1707 North 9th Street
PO Box 5523
Bismarck, ND 58506-5523
Phone: (701) 328 – 2800
Fax: (701) 328 – 3650

https://land.nd.gov

DEPARTMENT OF ND TRUST LANDS
INVESTING FOR EDUCATION

Lance D. Gaebe, Commissioner

July 27, 2017

RE: Calculation of Gas Royalties

The Board of University and School Lands (Board) manages land, minerals and proceeds as trustee on behalf of permanent trust funds. This responsibility is for the exclusive benefit of constitutionally identified beneficiaries with much of the income used to help fund North Dakota schools and institutions. The Board also manages sovereign minerals for the State of North Dakota.

This letter addresses three important issues that have arisen with respect to the Board's collection of royalties under the terms of its standard oil and gas lease (Board's Lease). First, the Board has a fiduciary responsibility when it enters into an oil and gas lease and it must adhere to the terms that relate to the collection of oil and gas royalties. Second, the terms of the Board's Lease relating to the payment of royalties have remained unchanged for almost 40 years. Lastly, as a matter of fairness, the Board must enforce the terms of its lease consistently with each lessee.

The Board operates in a fiduciary role when it offers its leases at auction for the right to produce oil and gas from trust or State mineral lands. Through these auctions, lessees compete for the opportunity to enter into the Board's Lease, the terms of which are available to each potential bidder prior to the auction. The current version of the Board's Lease has been in effect since 1979. By its terms, the Board's Lease includes the Board's Oil and Gas Rules. Operators who produce the oil and gas under these leases calculate the royalties due on behalf of the Board's lessees and are required to do so in accordance with the terms of the Board's Lease. We must ensure all operators are paying all royalties due under this lease.

The Board's Lease requires gas royalties to be calculated "based on gross production or the market value thereof, at the option of the lessor, such value to be based on the gross proceeds of sale where such sale constitutes an arm's length transaction." Correspondingly, oil royalties are based on the greater of: "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…."

Recent Department of Trust Lands' oil and gas audits found that some operators have been improperly calculating gas royalties under the Board's Lease. Because of contrary interpretations of the Board's Lease, guidance was requested from the Office of the Attorney General. The resulting letter (attached) verifies that the Board's lessees are not allowed to deduct any expenses from the payment of gas royalties.

This clarification is neither a change in the Department's interpretation of the Board's Lease nor a new policy proposal, but merely a reiteration of the policy that has been in effect since 1979. Our records indicate that you are a lessee or submit royalties under the Board's Lease. The letter is shared with you, and all lessees and operators, to explain the gas royalty provisions in the Board's Lease and to provide an analysis of applicable case law.

Under the gross proceeds royalty provision, the lessee may not reduce royalty payments for expenses incurred prior to the sale of oil and gas. Royalties must be paid on the gross proceeds of sale, which is the total of the gross production multiplied by the sales price at the point of sale.[1] Expenses incurred in connection with the production and sale of the hydrocarbons must be borne by the lessee, including any percentage of proceeds deductions.

Many operators are currently paying gas royalties properly. This clarification is sent, in part, to provide fairness to these lessees and to offer guidance to lessees who are paying gas royalties improperly, on the proper method of payment. Applicable penalties and interest may be assessed on underpaid royalties.

On behalf of the Board, it is the Department's fiduciary responsibility to ensure that the trusts and State are appropriately compensated per the Board's Lease terms and that it is enforcing these terms consistently with all lessees. I reiterate that there has been no change to the Board's Lease pertaining to the payment of royalties based on gross proceeds since 1979.

Sincerely,

Lance D. Gaebe

Lance D. Gaebe

Enclosure: Office of Attorney General Letter regarding gas royalty payments (March 8, 2017)

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[1] As noted herein, oil royalties are based on gross proceeds if this is the highest of three values.

