

SOUTHWEST KANSAS ROYALTY OWNERS ASSOCIATION
Excerpts from SWKROA Newsletters
(Emphasis added)

MARCH,1996:

Regulatory Changes Influence Gathering Charges.

The natural gas industry has undergone a fundamental restructuring in the past decade. Until the mid-1980s, the normal arrangement under which gas was marketed in the Hugoton and Panoma/Council Grove Fields in Kansas was through a federally-regulated sale occurring at or near the wellhead by the producer to the pipeline company. The pipeline company would then transport the gas and re-sell it to a local distribution company near the point of ultimate consumption.

With the advent of a series of regulations issued by the Federal Energy Regulatory Commission, together with the passage by Congress of an act which **decontrolled the federal wellhead pricing, a multitude of different arrangements for the sale of gas have now developed.**

In some instances, the producer **no longer sells the gas at the wellhead to the pipeline company.** Rather, it often makes its first sale of the produced gas near or at the point of consumption, using the same pipeline company (which had previously purchased the gas) to transport the gas. In such arrangement, the **producer pays the pipeline company for its services** in connection with the transportation of the gas.

In other arrangements, the **producer, (or a subsidiary, or sister company) may gather the gas from various wells and then place that gas into the pipeline system, at which point the gas is sold - either to the pipeline company (or a subsidiary, or a sister company), the distribution company, or the ultimate consumer of the gas.** Another example would be when the gathering system is owned by a party unaffiliated to the producer, and the producer is charged for gathering costs. There are numerous other possible arrangements for the sale of gas.

How Do These Arrangements Affect the Royalty Owner?

In many instances, unlike the past, there is frequently no specific gas purchase contract under which gas from a particular location is sold. The producer, rather, commits to deliver a certain quantity of gas to a specific location, sometimes far away from producing gas fields, to the buyer of that gas. Unlike in the past, it is often impossible to trace a molecule of gas produced from a particular well to the fulfillment of any particular gas purchase contract.

Formerly, producers generally paid royalty owners one-eighth of the market value or proceeds they received from the sale of gas under a contract to which the royalty owners' lands were committed. Because of the new contractual arrangements, no specific gas purchase contract can easily be identified as the one under which a specific royalty owner's gas was produced and sold.

On What Basis, Then, Does the Producer Calculate Royalty Amounts?

As far as can be ascertained, producers have begun to use a variety of starting points when calculating royalty payments, including reference to various spot gas price indexes or the weighted average price under several gas purchase contracts. A royalty owner will find no indication on his royalty check stub of how the beginning price was determined for purposes of royalty calculation or whether the price being paid is contrary to the terms of the lease.

The situation becomes even more complicated in view of the fact that the price noted on the royalty owner check stub sometimes is not the beginning price upon which royalty was calculated. The price reflected on the royalty check stubs may be the number left after deduction of certain expenses. In some instances, those deductions, without complete explanations, are noted on royalty check stubs, but often, they are not.

The deductions (disclosed or not) sometimes taken by producers are for charges such as compression, gathering, transportation, and marketing. The propriety of these deductions has over the years been the subject of court cases.

LEGISLATION NOW PENDING BEFORE THE KANSAS LEGISLATURE.

Senator Stephen R. Morris, Hugoton, introduced Senate Bill 472 (S.B. 472) at the request of SWKROA. The bill which at times has been referred to as the "Truth In Royalty" bill prescribes information to be included with payments to interest owners, including royalty owners, from production of oil and gas. The Bill has met with opposition, particularly from the Kansas Independent Oil & Gas Association (KIOGA). Below are excerpts of your Secretary's testimony on February 1, 1996 before the honorable members of the Senate Committee on Energy and Natural Resources. Senator Don Sallee, Troy, Kansas, serves as chairman of this committee.

"PROBLEMS WITH ROYALTY REMITTANCE STATEMENTS

"As Executive Secretary, I receive questions from our members on various issues which effect their royalty interests. Over the years, the Secretary's office has probably received the most complaints from information, or the lack thereof, provided to our royalty owner members from the gas and oil companies. The royalty remittance statement is generally the only regular communication from the gas and oil companies with regard to production of their mineral rights.

"When a royalty owner does not understand information provided to him on his royalty remittance statement he must try to contact the company for an answer. I believe from the feedback of comments by members of our Association that in many instances the royalty owner was either not able to receive a satisfactory answer, or was very frustrated with the run-around by persons who could not answer their questions. Other members contact us first to see if we can answer their question. However, in most instances, we are unable to provide our members with satisfactory answers regarding such remittance statements. We usually must advise them to contact their oil and gas lessee to further clarification. As a result of incomplete answers, confusion in understanding the answers, and in general the frustration of trying to obtain the information, our members often become skeptical and naturally untrusting in their dealings with their lessees and with information, or lack of information, provided to them by the gas and oil companies.

