House Legislative Analysis Section

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# SPECIFY PPCs IN GAS AND OIL LEASES

**House Bill 5262 as enrolled**
**Public Act 127 of 1998**
**Second Analysis (1-27-99)**

**Sponsor: Rep. Larry DeVuyst**
**House Committee: Forestry and Mineral Rights**
**Senate Committee: Economic Development, International Trade and Regulatory Affairs**

## *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. 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.

It was intended that the 1993 agreement between the DNR and the industry apply to leases on state-owned land, and not to those involving private land. 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 require full disclosure of a producer's deductions.

## *THE CONTENT OF THE BILL:*

House Bill 5262 would amend Part 615 (MCL 324.61503a) of the Natural Resources and Environmental Protection Act (NREPA), which regulates oil and gas wells, to specify that, beginning 12 months after the effective date of the bill, certain requirements would govern the conditions of gas leases: a person who entered into a gas lease would have to provide the lessor with 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. The provisions would apply to gas leases entered into both before and after the effective date of the bill. If a well began continuous gas production after the effective date of the bill, the provisions would be effective after production began. If a well began continuous gas production on or before the effective date of the bill, the provisions would be effective on the bill's effective date. House Bill 5262 is tie-barred to House Bill 4259, which was not enrolled. (This means that House Bill 5262, Public Act 127 of 1998, will not take effect.)

Itemized Deductions. Under the bill, a lessee would have to provide a lessor who had an interest in the leased property with monthly revenue statements, written in plain English, that provided all of the following:

• Under the heading "Unit Price," the price received by the lessee per 1,000 cubic feet or 1,000,000 BTUs of gas sold. The lessee would have to pay the lessor his or her proper share of the gross proceeds or value, as provided in the lease.

• An itemized list of all deductions taken from the lessor's royalty; and the purpose of those deductions. Deductions could be grouped under general categories provided that a separate itemized statement of the deduction was made available upon written request.

Estimated Deductions. The provisions of House Bill 5262 would not prohibit a lessee from estimating deductions for a calender year, or other 12-month accounting period, provided that this was disclosed in the monthly revenue statement or in the separate itemized statement. If an estimate *were* used, the actual amount would have to be determined, and any necessary adjustments made, within 180 days after the end of the calendar year or other 12-month accounting period. The lessee could also place an amount in reserve to cover costs until actual costs had been determined.

Annual Accounting of Gas Sales. Under the bill, after production began, monthly revenue statements and payments would have to be initiated promptly, after the division of interest between the entitled parties was determined, unless a valid agreement between the lessee and the lessor provided otherwise.

Deferred payment to Lessors. Payment could be deferred for the following reasons:

• The absence of a marketable record title put the lessor's entitlement in question.

• Any circumstance that could expose the lessee to the risk of multiple liability, or liability to a third party.

• The mailing address of the lessor, or place where payment should be made, was unknown.

• Royalties totaling less than $50 at the end of any month.

## *FISCAL IMPLICATIONS:*

The Department of Environmental Quality (DEQ) estimates that the provisions of the bill would have an indeterminate impact on state funds. The bill would require an increase in staff responses to answer complaints and inquiries from lessors about royalty payments and statements. However, the DEQ also reports that the bill might lessen conflict between lessors and lessees, thus decreasing the demand on staff time. (4-28-98)

The Senate Fiscal Agency (SFA) reports that the bill would have no direct fiscal impact on the state. However, the SFA also notes that the additional accounting information required on oil and gas production under the bill could alter the amount of royalties collect by the state for leased mineral rights. (3-20-98)

The House Fiscal Agency (HFA) estimates that the bill would have no fiscal impact on the state, since the bill's provisions regarding leases are currently required in leases between the department and oil and gas companies. (1-27-99)

## *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. MOGA, however, interpreted the agreement mainly as confirming 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 bill 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:***
The bill 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.

***Against:***
The bill does not go far enough. In testimony presented by northern Michigan landowners in public hearings, members of the House Committee on Forestry and Mineral Rights heard allegations that PPC deductions have sometimes *exceeded* the value of the royalty payments due the landowners. Accordingly, House Bill 5262, as introduced, was part of a package of legislation that, among other provisions, would have limited the categories of costs that could be deducted from royalty payments.

***Response:***
The provisions of the package of legislation that included House Bill 5262, as introduced, would have, in effect, allowed the conditions of existing lease agreements to be altered retroactively. Such a measure would likely have been challenged in court by oil and gas producers.

***Against:***
House Bill 5262 is tie-barred to House Bill 4259. That bill is similar to House Bill 5262 in that it specifies that, if any reductions in royalties are allowed under a least agreement due to PPCs, then the lessee must provide the lessor with a detailed and itemized list of these PPCs. House 4259 differs from House Bill 5262 in that it would have granted injunctive relief to petitioners in cases where lessees failed to comply with the criterion. At any rate, since the bills were tie-barred, and one was not enrolled, the end result is that this bill will not take effect.

Analyst: R. Young

■This analysis was prepared by nonpartisan House staff for use by House members in their deliberations, and does not constitute an official statement of legislative intent.