EXHIBIT 3
DATE 4/1/2011
SB 415

March 31, 2011
SB 415 – as amended

Mary Sexton, Director
Department of Natural Resources and Conservation

The Department, under the direction of the State Land Board, manages 5.2 million acres of surface and 6.3 million acres of minerals on behalf of the school trust beneficiaries. Oil and gas is produced from only about 230,000 acres, yet brings in $21 million per year.

- **It is important to note that a royalty is not a tax.** A royalty is payment to the mineral owner for the minerals that the oil and gas company is taking from the owner's property. The terms of that royalty payment are laid out in the lease contract between the company and the mineral owner.

- **The oil and gas companies should be expected to pay their fair share to take the state's oil and gas from state land.** The long recognized standard is a percentage of the revenue they receive for reselling the oil or gas, free of costs and deductions. This has been the contractual agreement in state oil and gas leases for decades. **This is the standard that has been recognized and upheld in court.** This is the standard that our responsible oil and gas companies recognize and adhere to.

  However, this is the long recognized standard that SB 415 seeks to wipe away. SB 415 would allow oil and gas companies to impose and take a myriad of deductions; deductions for compression, transportation and associated costs. Compression and transportation represent activities that oil and gas companies perform to get the oil and gas to market where it can be sold, on behalf of the company and the mineral owner. These are activities that for decades oil and gas companies have done for the state school trust as the mineral owner. These costs are not deductible from the gross revenue for royalty calculation. The Montana Supreme Court has reviewed state oil and gas leases and affirmed that they are not deductible.

- The department projects the loss in royalty revenue from these deductions to total approximately $1.0 million over the first four years. **As new leases become the majority of producing leases, the impact will increase to an estimated $2.5 million per year.** State royalty revenue has averaged nearly $21 million over the past five years. Deductions authorized by SB 415 could therefore generate a 12% decrease in royalty revenue to the school trusts.

The department recently completed four company audits that recovered $1.2 million in underpayments due to companies taking deductions for compression and transportation costs. Under leases issued pursuant to SB 415, this school trust revenue would not have been received.

Relevant Case Law

Department of State Lands v. Balcron Oil Company, Case No. 95-101, Montana Supreme Court (February 22, 1996)(State oil and gas lease form was recognized as entitling the State to its share of the gross proceeds of production, and tax reimbursements received by the lessee, without any deductions for compression or transportation to the point of sale.

TXO Production Corp. v. State ex rel. Com'rs of Land office, 903 P.2d 259, 262 (Okla. 1994). The Oklahoma Supreme Court held that the costs of compression, dehydration, and gathering under oil and gas leases on state trust lands were not chargeable to the state to the extent that these processes were necessary to render the product marketable at the point of delivery. The court's determination was predicated upon the lessee's implied duty to market the production.

Hanna Oil and Gas Co. v. Taylor, 759 S.W.2d 563, 564-565 (Ark. 1988) A "gross proceeds" royalty clause imposes upon the lessee all costs incurred in exploring for, producing, marketing, and transporting the product to the point of sale. ("Unless something in the context of an agreement provides otherwise, "proceeds" generally means total proceeds.").

Severson v. Barstow, 103 Mont. 526, 63 P.2d 1022 (1936) The implied covenant to market, which is present in every oil and gas lease in Montana, further imposes upon the lessee the legal obligation to: prepare the product for market; sell the production at the best available price; act as a reasonably prudent lessee to sell the production in the best mutual interests of the lessor and lessee; and refrain from any self-dealing.

Howell v. Texaco Inc., 112 P.3d 1154, 1160 (Okla., 2004) Under the implied covenant to market, moreover, a lessor has the right to be paid on the best price obtainable by the lessee. When a lessee is paying royalty based on one price but it is selling the gas for a higher price, the lessor is entitled to have its royalty payments calculated based on the higher price.

Pursuant to Art. X, § 4 and 11 of the 1972 Montana Constitution, and § 77-1-202, MCA, the State Board of Land Commissioners is obligated to manage these lands as a fiduciary to secure the largest measure of legitimate and reasonable advantage to the State, and to provide for the long-term financial support of education.

State v. Moncrief, 720 P.2d 470, 475 (Wyo. 1986) "A lease of school lands constitutes a contract between the state and the lessee, which vitally affects the public interest, and should be construed liberally in favor of the public."

Plateau Mining Co. v. Utah Division of State Lands and Forestry, 802 P.2d 720 at 729 (Utah 1990) Since the state has a duty not to act in the interest of a third party at the expenses of school trust beneficiaries; the mineral lessees of such lands should have known that they were obligated to comply with the highest valuation of royalties under such leases.