"FURTHER EXAMPLES OF PROBLEMS

"It is impossible to determine whether the price reported on the royalty remittance statement is a net or gross amount. (This also may be a similar problem for the starting point to determine the price for the State to collect for severance taxes, ad valorem taxes, and the KCC assessment fee.) **We must take it on blind faith that the price reported on the royalty remittance statement is correct.** We support S.B. 472 so that the payors on oil and gas production would be required to provide information on how the price reported on the remittance statement was calculated or determined.

"Likewise, the volumes of gas and oil reported on the remittance statements may cause confusion or may be inaccurate. I have had several instances where a royalty owner has tried to verify the production figures reported on the remittance statement with the production/allowable reports filed with the Kansas Corporation Commission. **The information which was obtained from the Commission did not jibe with the remittance statement.**

"Now that the Federal Regulatory Energy Commission (FERC) has "unbundled" services and allowed open access to the pipelines, it is more likely that more than one working interest owner in a gas unit will market its own share of the gas produced from the unit. As such the royalty owner could receive more than one royalty check for production from the same well. I know that this does not sound like a bad problem to have, but such a situation makes it impossible, without explanation by the producer, whether the volumes of gas and oil shown on the remittance statement represent the full production volumes, or if the volumes had been adjusted to reflect just that particular working interest owners' production from the well. The royalty owner's decimal interests may be similarly adjusted without explanation, making it impossible to verify whether

they had received proper credit for the production from the well. S.B. 472 should help to alleviate these problems.

"Also allegedly due to the recent changes in the Federal and State regulatory environment, the royalty owners have noticed that charges for costs such as gathering, compression, processing, and transportation are now showing up on the royalty remittance statements, with little or no explanation. Some of these charges may not even be proper deductions, but when there is not an explanation on the remittance statement, or if the gas and oil companies do not provide an adequate answer, it is impossible to determine whether the charges are proper.

"... It is difficult or impossible to determine from the statement the location of the well, the name of the well, or the producing formation. Such information would be very helpful in tracking royalty production and payments.

"In summary, we urge your consideration and support of a bill which will require payors of oil and gas production to provide information which will allow the royalty owner to clearly identify the amount of oil or gas produced, and the amount and purpose of each deduction made from the gross amount due to such royalty owner."

Nordling Meets with "Industry" on S.B. 472.

Secretary Nordling met with a dozen representatives of the oil and gas producers, in Wichita, Kansas, on March 8th to discuss the merits of S.B. 472, and the need for legislation in this area. Many of the representatives felt that their companies were either currently providing the requested information, or the royalty owners should be able to calculate or determine all of the information from the stub. Several also admitted that they were providing some of the requested information.

Nordling advised them that often the royalty owners must make numerous computations to decipher the remittance statement, or they become confused at the manner the information is reported to them on the remittance statement, or they can not make proper computations or determinations because of missing information.

One problem which may effect SWKROA members is where more than one working interest owner in a gas unit markets their share of the production from a well. This may be referred to as a "split stream sale." In such situation, the royalty owner may receive royalty checks from more than one working interest owner for production from the same well. As you can imagine, it becomes quite confusing to figure out the true production from the well. Often the decimal interest and/or the volumes sold are inflated or deflated to account to the royalty owner. It is

impossible for the royalty owner to determine the true volume and decimal for such production.

Kansas Independent Oil and Gas Association (KIOGA) and its representatives who were present, indicated they will continue to oppose the bill and suggested that the industry and the royalty owners further study the problem.

Status of S.B. 472.

It doesn't appear that any action will be taken on S.B. 472 this legislative session, even though the bill is still "alive." SWKROA officials will continue to work toward the passage of a favorable bill. Members are requested to contact their senator or representative on this important legislation.

JUNE, 1996

LEGISLATIVE PANEL DISCUSSES HIGHLIGHTS FROM 1996 KANSAS LEGISLATIVE SESSION

After complimenting Mr. Beren and the BEREXCO Exploration Team on its excellent presentation, President HAYWARD introduced a three member Kansas legislative panel composed of State Senator STEVE MORRIS, R-Hugoton, Senator JERRY MORAN, R-Hays, and Representative EUGENE SHORE, R-Johnson. President Hayward requested the legislative panel to discuss highlights from this year's Kansas legislative session, including the task force on gas gathering, the bill introduced to require more specific information on royalty remittance statements, the minimum royalty bill, and the 35-mill school levy.

Gas Gathering Issue

Senator Morris discussed the gas gathering issue and its importance to the Hugoton Field and southwest Kansas and the oil and gas industry in general.

He explained that about two years ago, the Federal Energy Regulatory Commission (FERC) decided it would no longer regulate gas gathering and would leave it up to the states to start regulating gas gathering facilities. Morris explained that gas gathering includes everything from the wellhead to the interstate system and observed that the southwest Kansas area has more gathering lines than anywhere else in the state.

