Gas Royalties

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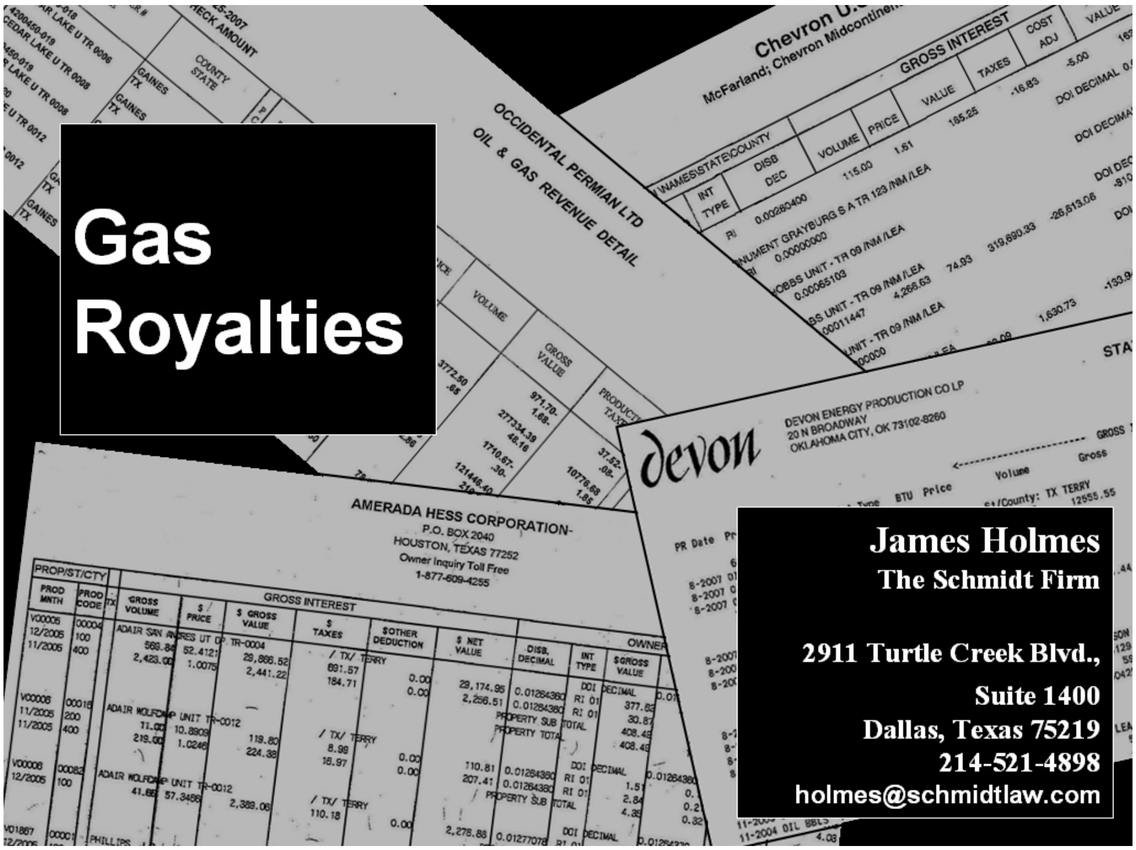

First Sketch

Ride the government's coattails! Encourage state or federal officials to rigorously enforce taxation laws and/or royalty-payment laws that force larger producers to pay either taxes or royalties to the government on true fair market value prices and free from unreasonable deductions. Competent state officials in Oklahoma, New Mexico and Wyoming have instituted successful litigation to force producers to measure and value oil and gas production fairly for tax purposes. *State ex rel. Okla. Tax Comm'n v. Texaco E. & P., Inc.*, 131 P.3d 705 (Okla. 2005); *Chevron U.S.A., Inc. v. State ex rel. Dep't of Taxation & Rev.*, 134 P.3d 785 (N.M. Ct. App. 2006); *Wyoming Dept. of Rev. v. Amoco Prod. Co.*, 7 P.3d 35 (Wyo. 2000). The federal government, through the Minerals Management Service in Denver, routinely engages in audits and, if necessary, in litigation in order to force producers to measure and value oil and gas production fairly for royalty-paying purposes. *E.g.*, *Amoco Prod. Co. v. Watson*, 410 F.3d 722 (D.C. Cir. 2006), *aff'd in part sub nom. BP Am. Prod. Co. v. Burton*, 127 S. Ct. 638 (2006). When the government acts, it establishes "benchmarks" and "target prices" for private royalty owners trying to obtain fair royalties and for independents trying to sell oil or gas on the best possible terms. Government action typically establishes precedents and publicly available pricing data, either of which royalty owners and independents can use in order to argue for better royalties and prices.

Encourage government action (so that you can ride the government's coattails). Adapt the letter below to your County and State officials who have the responsibility of drafting and/or enforcing tax laws relating to oil and gas production. Copy an oil and gas lawyer who represents royalty owners on the letter, so that he or she can give pointers as to how your particular State/County can use its laws to enforce taxes and royalties to be paid on true fair market prices and free from unreasonable deductions.

> Dear Representative ______ / Senator _______ / Lieutenant Governor ___________ / Speaker of the House __________ / Comptroller ___________ / Land Office Commissioner ______________ :
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> I am a royalty owner and member of your constituency. I am concerned about how certain large oil and gas companies – which own lucrative gas-transporting and gas-processing facilities in our State – interpret our tax laws in order to minimize, respectively, taxes paid to Counties, like ad valorem taxes, and severance taxes (or production taxes or extraction taxes) paid to the State. In short, these companies sell gas cheaply from their producing side (their "selling" side) to their transporting/processing side (their "buying" side). By

selling gas cheaply, they effectively minimize taxes paid to Counties and to our State.

