

GAS & OIL; POSTPRODUCTION COSTS

House Bill 5709 (Substitute H-2) First Analysis (5-23-00)

**Sponsor: Rep. Larry De Vuyst
Committee: Conservation and Outdoor
Recreation**

THE APPARENT PROBLEM:

Landowners (including the state) may lease mineral interests in property to companies that explore for and extract the oil and gas deposits below the surface. Landowners receive rent and bonuses for the "purchase of the lease", and royalties on any hydrocarbon production that occurs. The landowner's royalty interest in the well is defined in a lease, and represents the landowner's share of the hydrocarbon production, minus production expense. The Department of Natural Resources manages the state's holdings and has written a state lease for leasing state-owned oil and gas minerals. Lease contracts that define agreements between oil and gas producers and private citizens may incorporate provisions of the state lease, but there is no requirement that the language of the state lease be used in private contracts. Lease contracts define payments, and royalty percentages, and provide for the deduction of certain postproduction costs that are applied against royalties.

In response to concerns from private landowners, the legislature in 1998 and 1999 added provisions to the Natural Resources and Environmental Protection Act governing lease arrangements involving the extraction of minerals. Among other things, the act specifies that a person who enters into a gas lease cannot deduct from the lessor's (landowner's) royalty any portion of postproduction costs unless the lease explicitly provides for such deductions. Further, if a lease explicitly provides for the deduction of postproduction costs, the lessee may only deduct for certain specified items (items that are listed in the statute, including the reasonable costs of removal of carbon dioxide, hydrogen sulfide, molecular nitrogen, or other substances whose removal will enhance the value of the gas, and certain specified transportation costs), unless the lease explicitly and specifically provides for the deduction of other items.

In addition, if a court finds that a lessee deducted postproduction costs from a lessor's royalty in violation

of the act's requirements, a lessor may recover damages in the amount of wrongly deducted postproduction costs, and a party who prevails in litigation under this provision may recover reasonable attorney fees incurred in bringing an action, if the court finds that the position taken by the nonprevailing party was frivolous. Some people believe that requiring a landowner (the lessor) to prove that the oil or gas producer's position is frivolous sets a standard for recovery of attorney fees that is too high.

THE CONTENT OF THE BILL:

The bill would amend the Natural Resources and Environmental Protection Act to rewrite the provision governing the awarding of attorney fees in actions involving wrongly deducted postproduction costs. It would specify that a lessor could recover reasonable attorney fees incurred in bringing an action to recover wrongly deducted postproduction costs, unless the lessee endeavored to cure the alleged violation before the court action was initiated, and that a lessee who prevailed in litigation could recover reasonable attorney fees incurred in defending an action brought under the provision if the court found that the lessor's action was frivolous.

324.61503b and 324.61503c

FISCAL IMPLICATIONS:

Fiscal information is not available.

ARGUMENTS:

For:

The bill would clarify the attorney fee provision of the part of the NREPA that deals with litigation over postproduction costs. It would make the standard for recovering attorney fees easier for a landowner to meet, and it might have the effect of reducing litigation

altogether, as it could encourage oil and gas companies to attempt to cure the disputed violation of the statute before litigation commenced. It has been pointed out that most lessors are small landowners and have fewer resources for litigation than does a large corporation.

Against:

The bill should go further. As introduced, it would have deleted language allowing for the deduction of postproduction costs other than those listed in the statute. This would provide further protection for landowners who must negotiate individually with companies. Mineral lease arrangements are often complex; it is possible for deductions for postproduction costs to *exceed* the royalty payments due to the landowners.

Response:

The oil and gas industry opposes the broader change; it supports the right of parties to contract for royalties on any basis they choose, as long as the language is specific and explicit.

POSITIONS:

The Michigan Oil and Gas Association supports the bill. (5-18-00)

Analyst: D. Martens

■ 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.