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LIMIT CHARGES FOR GAS AND OIL POSTPRODUCTION COSTS

House Bills 5261 and 5262
(Substitutes H-2)
First Analysis (10-28-97)

Sponsor: Rep. Larry DeVuyst
Committee: Forestry and Mineral Rights

THE APPARENT PROBLEM:

The state has leased mineral resources drilling rights since 1927. Since the 1970s, oil and gas companies have been charging the state for certain costs, such as transportation costs, or the processing costs of natural gas. These charges are deducted as "post production costs" (PPCs) from the royalties paid to the state. Concern over inconsistencies in the manner in which PPCs were being deducted eventually resulted in the Department of Natural Resources (DNR) and the oil and gas industry working together to reach an agreement that defined and standardized which PPCs would be allowed. The agreement was reached on November 10, 1993, and it was intended that it apply to leases on state-owned land, and not to those involving private land. In 1996, further concerns over the types of PPCs oil and gas companies charge led the DNR to conduct audits on several oil and gas companies, to rescind the November, 1993, agreement, and to further reduce the types of PPCs that could be deducted. However, some private royalty owners claim that oil and gas companies have applied the terms of the 1993 agreement to privately held leases. Moreover, they have done so without renegotiating the terms of those leases with the landowners. Typically, royalty owners in Michigan receive one-eighth of the value of the oil or gas in royalty payments; the oil or gas company keeps the remaining seven-eighths. Lately, however, some royalty owners claim that PPC deductions have drastically reduced these royalty payments. Accordingly, legislation has been introduced to restrict PPCs to those currently allowed in leases on state owned land, require full disclosure of a producer's deductions, and block PPC deductions that are not specified in a lease.

THE CONTENT OF THE BILLS:

The bills would amend Part 615 of the Natural Resources and Environmental Protection Act (NREPA), which regulates oil and gas wells, to establish new procedures regarding oil and gas leases and the methods by which postproduction costs (PPCs) are charged. Among other provisions, the bills would limit allowable PPCs, require full disclosure of a producer's deductions, and prohibit PPC deductions that were not specified in a lease. Under the bills, a person who entered into a gas lease would have to provide the lessor with certain detailed information regarding gas production operations; an itemized accounting of all postproduction costs (PPC's); and monthly revenue statements that itemized all deductions taken from the lessor's royalty and the price received for gas that had been sold. In addition, House Bill 5261 would specify that a division order from a lessee could not alter or define the terms of a lease. (A "division order" is a document, prepared by the company that purchases oil or gas from an operator, that specifies how the proceeds of the sale will be distributed between the royalty owner and the operator, or lessee. The royalty owner and the operator must sign and return the division order to the purchaser to receive payment. "Division order" is not defined under the bill.)

House Bill 5261 would amend Part 615 (MCL 324.61503b) to specify that a person who entered into a gas lease as a lessee could not charge PPCs unless the lease explicitly allowed for the deduction, in which case, unless the lease explicitly and specifically provided for the deduction of other items, the deduction would be limited to the reasonable costs of the removal of carbon dioxide (CO_2), hydrogen sulfide (H_2S), or molecular nitrogen (N_2) removal; and transportation costs after the point of entry into any of the following:

• An independent, nonaffiliated, third-party-owned pipeline system.

• A pipeline system owned by a gas distribution company or any subsidiary of the gas distribution company, which is regulated by the Public Service Commission (PSC).

• An affiliated pipeline system, if the rates charged by it have been approved by the PSC, or if the rates charged are reasonable, as compared to independent pipeline systems, based on the pipeline system's location, distance, cost of service, and other pertinent factors.

House Bill 5261 would also specify that a person who entered into a gas lease as a lessee, and who planned to, or did, charge the lessor for any portion of postproduction costs would have provide the lessor with the following information:

• Detailed written information regarding all operations related to gas production associated with the property.

• A specific itemized accounting of all postproduction costs that the lessee proposed to assess, prior to assessing them.

House Bill 5261 would also specify that a division order from a lessee could not alter or define the terms of a lease.

House Bill 5262 would amend Part 615 (MCL 324.61503a) to specify that, beginning on the effective date of the bill, certain requirements would be placed on a person who entered into a gas lease as a lessee. Starting when production began, the lessee would have to provide the lessor with monthly revenue statements written in plain English that provided a specific itemized list of all deductions taken from the lessor's royalty; and, under the heading "Unit Price," the price received by the lessee per 1,000 cubic feet and 1,000,000 BTUs of gas sold and the name of the purchaser. The lessee would have to pay the lessor his or her proportionate share of the gross proceeds. In addition, when production began, a lessee would have to contract with a certified public accountant to prepare an annual audit. The audit would have to include any tax credits, or other tax or financial benefits received by the lessee for operations on the leased property; a list of all purchases and gas purchase prices by the lessee or by a subsidiary or affiliate of the lessee; and the name of the seller; and would have to be provided to all lessors of the audited property. The audit would be conducted at the lessee's expense.