Because of the complexity of so many issues involved, Morris advised that the legislature decided a comprehensive study was needed on gas gathering, and a bill was passed to establish a Gas Gathering Task Force consisting of 14 members. Two of the members will be *ex officio*

and non voting, while the remaining 12 members will have voting powers.

The two *ex officio* members will be the Chairman of the Kansas Corporation Commission and the other an expert in oil and gas law appointed by the governor. The 12 voting members will be four legislators: (1) the Chairperson of the Senate Energy and Natural Resources Committee or designee of the Chairperson; (2) the Chairperson of the House Energy and Natural Resources Committee or the chairperson's designee; and (3) and (4), the ranking minority members of each of those two committees or their respective designees. Governor BILL GRAVES will appoint the eight remaining members, including one person each representing royalty owners, irrigators, independent gas producers, gas gathering companies affiliated with major pipeline companies, major gas producers, intermediate gas gatherers, independent gas gatherers, and a county appraiser.

The governor is required to make his appointments before June 1 and the Task Force is scheduled to meet, starting in July and meeting through December.

The task force is charged with at least 16 separate issues. Senator Morris expressed his concern that, "If they're not careful, gas gathering, transmission charges, compression charges, and other charges will end up being subtracted from the wellhead price which would significantly impact the royalty owners."

Secretary's note: Since the annual meeting, Governor Bill Graves has appointed SWKROA Executive Secretary ERICK E. NORDLING as the royalty owner representative on the Gas Gathering Task Force. The first meeting of the task force is scheduled for July 25, 1996.

Senator Morris briefly discussed a bill he introduced this session which would require all companies to furnish more accurate information to royalty owners on royalty remittance statements. He stated that most of the major producers indicated their willingness to go along with such a bill, but that, unfortunately, some of the independents thought it was too much paperwork for them and consequently, the bill was held up for further study and will be one of the issues to be discussed by the Gas Gathering Task Force.

AUGUST, 1996

IMPORTANT GAS GATHERING TASK FORCE MEETING IN LIBERAL NEXT MONTH

The Gas Gathering Task Force, created by action of the 1996 Kansas Legislature to study issues relating to deregulation of the natural gas gathering systems in Kansas, met for the first time in Topeka last month. One of its next meetings will be held in Liberal on September 18, 1996, and we encourage our members to attend and participate in this important meeting.

Gas Gathering Task Force Members

As mentioned in the June 1996 SWKROA newsletter, the Gas Gathering Task Force consists of 14 members and is chaired by State Senator DON SALLEE, R-Troy. The four legislative representatives are Senator SALLEE; Representative JOANN FREEBORN, R-Concordia, Vice-chairperson; Senator BILL WISDOM, D-Kansas City; and Representative ROBERT KREHBIEL, D-Pretty Prairie. The two non voting ex officio members are TIMOTHY E. McKEE, Chairman of the Kansas Corporation Commission, Topeka, and JON R. VIETS, of Independence, an expert in oil and gas law.

The eight remaining members, appointed by Governor BILL GRAVES, are ERICK E. NORDLING, of Hugoton, Executive Secretary of the Southwest Kansas Royalty Owners Association, representing royalty owners; RANDAL K. LODER, of Garden City, board member of the Southwest Kansas Irrigation Association, representing irrigators; STEVE M. DILLARD, of Wichita, Vice President of Pickrell Drilling Co., Inc., representing independent gas producers; MARI M. RAMSEY, of Tulsa, counsel for Williams Field Services, representing gas gathering companies affiliated with major pipeline companies; EMERY J. BIRO, III, of Houston, Senior Attorney for Anadarko Petroleum Corporation, representing intermediate gas gatherers; CHARLES B. WILSON, of Wichita, Vice President of BEREXCO, INC., representing independent gas gatherers; EDWIN E. HANCE, of Irving, Texas, Manager of Engineering and Development, Mesa Operating Co., representing major gas producers; and ANN PAPAY, of Ulysses, County Appraiser for Grant, Haskell, Stanton and Stevens counties, representing county appraisers.

Among the sixteen specific gas gathering issues to be studied by the Task Force which will greatly affect royalty owners and irrigators in the Hugoton Field are:

1. Implications of gas gathering for royalty owners;
2. Concerns about adequacy of information reported on royalty check stubs, including non-price issues;
3. Implications for irrigators in the region;
4. Implications for county property tax base and associated concerns; and
5. Implications for the Department of Revenue's collections of the severance tax.

The above issues are of vital concern to SWKROA members and citizens living in Southwest Kansas.

