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DEPARTMENT OF ND TRUST LANDS
INVESTING FOR EDUCATION

Lance D. Gaebe, Commissioner

January 12, 2012

RE: Request for Public Comment Related to the ND Board of University and School Land's Oil and Gas Lease Royalty Rate

A land grant from the federal government at statehood and Article IX of the State Constitution both provide that the Board of University and School Lands (Board) shall manage those lands, minerals and the proceeds there from, for the exclusive benefit of the institutions for which they were granted. The ND Department of Trusts Lands (Department) manages the permanent educational trust funds and assets under the Board's control as outlined in the Constitution and Century Code. In addition, state law gives the Board and Department responsibility for managing mineral resources for designated non-permanent trusts as well.

This correspondence relates to management of mineral acres under the Board's authority – more specifically, the royalty rate associated with the Board's oil and gas leases. The royalty rate for all oil and gas leases issued by the Department is currently 1/6. At the Land Board's January 4, 2012 meeting, the Commissioner proposed adjusting the royalty rate to 3/16, to bring the rate more in line with the royalty rate received by fee owners in western North Dakota.

The Commissioner sited the following reasons for adjusting the royalty rate at this time:

- A recent analysis of leases recorded in western North Dakota showed that 2/3 of fee leases had royalty rates of 3/16 or more.
- The analysis of recorded leases also showed that more than 75% of leases were for terms of 3 years or less, making the Department's 5 year lease more valuable to lessees.
- A large amount of acreage (833 tracts totaling 73,000 acres) is up for lease at the Department's February 2012 mineral lease auction. If production is initiated on these tracts, royalty will be held at less than market rates for years to come.
- The high success rate of Bakken/Three Forks wells has resulted in companies being willing and able to pay substantially higher royalty rates than in the past.

Historically, the Board has not set or established the market for royalty rates in North Dakota; however, the Board has a fiduciary responsibility to the trusts it manages to seek and receive fair royalty rates for the leases it issues.

When the royalty adjustment was proposed, the ND Petroleum Council (NDPC) expressed concerns that raising royalty rates could impact exploration in areas with new or marginal production. The Board directed the Department to invite comment on royalty options. During subsequent discussions, a number of suggestions were proposed, including the following.

1. **A variable royalty rate, by county, where the rate would vary from 1/6 (16.67%) to 1/5 (20%), depending on certain thresholds in exploration.** Thresholds that could result in a royalty rate of 1/6 might include counties with production of less than 100,000 barrels per month, or less than 4 active rigs, or less than 35% of Department minerals under lease. A threshold that could be used to establish a 20% royalty rate might be those counties with more than 50,000 BOPD of production.

2. **A variable royalty rate, that would vary from 1/6 (16.67%) to 1/5 (20%) depending on how far a tract is from current oil and gas production**. This type of rate structure was used from the 1980s until 2008. An example of how this might work would be to require a 1/6 royalty on leases more than 20 miles from current production, a 3/16 royalty between 5 and 20 miles from current production, or a 1/5 rate if it is within 5 miles of current production.

3. **A variable royalty rate, where the rate would be determined based on the formation from which a well produces.** Wells drilled to the Bakken/Three Forks formation could receive a 3/16 royalty rate while wells drilled to the Madison, Red River or other formations could receive a royalty rate of 1/6. This could be accomplished by:

    a) leasing only 50' above and 50' below the Bakken/Three Forks formation at a 3/16 rate, then leasing remaining formations separately at a 1/6 rate, or

    b) writing into the lease that if a well is drilled in the Bakken/Three Forks formation it would have a 3/16 royalty rate, but if it was drilled to other formations, it would have a 1/6 royalty rate.

The Commissioner believes that a variable royalty rate that provides for a higher rate in prolific production areas and a lower rate in less established production areas (Options 1 and 2 above) is logical, and would bolster trust revenues. Either approach could encourage development in marginal areas while allowing the trusts to benefit from an increased royalty in areas where "the market" warrants a higher rate. Such a system would be relatively easy to manage, as royalty rates would be established at the time the lease is issued.

Determining a royalty rate based on Option 3 can be done, but it would be more complicated to implement and manage for both industry and the Department. Under option 3a, each mineral tract would be divided into two; a Bakken/Three Forks portion, and an all other formations portion. Under Option 3b, the royalty rate for each well would not be determined until such time that a well was drilled and the producing formation was known. The Commissioner believes that Option 3a could potentially generate more combined royalty and bonus revenue than either Options 1 or 2, while Option 3b would generate less total revenue than either Option 1 or 2.

The Commissioner believes that the 3/16 royalty rate recommended to the Land Board for all new leases creates an appropriate balance between the Board's fiduciary responsibility of generating revenues for the trusts, and encouraging development of the trusts' mineral assets.

While an increase to 3/16 across the board may result in slightly smaller bonus collections in areas without active production, it would likely result in higher royalty revenues when those marginal areas are developed. It would also have less potential to reduce bonuses in established production areas than the 20% royalty discussed in Options 1 and 2.

Please submit comments to landinfo@nd.gov or mail to ND Department of Trust Lands, PO Box 5523, Bismarck, ND 58506-5523. In order to be considered by the Department and the Land Board, comments must be received by January 20, 2012.