Legislative Management to consider studying postproduction deductions from royalty payments. If prioritized by the Legislative Management, the study was to have included:

- Consideration of the methods used to calculate the value of oil and gas, the point of sale used to determine the value, oil and gas sales in the absence of an arm's-length contract, any deductions or incentives applied to the value, and the methods used to report any deductions or incentives on mineral royalty statements; and
- Input from representatives from the oil and gas industry, representatives from an organization representing royalty owners, the Department of Mineral Resources, the Department of Trust Lands, the Attorney General, and other state agencies.

Senate Concurrent Resolution No. 4010 was not prioritized for study by the Legislative Management.

OIL AND GAS LEASE POSTPRODUCTION DEDUCTIONS IN NORTH DAKOTA

Background

In North Dakota, royalties due to mineral owners for the production and sale of oil and gas is governed by contract law, meaning the express oil and gas lease contract entered between the mineral owner and the lessee. Likewise, how royalties are calculated depends on the lease royalty clause. A royalty clause typically sets forth the point at which the value of the oil is determined and what deductions may be applicable.

Typically, most royalty clause provisions provide royalties due to the mineral are determined based on the value of the gas "at the mouth of the well" or "the market value at the well." This is because in *Bice v. Petro-Hunt, L.L.C.*, 2009 ND 124, the North Dakota Supreme Court joined the majority of states following the "at the well" rule for calculating royalties on oil and gas leases. The "at the well" rule defines the wellhead as the appropriate point for royalty calculation. Royalty may be calculated using the comparable sales method or the workback method for calculating market value. Under the workback method, the lessee calculates the market value of the gas at the well by taking the sales price it received for its oil or gas production at a downstream point of sale and then subtracting the reasonable postproduction costs the lessee incurred after extracting the oil or gas from the ground, including transportation, gathering, compression, processing, treating, and marketing costs. Gas usually is sold at the well to a gas processor, and 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."

These postproduction costs are shared proportionately by the working interest and royalty owners under the gas royalty clauses, but both the mineral owner and working interest owners likewise share proportionately in the enhanced value of the oil or gas from downstream sales.

Royalty Clauses in North Dakota

The following represents common royalty clauses in North Dakota:

Gas royalty clauses.

- To pay the lessor for gas produced from any oil well and used off the premises or in the manufacture of gasoline or any other product a royalty of one-eighth 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 one-eighth of the gas produced from the land and sold.

Oil royalty clauses.

- To deliver to the credit of lessor, free of cost, in the pipeline 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 one-eighth 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, one-eighth 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 allowed. (*Kittleson v. Grynberg Petroleum Co.*, 2016 ND 44, 876 N.W.2d 443) **(Emphasis supplied)**

- 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**.

Regulations

North Dakota Century Code (NDCC) Section 38-08-06.3 requires a person that makes a payment to an owner of a royalty interest in land for the purchase of oil or gas produced from that royalty interest to provide with the payment to the royalty owner an information statement that will allow the royalty owner to clearly identify the amount of oil or gas sold and the amount and purpose of each deduction made from the gross amount due. A violation of Section 38-08-06.3 is a Class B misdemeanor. Section 38-08-06.3 also tasks the Industrial Commission with approving the forms the statements must be on and adopt rules relating to the information the statements must contain.

North Dakota Administrative Code (NDAC) Chapter 43-02-06 sets forth the rules adopted by the Industrial Commission under NDCC Section 38-08-06.3 relating to royalty statements. North Dakota Administrative Code Chapter 43-02-06 provides whenever payment is made for oil or gas production to an interest owner, the following information must be included on the check stub or on an attachment to the form of payment:

- The lease, property, or well name or any lease, property, or well identification number used to identify the lease, property, or well.
- The month and year during which sales occurred for which payment is being made.
- 100 percent of the corrected volume of oil, regardless of ownership, which is sold measured in barrels, and 100 percent of the volume of either wet or dry gas, regardless of ownership, which is sold or removed from the premises for the purpose of sale, or sale of its contents and residue, measured in thousand cubic feet.
- Price.
- Total amount of state severance and other production taxes.
- Producer's net value of total sales after taxes and deductions.
- The amount and purpose of each owner deduction made, identified as transportation, processing, compression, or administrative costs.
- The amount and purpose of each owner adjustment or correction made.
- The owner's interest in sales from the lease, property, or well expressed as a decimal.
- The owner's share of the total value of sales prior to removing any taxes. The value can be calculated before or after removing owner's deductions if it is clearly noted on the royalty statement or included on an attachment to the royalty statement.
- The owner's share of sales value less taxes and deductions.
- An address where additional information may be obtained and any questions answered. If information is requested by certified mail, the answer must be mailed by certified mail within 30 days of receipt of the request.

In addition, NDAC Chapter 43-02-06 requires an operator or payor to provide a mineral owner with a statement identifying the spacing unit for the well, and the effective date of the spacing unit change or decimal interest change if applicable, the net mineral acres owned by the mineral owner, the gross mineral acres in the spacing unit, and the mineral owner's decimal interest that will be applied to the well. This statement must be provided within 120 days after the end of the month of the first sale of production from a well or change in the spacing unit of a well or a decimal interest in a mineral owner. If gas either wholly or partially owned by a royalty owner is being placed into storage off the leased premises, NDAC Chapter 43-02-06 requires a person that is required to submit statements to a royalty owner in accordance with the chapter to provide the royalty owner with an annual statement containing the following information:

- Total corrected volume of gas measured in standard thousand cubic feet (MCF) in storage at the beginning of the calendar year.

- Total corrected volume of gas measured in thousand cubic feet added each month to storage during the calendar year.
- Total corrected volume of gas measured in thousand cubic feet removed each month from storage during the calendar year.
- Total corrected volume of gas measured in thousand cubic feet in storage at the end of the calendar year.

OIL AND GAS LEASE POSTPRODUCTION DEDUCTIONS IN OTHER STATES

Generally, states can be divided into two categories--those that follow the at-the-well rule and those that follow the marketable-product rule. Under the marketable product rule, lessees impliedly covenant to bear the costs of getting gas into marketable condition and transporting it to market. The marketable product rule essentially requires a lessee to bear the costs incurred for obtaining a marketable product. The problem that has emerged with the first marketable product doctrine is the difficulty in determining when the gas has become a marketable product. A majority of oil and gas jurisdictions, including North Dakota, adhere to the "at the well" rule and calculate the royalty based on the value of the gas at the well-head. In these jurisdictions, the workback method is used to calculate the value of the gas at the well head. A minority of jurisdictions have rejected the workback method. These jurisdictions, which include Colorado, Kansas, Oklahoma, and West Virginia, do not calculate the royalty based on the purported value of the gas at the well head. Instead, these jurisdictions calculate the royalty at the point the gas first becomes a marketable product--the marketable product rule.

SUGGESTED STUDY APPROACH

In conducting the study, the committee may desire to receive testimony from representatives from the oil and gas industry, representatives from an organization representing royalty owners, the Department of Mineral Resources, the Department of Trust Lands, the Attorney General, and the Industrial Commission. The focus of the testimony should be on the methods used to calculate the value of oil and gas, the point of sale used to determine the value, oil and gas sales in the absence of an arm's-length contract, any deductions or incentives applied to the value, and the methods used to report any deductions or incentives on mineral royalty statements.