Here's the bottom line: The less these companies pay, the more other taxpayers must pay in order to meet yearly County and State budgets. It's time to amend our tax laws or to enforce them more vigorously in order to make clear that such companies should pay County taxes and State taxes **on true fair market prices** – and not on prices they create between their "selling" and "buying" sides.

Here's how the tax-avoidance problem arises: a large oil and gas producer sells gas from the wellhead side, which it owns/controls, to the plant side, which it also owns/controls. By lop-siding wellhead-to-plant sales terms in favor of the plant side, the producer successful minimizes wellhead revenues from gas processing and marketing. By minimizing the wellhead gas revenues, the producer pays less in gas royalties, County taxes and State taxes – all of which depend on the wellhead side's revenues (and not on the plant side's revenues). **The producer, therefore, can shield substantial revenues from taxing authorities under its wellhead-to-plant arrangements – which it entirely creates and controls without input from taxing authorities.**

I request that you sponsor a bill, or support a bill sponsored by another, in order to disallow any wellhead-to-plant arrangements that depress not only my gas royalties, but County and State taxes and royalties as well. In short, our State should strictly and clearly forbid any wellhead-to-plant arrangements that enable a producer who owns/controls both the producing side (the "selling" side) and the transporting/processing side (the "buying" side) to pay taxes or royalties to our government on below-market prices and/or lessened by unreasonable deductions.

I further request that you encourage County and State auditors to enforce those portions of our tax laws that apply tax rates to **true fair market prices and free from unreasonable deductions**. County and State auditors or other persons who monitor tax revenues from oil and gas production can and should require full disclosure of the prices at which the larger oil and gas companies sell/transfer gas from their "selling" sides to their "buying" sides. Such audit work may reveal discrepancies that Counties or the State can address by way of tax-deficiency procedures and/or litigation.

I further request that you encourage County and State auditors to ensure that royalties paid to the State **are based on true fair market prices and are free from unreasonable deductions**.

30 C.F.R. 206.153, .156, .157 and .159 provide a good starting point for assessing true fair market prices in our Counties and State. Under 30 C.F.R. 206 and related sections, the federal government prevents producers that control

the wellhead side and the plant side from structuring arrangements that depress gas royalties and taxes. The federal government does not allow an producer to arbitrary remit low gas revenues to the wellhead side, paying lower royalties and local taxes thereon, while keeping the majority of such revenues in the plant side. How? In short, 30 C.F.R. 206 and related sections allow the producers to deduct from wellhead revenues only reasonable operating and maintenance expenses, overhead, and either depreciation or a reasonable return on plant investment. Also, such producers cannot deduct from wellhead revenues the costs associated with removing non-royalty-bearing substances, such as non-marketed CO_2 or gaseous inerts, unless they sell (market) such substances.

Our State and Counties need additional tax revenues and, where possible, greater royalty income**.** Legislative changes to our tax laws and more rigorous enforcement of existing tax laws will provide additional tax revenues and would eliminate "sham" agreements whereby producers that control both the wellhead side and plant side of a gas sale minimize taxes paid to the State and to Counties on oil and gas production.

Sincerely,

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Second Sketch

An "oil and gas lease" is a great misnomer. It is not a "lease" in a landlord-tenant sense of the word. Rather, it is a unique real estate conveyance – one that typically grants an interest in the oil and gas beneath the surface to a "lessee" (a producer), allowing the "lessor" (the grantor, the landowner) to retain surface rights and to receive a royalty share of oil and gas production (typically 1/8th), so long as the lessee timely finds and produces the oil and gas.

The lessor's surface rights typically yield to the lessee's mineral rights, whenever the two sets of rights conflict with each other. *See Duvall v. Stone*, 54 N.M. 27, 32, 213 P.2d 212, 215 (1949) ("In this state [of New Mexico] a grant or reservation of the underlying oil and gas, or royalty rights provided for in a mineral lease as commonly used in this state, is a grant or reservation of real property. Mineral royalty retained or reserved in a conveyance of land is itself real property." (citation omitted)).

"Each owner of land owns separately, distinctly and exclusively all the oil and gas under his land . . . ." *Elliff v. Texon Drilling Co.*, 210 S.W.2d 558, 561 (Tex. 1948). Put in a more "legal" way, the landowner has "absolute title in severalty to the oil and gas in place beneath his land." *Id.* If the landowner leases his minerals, as many American ranchers, farmers and governmental entities have done in favor of legacy producers, the landowner's lessee owns a "determinable fee" – a right to drill and produce the landowner's oil and gas subject to all lease provisions, including the ever-important royalty clause. When oil and gas production ceases, typically the lessee loses the mineral estate, which reverts in ownership to the rancher, farmer or government. *See Sun Oil Co. v. Madeley*, 626 S.W.2d 726, 732 (Tex. 1981) ("The lease conveys a determinable fee estate in the oil, gas and minerals to the lessee . . . ." (citation omitted)); *Rogers v. Ricane Enters.*, 884 S.W.2d 763, 766 n.2 (Tex. 1994) (construing an oil and gas lease as "[a] determinable fee . . . a property interest which is burdened by a provision in the conveyance providing for automatic expiration of the estate upon occurrence of an operative event [usually, the cessation of oil and gas production by the lessee], an event which may or may not occur").

Through case law, good courts strive to balance the rights of royalty owners (frequently called surface owners) and producers (mineral-estate owners):

> "[When] [t]he factual context is unique and there is no directly controlling precedent . . . this Court has led the way in conciliating conflicts between owners of the surface and of the mineral rights, and in requiring reasonable accommodations between them."
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> *Humble Oil & Ref. Co. v. West*, 508 S.W.2d 812, 815 (Tex. 1974).