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MINERAL RESOURCES: REGULATE PPC CHARGES

House Bill 4280 with committee amendment
House Bill 4281 (Substitute H-1)
First Analysis (10-19-99)

Sponsor: Rep. Larry DeVuyst
Committee: Conservation and Outdoor Recreation

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. In response to concerns of royalty owners who claimed that PPC deductions had drastically reduced these royalty payments, a package of legislation was introduced in the 1997-98 legislative session which, among other provisions, would have limited the categories of costs that could be deducted from royalty payments to those currently allowed in leases on state owned land, and established penalties for failure to comply with these provisions. The package of legislation included Public Act 127 of 1998, which required full disclosure of a producer's deductions. Though enacted, Public Act 127 could not take effect, since it was tie-barred to a bill – House Bill 4259 of 1997 – that was not enrolled. Now legislation has been introduced to repeal this tie-bar and to reintroduce the other provisions of the proposed 1997-98 legislation.

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 gas leases and the methods by which postproduction costs (PPCs) are deducted from a lessor's royalty. Among other provisions, the bills would limit allowable PPCs and establish penalties for failure to comply with these limits. The bills are tie-barred to each other, and would take effect 90 days after enactment.

Public Act 127 of 1998 specifies, among other things, that a person who enters into a gas lease must provide the lessor with certain detailed information regarding gas production operations, and an itemized accounting of all postproduction costs, monthly revenue statements that itemized all deductions taken from the lessor's royalty payments and the price received for gas that had been sold. Though enacted, Public Act 127 could not take effect, since it was tie-barred to a bill (House Bill 4259 of 1997) that was not enrolled. (A "tie-bar" is a provision that specifies that a bill cannot take effect unless other specified legislation is also enacted.) House Bill 4281 would amend Public Act 127 to repeal the tie-bar, so that the 1998 act could take effect.

PPC Charges. Further, House Bill 4281 would amend Part 615 (MCL 324.61503b) to specify that a person who enters into a gas lease as a lessee could not charge

PPCs unless it was explicitly allowed in the lease, in which case the deduction would be limited to the following:

*The reasonable costs of the removal of carbon dioxide (CO_2), hydrogen sulfide (H_2S), molecular nitrogen (N_2), or other constituents, except water, the removal of which would enhance the value of the gas for the benefit of the lessor and lessee.

*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); or an affiliated pipeline system, if the rates charged by it had been approved by the PSC, or if the rates charged were reasonable, as compared to independent pipeline systems, based on the pipeline system's location, distance, cost of service, and other pertinent factors.

*House Bill 4281 would also specify that a lessee who entered into a gas lease prior to, or after, the effective date of the bill, and who charged the lessor for any portion of postproduction costs, would have to notify the lessor, in writing, that a specific itemized explanation of all postproduction costs that the lessee proposed to assess was available.

Unit Areas. The bill would also specify that a lessee could not charge PPCs incurred on gas produced from one drilling unit, pooled or communities area, or unit area, against a lessor's royalty for gas produced from another drilling unit, pooled or communities area, or unit area. (The bill would define "unit area" to mean the formation or formations that were unitized and surface acreage that was a part of the unitized lands, as described in either the plan for unit operations approved by order of the supervisor of wells, or in an applicable agreement providing for unit operations.

Division Orders. House Bill 4281 would also specify that a division order from a lessee could not alter or define the terms of a lease unless both parties expressly indicated their intention to amend it voluntarily and explicitly in a signed document, or documents. In addition, a lessee could not precondition royalty payments upon a lessor who signed a division order, or other document stipulating how production proceeds were distributed, except as provided under the bill. As a condition for the payment of royalties under a lease, other than one granted by the state, a lessee or other payors would be entitled to receive a signed division order from the payee, containing only the following provisions (unless others had been voluntarily agreed to by both parties in a signed document or documents that expressly indicated their intention to waive the provisions of the bill):

*The effective date of the division order.

*A description of the property from which the oil or gas was being produced, and the type of production.

*The fractional or decimal interest in production, or both, claimed by the payee; the type of interest; the certification of title to the production share claimed; and, unless otherwise agreed to by the parties, an agreement to notify the payors at least one month in advance of the effective date of any change in the interest in production owned by the payee, and an agreement to indemnify and reimburse the payors for payments, if the payee did not have merchantable title to the production sold.

*The authorization to suspend payment to the payee for production until the resolution of any title dispute or adverse claim that had been asserted regarding the production interest being claimed by the payee.

*The name, address, and taxpayer identification number of the payee.

*A statement that the division order did not amend any lease or operating agreement between the interest owner and the lessee or operator, or any other contracts for oil or gas purchases.