STATE OF NORTH DAKOTA
OFFICE OF ATTORNEY GENERAL
STATE CAPITOL
600 E BOULEVARD AVE DEPT 125
BISMARCK, ND 58505-0040
(701) 328-2210
www.ag.nd.gov

Wayne Stenehjem
ATTORNEY GENERAL

CIVIL LITIGATION
NATURAL RESOURCES
AND INDIAN AFFAIRS
500 NORTH 9TH STREET
BISMARCK, ND 58501-4509
(701) 328-3640 FAX (701) 328-4300

March 8, 2017

Taylor K. Lee
North Dakota Department of Trust Lands
1707 North 9th Street
PO Box 5523
Bismarck, ND 58506-5523

Dear Taylor:

The purpose of this letter is to provide lessees with the proper legal analysis of the Board of University and School Lands' (the "Board") lease (the "Lease") insofar as it relates to gas royalty payments in an arm's length transaction.[1] Lessees are inconsistently calculating gas royalties owed to the Board under the terms of its Lease. Some lessees are deducting various costs such as processing and transportation costs, while others are not. This letter provides the Board's legal analysis regarding gas royalty payments under its Lease and, accordingly, instruction for all lessees as to the proper method of calculating gas royalties.

Pursuant to Section 4(c) of the Lease, "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." Simply put, the gas royalty is based on the value of the gross production[2] unless the Board elects to take its royalty in-kind.[3] The value is determined by the gross proceeds of the sale of the gas. Because the royalty is based on gross proceeds, deductions are not allowed, including percent of proceeds.

The Lease provides for two payment options. Payment can be taken either in-kind or as a cash payment. *See Comm'r of Gen. Land Office v. SandRidge Energy, Inc.*, 454

[1] Non-arm's length transactions are governed by § 85-06-06-08 of the Board's rules.
[2] Paragraph 4(H) provides that royalty is not due on gas unavoidably lost, lessee's proportionate share of plant fuel, and on-lease fuel usage.
[3] Absent an in-kind payment election, the gas royalty shall be a cash payment.

S.W.3d 603, 613 (Tx. App. 2014) (interpreting Texas General Land Office lease's raw gas royalty provision granting the lessor the option to take payment based on gross production or the market value thereof). If the Board elects to take payment in-kind, paragraph 4(G) of the Lease requires that the Board give the lessee at least a 60-day notice of such election. If it does not elect in-kind payment, the lessee must pay royalties as a cash payment. As of this date, the Board has not elected an in-kind payment under any lease and, as such, is being paid royalties by cash payment from all lessees.

As previously noted, "gross proceeds" is the basis for the value component of the gas royalty payment. "Gross proceeds" does not allow for deductions of any kind. "Gross proceeds" is defined as income before deduction of expenses. *Black's Law Dictionary* 832 (4th rev. ed. 1968); *Webster's II New Riverside University Dictionary 550* (1984). "There are many cases construing the term 'gross proceeds' and they uniformly hold that the term means 'without deduction of any kind.' The key word is 'gross' and it is consistently construed as meaning 'all,' 'entire,' 'whole,' 'total,' or 'without deduction.'" *Brown, Royalty Clauses in Oil & Gas Leases: Their Nature, Construction & Remedies for Breach Thereof,* 14 S.W. Inst. on Oil & Gas L. Tax'n, 139, 161 (1965). *See Old Kent Bank & Trust Co. v. Amoco Prod. Co.*, 679 F. Supp. 1435, 1445 (W.D. Mich. 1988) ("The meaning of 'gross proceeds' is self-evident. It is the contract price settled on by the producer and the buyer [of the minerals produced]"). Consequently, the gas royalty payment must equal the total of the applicable royalty rate multiplied by the product of the gross production multiplied by the price actually received by the lessee at the point of sale. *See Judice v. Mewbourne Oil Co.*, 939 S.W.2d 133, 136 (Tex. 1996) (stating that inclusion of the term "'gross proceeds' means that the royalty is to be based on the gross price received by [the lessor]").

