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SB 415

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- 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. This acreage is scattered across the state. Oil and natural gas is actually produced from only about 230,000 acres, yet this acreage generates an average of nearly $21 million per year in royalty revenue to the school trusts.

- 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. If a private individual is the mineral owner, that owner is paid a royalty; if the Federal government is the mineral owner, the royalty goes to them; and if the state school trust is the owner of the mineral estate, they receive the royalty payment for their minerals. The terms of that royalty payment are laid out in the lease contract that is signed by the oil and gas company and the mineral owner.

- The department rises in opposition to SB 415 for one straightforward reason. 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 fair share 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.

  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 taxes paid by the companies for their share of oil and gas production; deductions for compression, transportation and associated costs. Compression, transportation and associated costs 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. SB 415 even allows the oil and gas company, through royalty payment reductions, to force the mineral owner to pay a portion of the company's taxes.

- State of Montana oil and gas lease contracts have always contained a simple, straightforward royalty payment provision. In short, the royalty clause bases the payment for taking oil and gas on the amount taken, the gross revenue received, and the royalty rate. Gross revenue is multiplied by the lease royalty rate, thereby generating the amount to pay the state for the oil and gas removed.

  This type of royalty clause is common in the oil and gas industry. It is called a "gross proceeds" royalty. Courts in this and other states recognize gross proceeds royalty contracts as being free of costs and deductions for activities by the oil and gas company to produce and deliver the product to market where it is sold. The Montana Supreme Court has consistently recognized that the oil and gas company has the duty to market the oil and gas production in the mutual best interests of both the company and the mineral owner. The court has held that a company may not engage in "self-dealing" by marketing production in a manner that deprives the mineral owner of its fair share of production royalties. SB 415 invites such self-dealing because it enables the oil and gas companies to devise all manner of costs to deduct from royalty payments.

- Industry may refer to their proposed royalty provisions as common and representative of an industry standard. That is only true if you limit your discussion to the lease contracts typically offered by companies to individuals. Oil and gas companies have a boilerplate contract that they offer. It is called a "producer's 88" lease. As the name implies, it has been drafted by oil and gas producers, and its terms and provisions are generally structured to be favorable to the producer.

  However, all oil and gas lease contracts are not the same. The State of Montana, other states and the federal government do not use producer's 88 lease forms. Oil and gas owners, particularly those that consult an attorney, typically utilize the producer's base form but negotiate various provisions so that the contract is acceptable to both parties.

- Under SB 415, new leases issued by the state would contain a revised royalty clause that is consistent with the deduction provisions in Section 1. This would be the end result even though the department and Land Board have long utilized, and companies have long complied with, a gross proceeds royalty clause. The royalty clause reflects the Land Board's selection of a key lease provision that meets the Board's fiduciary duty to the school trusts. Instead, the Land Board and department would be directed to utilize royalty provisions consistent with language typically found in industry's boilerplate lease form.

- The fiscal impact is estimated to be small at first since only a few new leases would be generating production and royalty payments subject to SB 415. As new leases continue to be issued and old leases expire, the proportion of production coming from the new leases would continue to increase. The proportion of production subject to the deductions allowed by SB 415 would therefore continue to increase over time.

  The department projects the loss in royalty revenue from these deductions to total approximately $2.0 million over the first four years. As new leases become the majority of producing leases, the impact will increase to an estimated $4.8 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 20 – 25% decrease in royalty revenue to the school trusts.

- Audits demonstrate how profound SB 415's impact could be. 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 revenue would not have been received by the school trusts.

- There is a chance that the fiscal impact could be more dramatic in the near term. The department's legal interpretation is that SB 415 would affect only new leases issued after the effective date of the bill. The basis for this interpretation is the royalty provisions in existing leases should not be altered by subsequent legislation that would impair the obligations arising under the lease contract. If the department's interpretation were challenged, and if a court were to rule that the provisions of the bill alter the application of language contained in all state oil and gas leases, the result would be an immediate fiscal impact in the range of $4.8 million annually.

  In either case, the fiscal impact is important to the funding of schools. Over the long term, the less money generated from the management of school trust lands means more general fund money is required to fully fund education.

- The department believes that the long-standing royalty payment standard should not be modified as proposed in SB 415. The result is that oil and gas companies would pay less than their fair share in royalties to the state; less than what the Montana Supreme Court has said they should pay; and less than what the companies have been paying for decades. As a result, the department urges a "do not pass" on SB 415.

SB 415
Relevant Case Law

Schumacher v. Cole, 131 Mont. 166, 172, 309 P.2d 311, 314 (1957) In Montana, oil and gas leases are to be construed liberally in favor of the lessor and strictly against the lessee. See e.g. Clawson v. Berklund, 188 Mont. 48, 610 P.2d 1168 (1980); Christian v. A.A. Oil Corp. and Byrne, 161 Mont. 420, 506 P.2d 1369 (1973); McDaniel v. Hagar-Stevenson Oil Co., 70 Mont. 156, 224 P. 870 (1924). This rule of construction is based on the recognition that the lessor is a passive participant in the lease and that the lessor wholly depends upon the good faith of the lessee to operate the lease in the mutual best interests of the lessor and lessee.

Ladd v. Upham, 58 S.W.2d 1037, 1039 (Tex.Civ.App. 1933)(Oil and gas leases are interpreted in the same manner as insurance policies are resolved between an insurance company and its customers.)

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.

Estate of Tawney v. Columbia Natural Resources, L.L.C., 633 S.E.2d 22, 28 (W. Va. 2006) The West Virginia Supreme Court held explicitly that "at the wellhead" language in a lease was insufficient to overcome the general rule that "the lessee must bear all costs of marketing and transporting the product to the point of sale."

Wood v. TXO Production Corp., 854 P.2d 880, 881 (Okla. 1992). The Supreme Court of Oklahoma determined that the lessee's duty to market the production implicates the lessee's obligation to render the gas marketable, especially where no cost sharing agreement between lessor and lessee dictates otherwise.

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.").

Clark v. Slick Oil Co., 211 P. 496 (Okla. 1922), the royalty clause in an oil and gas lease similarly provided that the lessee was "to deliver to the credit of the lessor . . . free of cost, in the pipeline to which lessee . . . may connect the well or wells, the equal one-eighth part of all oil produced and saved from the leased premises. Under this language the Court held that "[i]t was just as much a part of the duty of the defendant [the Lessee] under the contract to prepare this oil for market so that it would be received by the pipe line company as it was its duty to pump the oil from the wells or drill the wells. The plaintiff [the Lessor] had a right to demand his oil delivered in the pipe line, and the defendant's duty was not discharged until it was so delivered.

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.

Berthelote v. Loy Oil Co., 95 Mont. 434, 28 P.2d 187 (1933).In order to avoid lease cancellation for breach of the implied covenant to market, the burden of proof rests upon the lessee to establish that the lessee has acted with reasonable diligence.

Fey v. A. A. Oil Corp., 129 Mont. 300, 318-319, 285 P.2d 578, 587 (1955) In judging whether a lessee has complied with the implied covenant to market, Courts will examine whether the lessee has acted as a reasonably prudent operator to market the production in the mutual best interests of both the lessor and lessee.

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.