House Bill 4280 would amend Part 615 (MCL 324.61503c) to establish the following penalties for failure to comply with the provisions of the bills.

*A knowing violation of the provisions would be punishable by a civil fine of up to $1,000. A default in the payment of a fine, costs, or an installment of the fine or costs, could be remedied by any means authorized under the Revised Judicature Act.

*The attorney general, or the lessor of a gas lease, could bring an action in circuit court for injunctive relief or damages, or both.

*Each day a violation continued would constitute a separate offense for five days only. In addition, a violation that affected more than one lessor with an interest in the same well, pooled unit, or unitized area, would constitute only one offense.

*A lessor could recover PPC amounts in damages in situations where a court found that the PPCs had been deducted in violation of the provisions of House Bill 4281. However, if a court found that the position taken by the nonprevailing party in the litigation was frivolous, then the party who prevailed could recover reasonable attorney fees.

*A person could not bring an action without first giving the lessee a written, reasonably comprehensive, notice of the alleged violation, and allowing at least thirty days for the lessee to cure the alleged violation.

FISCAL IMPLICATIONS:

According to the House Fiscal Agency (HFA), the bills would each result in an indeterminate increase in state revenues from royalties on oil and gas leases entered into by the state. However, revenues would depend on the scope and amount of post production costs (PPCs) related to each oil or gas lease and the market value of the oil and gas produced. (10-18-99)

ARGUMENTS:

For:

House Bill 4281 would repeal the tie-bar on Public Act 127 of 1998, and also restrict post production costs (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. 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 in 1997, 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. The Michigan Oil and Gas Association (MOGA), however, interpreted the agreement mainly as confirming that the point of gas sales had 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 *gross* proceeds for gas produced at the wellhead.

For:

In addition to repealing the tie-bar on Public Act 127 of 1998, House Bill 4281 would address concerns that were raised over certain provisions of Public Act 127: northern Michigan landowners had protested that PPC deductions have sometimes *exceeded* the value of the royalty payments due them. Accordingly, Public Act 127, 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. This limitation was omitted from the enrolled 1998 legislation, but has been reinstated under House Bill 4281. Moreover, the bill stipulates that restrictions on PPC deductions apply only to leases entered into after the effective date of the bill. This stipulation should alleviate concerns that the provision might be interpreted as allowing existing lease agreements to be altered retroactively.

Against:

As written, the bills raise some questions. For example, should the provisions of the bills be placed under Part 615 of the Natural Resources and Environmental Protection Act (NREPA)? The Department of Environmental Quality (DEQ) points out that Part 615 of the act does not, strictly speaking, pertain to this type of legislation. Rather, Part 615 charges the supervisor of wells with regulation of unnecessary waste of oil and gas resources.

Also, under the bills, penalties would be established for failure to comply with the new provisions. However, the bills also specify that each day a violation continues would constitute a separate offense for five days only. Some people might be encouraged to continue violations for longer periods under this latter provision, since no additional penalties would be incurred.

Response:

The bills, as written, do not require oversight by the supervisor of wells. House Bill 4280, however, would permit the attorney general or the lessor of a gas lease to bring action in circuit court for injunctive relief and/or damages. According to the DEQ, the supervisor of wells *would* act in these situations, but only by withholding permits when a court ruled against the lessee. Also, according to testimony presented before the House committee, violations typically do not come to light until several days have passed, so violators would typically be penalized for five days.

Against:

The penalty provisions established under the bills for violations of provisions concerning gas leases are inadequate. In the past, it has been noted that it may be more economical for companies to pay fines than to comply with environmental regulations. Therefore, a much higher penalty than $1,000 should be imposed. In fact, Public Act 127 of 1998 was part of a package of legislation that, as introduced, would have provided a civil fine of up to $25,000 for such violations.

Response:

In testimony before the House committee, representatives of the Michigan Oil and Gas Association (MOGA) reported that the average value of the gas produced at a gas well is $200 per day. Therefore, it would be unfair to assess higher penalties on operators for violations.

Rebuttal:

A gas yield valued at $200 per day is equal to $73,000 per year. Furthermore, the life of a well is 15 to 20 years. Therefore, a fine of $25,000 should not be considered excessively high.

POSITIONS:

The Department of Environmental Quality (DEQ) supports the bills. (10-15-99)

The Michigan Environmental Council (MEC) supports the bills. (10-15-99)

The Michigan United Conservation Clubs (MUCC) supports the bills. (10-14-99)

The Michigan Oil and Gas Association (MOGA) supports the bills. (10-18-99)

The Michigan Land Use Institute supports the bills. (10-18-99)

The Michigan Manufacturers Association (MMA) has no position on the bills. (10-18-99)

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