FISCAL IMPLICATIONS:

According to the House Fiscal Agency (HFA) the bill could result in an indeterminate increase in state royalty revenues on governmental leases. Since no additional duties would be assigned to the supervisor of wells, there would be no increase in state costs. (10-21-97)

ARGUMENTS:

For:

PPCs were virtually unheard of before 1993. In November, 1993, an agreement was reached between the Department of Natural Resources (DNR) and the Michigan Oil and Gas Association (MOGA), specifying the types of PPCs that the DNR would allow oil and gas companies to deduct from state royalty payments. Since then, according to testimony presented in public hearings to members of the House Committee on Forestry and Mineral Rights, PPC deductions have reduced the royalty payments of some northern Michigan landowners who lease their mineral rights by one-half. Moreover, most royalty owners weren't notified of companies' decisions to deduct PPCs; they receive no accounting information explaining these costs; and their oil and gas leases contained no provisions allowing for such deductions.

According to the DNR, it was intended that the 1993 agreement would standardize which PPCs would be permitted as deductions from royalty payments to the state. According to MOGA, however, the agreement confirmed that the point of gas sales has changed. Gas was historically purchased by utilities at each wellhead (the point at which the well is drilled); and PPCs -- the cost of gathering, treating, and transmission -- was reflected in the price they paid. This is no longer the case. That is, gas is now purchased by utilities away from the wellhead, at the point of delivery, and the PPCs that are incurred in order to deliver the gas to the point of sale are included in the cost. PPCs are then deducted from the sale price of gas to determine the value at the wellhead.

The bills would serve to clear up existing confusion on this matter. Indeed, most participants in the issue -- including MOGA -- agree that it is unfair that the accounting methods established by some oil and gas companies should be applied to private leases. More important, it is unfair that oil and gas producers should arbitrarily decide which PPCs they will deduct from royalty payments. In fact, most leases do not specify that PPC deductions may be made; they usually specify that the lessee agrees to pay a percentage of the *gro*ss proceeds for gas produced at the wellhead.

Against:

Rather than solve existing problems, the bills could serve to create a new set of confusing issues. First, House Bill 5261 would specify that, if an existing lease allowed the deduction of PPCs, then the lessee could only deduct PPC costs for certain items, including certain transportation costs and the costs of removing some impurities. Some have pointed out that this provision would, in effect, allow the conditions of an existing lease agreement to be altered retroactively. Such a measure would likely be challenged in court by oil and gas producers. Second, House Bill 5262 would specify that, when production began, a lessee would have to contract with a certified public accountant (CPA) to prepare an annual audit for lessors. However, some have pointed out that no specific standards are prescribed by the accounting profession for this type of audit.

Against:

The bills would add new sections to Part 615 of the Natural Resources and Environmental Protection Act (NREPA). This would create a conflict, according to the Department of Environmental Quality (DEQ): it would have the effect of placing the provisions under the oversight of the supervisor of wells (the DEQ), and departmental staff would have to be doubled to handle the required supervision. Also, it is pointed out that Part 615 of the act does not, strictly speaking, pertain to this type of legislation. Rather, Part 615 regulates the unnecessary waste of oil and gas resources.

POSITIONS:

The Michigan Farm Bureau supports the bills. (10-21-97)

The Michigan Environmental Council (MEC) supports the bills. (10-22-97)

The Michigan Land Use Institute supports the bills. (10-22-97)

The Michigan Energy Reform Coalition supports the bills. (10-22-97)

The Department of Environmental Quality (DEQ) supports the concept of the bills, but has concerns over provisions that would allow existing leases to be altered retroactively. (10-21-97)

The Michigan Oil and Gas Association (MOGA) supports the concept of the bills, but has concerns over provisions that would require existing leases to be altered retroactively, as well as provisions that would require lessees to provide audits, for which there are currently no standards. (10-21-97)

Shell Oil Company supports the concept of the bills, but has concerns over the legal issues raised by the DEQ and by MOGA. (10-21-97)

The Department of Natural Resources (DNR) has no position on the bills. (10-21-97)

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