SENATE BILL 98-159 Signed into Law May 15, 1998 at 8:39 am

Fact Sheet: Payment of Royalties

"Those gray areas in Colorado Law that allow frivolous law suites"

Colorado Revised Statutes 34-61-118.5, (2.3) Payment of proceeds says, "Every payment of proceeds derived from the sale of oil, and gas or associated products shall be accompanied by information that includes, at a minimum:

(b) **"The month and year during which the ~~sale~~ PRODUCTION occurred for which payment is being made;**
   a. *"The month and year of the "sale" can only be determined by the royalty payer. Royalty owners have no way to verify the dates or volume sold by royalty payers . The gas/oil belongs to the working interest owner when it leaves the meter. Royalty owners should be paid based on the month of production.* ***After the commodity leaves the meter, producers can store, use, give away or hedge it.***

(c) **"The total quantity of product ~~sold~~ PRODUCED attributable to such payment, including the units of measurement for the PRODUCTION AND sale of such product, AND THE AMOUNT AND DISPOSITION OF ANY UNSOLD PRODUCT"**
   a. *Currently we are being paid by three entities. One reports the volume they say they sell, prior to 2005 one reported 100% of what was reported to COGCC as produced, and the other reports the amount reported sold on Form 7.*
   b. *Gas is used at the compressor. Very little if any is used at the well. When the gas leaves the well meter it enters gathering lines that belong to the gathering company. The compressor also belongs to the gathering company.*

(d) **"The price received per unit of measurement, which will be the price per barrel in case of oil and the price per thousand cubic feet (MCF) or per million British Thermal Units (MMBTU) in the case of gas."**
   a. *The question is where the price received for gas is determined. The point of sale to an unaffiliated party? The market price is the point where it can be sold on the open market. They say now there is no market at the wellhead, but one company pays us at the wellhead, and recently informed me that they sell under a long-term contract to the gathering company.*
   b. *I have graphed SIX weighted average prices, received monthly, as royalty, with prices available through Colorado Oil & Gas Conservation Commission (Colorado Index, Colorado Interstate Gas, and Colorado Weighted Average) and the "pass through" commodity price (regulated by the PUC) from a Wray, Colorado consumer utility bill. There is as much as $.90 difference in prices paid by royalty payers in a given month.*

The difference between what Colorado royalty owners are paid and what Colorado consumers pay may need some study.

c. **Several statutes may need to be changed to make prices verifiable. The Colorado Public Utilities Commission, County Assessors, the Department of Revenue and royalty owners must have access to true and honest prices.**

(e) "The amount of Severance Taxes and any other production taxes or levies applied to the sale."

a. **The instructions for filing severance tax needs to be revised. One place it says "stripper wells are exempt", another place it says producers are to withhold 1% of gross from all wells. There really isn't any reason for withholding any severance when 87.5% of ad valorem withheld is more than the severance tax would be.**

b. *This allows all taxes to be lumped together as Production Taxes.*

c. *As of April 2006 this one may cause a stir. One company operating in Yuma County reported on the Department of Revenue DR21-W for 2005 that they withheld no ad valorem and recognized no stripper wells that are exempt from severance tax in the State of Colorado.*

   i. *The Royalty Owner's Severance Tax due was over $1400. Research proved that all wells were stripper wells*

   ii. *In recent years the rules applied to payment of Ad valorem on production has changed from paid on Gross to the allowance of deductions for certain expense. It is called "Net-Backing". Because of this rule change, the company had withheld enough from 2001 through 2004 to cover all the ad valorem that would be due in 2006.*

   iii. *Deductions allowed by Netback Valuation are determined by The Colorado Department of Property Taxation.*

(From the royalty payer's viewpoint, they had to withhold ad valorem the year of production, to be valued the next year, and paid in the next. The rules changed. They didn't have to pay as much as they estimated. Crediting the excess back to each royalty owner would be a bookkeeping and reporting nightmare, just to give each a small amount that they would have to withhold the next year.)

d. *When 2 or more companies make royalty payments, on the same wells, the percent of gross that is deducted for severance and ad valorem is unique to each company.*

   i. *Total Ad valorem withheld from royalty payments for 2000 thru 2005 was around* ***6% of gross.*** *Mill levies average about 6%, but ad valorem is only paid on 87.5% of gross, and now it is adjusted by "Net Backing".*

(f) "The payee's interest in the sale expressed as a decimal and calculated to at least the sixth decimal place."

a. **Changing the measurement from the amount sold to the amount produced would eliminate the problems described below.**
b. *On Division Orders the percentage to be paid by each payer totals to 100% of the payee's share, as defined by the lease and ownership of minerals.*
   i. *One company pays the DO percent and adjusts the company gross by an "adjustment factor" that is the percent of their working interest they sold of the total produced.*
   ii. *One company pays the percent from the Division Order of the production reported to COGCC minus the gas that is used.*
   iii. *The other company divides the percent from the Division Order by their working interest in the well and reports only the volume they sell.*
   iv. *If you think this is confusing, you are right.*

(g) "The payee's share of the sale before any deductions or adjustments made by the payer or identified with the payment."

a. *This is the royalty owner's gross. When dividing by the royalty owner percentage should net a Company Gross that differs a little from the stated gross because volumes are often rounded and prices averaged. If you multiply the volume stated by the listed price to get a Company Gross, and then divide the gross royalty by this company gross, the percentage paid use to be very close to the stated royalty percentage. If it was greatly different someone made a mistake somewhere. Usually it was mine. Now one company pays a decimal they call Sales Decint. It is the percent listed on the Division Order divided by the companies working interest, not by the percent of RI they disburse.*

(2.5) "Upon written request by the payee, submitted to the payer by certified mail, the payer shall provide to the payee within sixty days a written explanation of those deductions or adjustments over which the payer has control, and for which the payer has information, whether or not identified with the payment. This requirement shall not preclude the payer from answering the inquiry by referring the pay to the royalty clause or payment provision in a lease or other agreement."

What does this mean, and what good does it do?

A payee simply doesn't know, and can't prove, what has been deducted from the volume or price. We do have this one example where we can prove that enough "production tax" was withheld to cover the ad valorem that was denied by the producer. All we got from the company was the simple statement, "It is Company Policy."

When I contacted the Company that paid the lowest prices in 2005 to ask why, the answer was, "Obviously, we didn't do as good job of marketing."

If a payee signed a lease, or agreement, that lets the working interests deduct transportation, gathering, etc, they gave the producer a blank check.

Those who signed a lease (years ago) where production cost were not mentioned, and the Supreme Court Ruled that production costs should not be

deducted (see Garman vs. Conoco Inc., Case # 94SA191, Dec. 5,1994 and Rogers v. Westerman Farms, Colorado Supreme Court Case # 99SC293, about July 2001) it is a different story. Costs should not be deducted from royalties no matter how they do it.

On most property this RI owner owns 1/3 of 75%. On property where minerals and/or land are owned by someone else, he owns as little as .781253 %, the most is 4.166667%. In other words he owns such a small percent of production, that his interests are "frivolous" to the producers.

This whole statute needs some teeth.