JULY, 1997

KANSAS CORPORATION COMMISSION CHAIRMAN IS KEYNOTE SPEAKER

TIMOTHY E. McKEE, of Wichita, Chairman of the Kansas Corporation Commission (KCC), was our keynote speaker. He did a very commendable job covering the new natural gas gathering legislation, infill drilling, and current development activities of the mineral resources in Southwest Kansas.

McKEE was appointed to the Kansas Corporation Commission on June 2, 1995, by Governor Bill Graves for a four year term. He has served as Chair of the three-member Commission since April 5, 1996. Prior to joining the Commission, McKee practiced law in the state and federal courts in Kansas and before the Tenth Circuit Court of Appeals, with primary emphasis on natural resources law.

Gas Gathering

McKEE informed the audience of the grassroots leadership role by SWKROA and irrigation interests in the passage of legislation to create regulations for natural gas gathering activities in Kansas. The issues were many, complex and controversial. Some legislative commentaries noted that this legislation was the most active and lobbied legislation of the session.

Natural gas gathering is the process of getting natural gas from the wellhead through a series of gathering pipelines, compressors, and treatment facilities until the gas has been gathered, compressed and placed into a quality acceptable to the main transmission pipeline companies. Prior to legislation of gas gathering in Kansas, gathering pipelines were either subject to federal jurisdiction (Federal Energy Regulatory Commission - FERC) or were not regulated.

FERC recently had ruled that the states should be responsible for regulating gathering lines. The gas gathering legislation passed by the Kansas Legislature this past session establishes such regulations.

According to McKEE, "At the ends of these pipelines are fingers or tentacles for the gathering systems that take the gas from the wellhead to the transportation system."

McKEE reported that FERC decided about two years ago it was removing itself from the gas gathering regulation business. FERC reasoned that since the pipeline gathering systems are located in the states, the states should regulate such systems. FERC made it clear if the states didn't get busy and do something, it would do something.

McKEE commented, "I want to compliment ... the agri-royalty owner industry... It was generally a fight between the producers and the pipelines. They were standing over here arguing. While they were standing on the curb arguing about it, a little parade went down the street behind them in a cloud of dust and it was the irrigators and the ag users, and they took the issue and got a bill."

[**Secretary's Note:** Although the royalty owners are being charged for gathering and other expenses to place the gas into quality for pipeline transmission, Association officials have strongly maintained that the costs incurred in placing the gas in a marketable condition, including gas gathering, are not proper deductions from the royalty interest. Because the natural gas gathering legislation is perceived by many to affect the royalty interests, it was very important for the Association to participate in the legislative process.

The new gas gathering law became effective on July 1, 1997. From the royalty owner and irrigator perspective, the legislation contains provisions for price transparency (information sufficient to determine what charges are being made), and standing for royalty owners who have been impacted by gathering charges to obtain information on such charges and a mechanism to complain to the KCC about gas gathering services which would not be just, reasonable, not unjustly discriminatory and not unduly preferential.]

DOUG SMITH SPEAKS ON LEGISLATIVE ACTIVITIES ON BEHALF OF SWKROA

DOUG SMITH, Pinegar-Smith Company, of Topeka, reported to SWKROA members and guests on the successful legislative struggle which resulted in the passage of a number of bills. For several years, the Pinegar-Smith firm has been providing the Association services to monitor the Kansas legislative sessions and to lobby, if needed, on issues which might impact the Association.

Smith praised the efforts of the Association through its Executive Secretary, ERICK NORDLING, and Assistant Executive Secretary, BERNARD NORDLING, and several SWKROA Directors and SWKROA members who provided timely and powerful testimony to the legislators. "We made a lot of inroads," he confirmed.

The two most significant measures passed included the royalty owner "check-stub bill" (Senate Bill No. 147) requiring producers to provide the royalty owner with information on production figures and the costs taken out. (The key provisions of the bill have been reported in earlier SWKROA Newsletters and, space permitting, a final version of the bill will be reported in a later newsletter.)

This bill was presented as an industry/royalty owner compromise and should have sailed through the legislative process. However, it ran into difficulty by a few key legislators on the provision which allowed for the state district courts to have discretion to award costs, attorney's fees and expenses of a royalty owner for enforcement of the law in the event a producer would not provide the mandated information. This critical provision was removed from the bill which gave us a victory, but no teeth for enforcement. The bill was signed by Governor Graves and will become effective as of January 1, 1998.

The second major issue was the gas gathering bill, which ultimately became a part of a conglomeration with other bills, and was passed by the legislature as Senate Bill No. 333. Smith reported that the gas gathering bill provides for a complaint-based process of oversight of gas gathering throughout Kansas. The bill also includes price transparency provisions which require producers and gas gatherers to list their prices and service fees so customers can determine if the rate they are paying fees which are "just, reasonable, not unduly discriminatory, and not unduly preferential."

"We made a lot of progress," Smith concluded. "People say it's heavy-handed legislation but it's only heavy-handed if you abuse the system."