The North Dakota Supreme Court's decision in *West v. Alpar Resources, Inc.* is controlling over analysis of the Lease. In *West*, the Court held that the term "proceeds" was ambiguous as to the proper method of calculating a gas royalty payment. *West v. Alpar Res., Inc.*, 298 N.W.2d 484, 490 (N.D. 1980). Based on the Court's reasoning, however, inclusion of the term "gross proceeds" would have removed any such ambiguity. *Id.* According to the Court, gross proceeds means "proceeds without deduction for expenses." *Id.* Furthermore, inclusion of the term gross proceeds would also determine the appropriate point of sale. For instance, if the sale occurred at the wellhead there would be no deductions to charge to the lessor and, thus, a net or gross proceeds lease would yield the same results. If the sale occurred downstream, however, any deductions charged against the lessor would render the term "gross proceeds" indistinguishable from "net proceeds," in direct contravention to the reasoning in *West*. In other words, under a "net proceeds" lease, the royalty is calculated using the "work back method" and all expenses incurred from the leasehold to the point of sale are proportionately shared by the lessor and lessee. Because the Board's royalty is based on "gross proceeds," however, it must be "without deduction for expenses." *Id.*

North Dakota's status as an "at the well" state is irrelevant to the interpretation of the Board's gas royalty provision. *See Bice v. Petro-Hunt, L.L.C.*, 2009 ND 124, ¶ 21, 768 N.W.2d 496 (adopting the "at the well" rule). The "at the well" method of calculating royalties is a default position and does not control the interpretation of a lease that requires royalties to be paid based upon "gross proceeds." *See generally Bice*, 2009 ND 124, 768 N.W.2d 496 (applying "at the well" rule in interpreting a lease in which gas royalties are to be paid based on the "market value at the well"). That is, the Board and each of its lessees have elected to contract around the default "at the well" method by entering into leases that determine royalties based on "gross proceeds" of sale. *See Chesapeake Explor., L.L.C. v. Hyder*, 483 S.W.3d 870, 872 (Tex. 2016) (holding general rules may be modified by agreement of the parties to a lease). Consequently, the inclusion of the term "gross proceeds" in the Lease does not create any ambiguity that would require application of the default "at the well" method of payment and, therefore, requires payment without deduction.

Any reliance on the marketable product doctrine as a basis for allowing deductions is misplaced. North Dakota has expressly rejected the marketable product doctrine and, thus, it is inapplicable to an analysis of the Lease. *Bice*, 2009 ND 124, ¶ 21, 768 N.W.2d 496. Many states that follow the marketable product doctrine agree, however, that a royalty provision providing for payment based on "gross proceeds" generally does not allow for deductions. *Estate of Tawney v. Columbia Nat. Res., L.L.C.*, 633 S.E.2d 22, 28 (W. Va. 2006); *Mittlestaedt v. Santa Fe Minerals, Inc.*, 954 P.2d 1203, 1206 (Okla. 1998). These courts uphold deductions from royalty payments solely based on the marketable product doctrine and the theory that once a product is marketable, the lessor and lessee should share in the costs. Thus, it is reasonable to conclude that if these states did not follow the marketable product doctrine they too would prohibit deductions from royalty payments under a "gross proceeds" lease.

The Lease requires payment of gas royalties based on the gross production to be valued by the gross proceeds of sale. As such, it does not allow a lessee to deduct expenses from royalty payments, regardless of whether the gas is sold at the well or downstream. The North Dakota Supreme Court has held that the term "proceeds" in a royalty provision is sufficient to prohibit a lessee from deducting expenses from gas royalty payments. *West*, 298 N.W.2d at 490-91. In so doing, North Dakota has recognized the distinction between "gross" and "net" proceeds and does not allow for the deduction of expenses from a royalty payment if the provision was based on the value of gross proceeds. *Id.* at 491. Moreover, other states that follow the "at the well" rule, such as Texas, have rendered the same conclusion holding that gas royalties based on the price actually received by the lessee do not allow for deductions and that such language is the equivalent of royalty payments based on gross proceeds. *See Chesapeake Explor., L.L.C.,* 483 S.W.3d at 876; *Judice*, 939 S.W.2d at 136. Finally, the fact that a lessee may incur expenses that improve the value of gas after it is marketable does not control the interpretation of the Lease as North Dakota has rejected the marketable product doctrine.

Based on the foregoing, the Board's lessees are not allowed to deduct any expenses from the payment of gas royalties. The Board's royalty must be paid on the gross proceeds of sale, which is the total of the gross production multiplied by the sales price. Any expenses the lessee incurs in connection with the production and sale of the gas must be borne solely by the lessee, including any percentage of proceeds deductions.

Sincerely,

David Garner
Assistant Attorney General
(701) 328-3078
dpgarner@nd.gov

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