Approved: April 30, 2003
Date

MINUTES OF THE SENATE ASSESSMENT AND TAXATION COMMITTEE

The meeting was called to order by Chairperson David Corbin at 11:25 a.m. on April 3, 2003, in Room 519-S of the Capitol.

All members were present except:

Committee staff present: Chris Courtwright, Legislative Research Department
Shirley Higgins, Committee Secretary

Conferees appearing before the committee: Steve Johnson, ONEOK Field Services
Ron Hein, Pioneer Natural Resources U.S.A.
Dennis Stell, Duke Energy Field Services
David Bleakley, Eastern Kansas Oil and Gas
Joan Wagnon, Secretary, Kansas Department of Revenue

Others attending: See attached list.

SB 267–Oil and gas percent of proceeds gas purchase contracts

Senator Corbin noted that the Chairman of the Senate Ways and Means Committee requested a hearing on **SB 267**. However, there were no conferees in support of the bill present.

Steve Johnson, representing ONEOK Field Services (OFS), testified in opposition to **SB 267**. He contended that the bill, in all probability, would be impossible to implement because the intent is unclear. He discussed the advantage of a Percent of Proceeds (POP) agreement, noting that the POP agreement is a standard contract form which has been used for many years to purchase natural gas from producers. Due to the difficulty of making a definitive calculation using the language in **SB 267** and OFS's desire to leave the negotiation of contracts between the parties involved, Mr. Johnson requested that no action on the bill be taken until OFS has an opportunity to gain a more thorough understanding of the intent of the bill and offer further comments. (Attachment 1)

Ron Hein, representing Pioneer Natural Resources U.S.A., testified in opposition to **SB 267**. In his opinion, the bill would ultimately result in reduced revenue to both royalty owners and the state. He explained that, under current POP contracts, royalty owners and the state generally share in the increased value of the bi-products of processing and also share the risk that the net value obtained from processing will not exceed the net value of the wellhead sale. The bill would place all the risk of POP contracts, even those entered into in good faith, upon the producer. By altering the risk/reward balance of these contracts, gas which could and should be processed will not be processed, causing a loss to producers, royalty owners, and the state. In conclusion, Mr. Hein noted that the sponsor of the bill is aware of the concerns about the proposal and agrees that the issue should be studied by an interim committee. (Attachment 2)

Dennis Stell, Duke Energy Field Services (DEFS), testified in opposition to **SB 267**. At the outset, he informed the Committee that he is currently responsible for the natural gas gathering and processing (G & P) activities of DEFS in Kansas. He discussed the following types of contracts for compensation for services provided by G & P companies: (1) fixed fee, (2) variable fee, (3) percent of index (POI), (4) two part payment percent of proceeds (POP), and based on indices (POPI). He noted that POI and POP-POPI contracts are beneficial to G & P companies because they provide some upside opportunity when prices are favorable, and they benefit producers because, when prices go down, so does the dollar amount retained by the G & P service provider. In his opinion, depending on the pricing environment, POP contracts can actually increase the amount of severance taxes paid. To illustrate, he referred to a table attached to his written testimony. In conclusion, Mr. Stell expressed his concern that the bill would outlaw a type of contract that best aligns the interest of producers and G & P companies. He observed that, although the intent of the bill may be to extract additional taxes and royalty payments from producers, the result of the bill may be to further discourage new drilling and investment by producers to extend the lives of existing wells. Over time, this will contribute to premature abandonment of wells and loss of recoverable reserves. (Attachment 3)

MINUTES OF THE SENATE ASSESSMENT AND TAXATION COMMITTEE at 11:25 a.m. on April 3, 2003, in Room 519-S of the Capitol.

David Bleakley, Eastern Kansas Oil and Gas (EKOG), testified in opposition to **SB 267**. As a producer and gas gatherer, EKOG consulted with many persons to find which type of agreement most fair to the gas producer, gas gatherer, and the royalty owner. The overwhelming recommendation was the POP contract. EKOG has found that the POP works very well compared to a fixed price. For the Committee's further information, Mr. Bleakley called attention to a copy of a letter addressed to the Committee from Jon R. Viets, an attorney who recommended the POP agreement not only to EKOG but also to many royalty owners, producers, and gas gatherers. Mr. Viets concludes, "If the legislature believes the severance tax scheme needs to be fixed, then it should enact a tax on the volume of gas, without reference to price. If the Legislature believes royalty owners should receive higher royalty shares than those specified in the underlying oil and gas leases, it should do so by open fiat." (Attachment 4)

Senator Corbin called attention to informational material on **SB 267** provided by Bob Krehbiel, Kansas Independent Oil and Gas Association. (Attachment 5) In addition, written testimony in opposition to **SB 267** was submitted by Douglas L. Lamb, President of Quest Resource Corporation, (Attachment 6) and Erick E. Nordling, Executive Secretary, Southwest Kansas Royalty Owners Association (Attachment 7).

There being no others wishing to testify, the hearing on **SB 267** was closed.

HB 2416–Amnesty from assessment or payment of penalties and interest on certain unpaid taxes

Senator Corbin pointed out that **HB 2416** went through the House on the Consent Calendar.

Joan Wagnon, Secretary, Kansas Department of Revenue, explained that the Department has implemented a two-phased tax amnesty program, with Phase 1 beginning in early February. In Phase 1, the Department is exercising its existing authority to settle disputed matters, including those pending before the Office of Administrative Appeals, the Board of Tax Appeals, or in the judicial review process. Phase 1 involves an aggressive campaign to pursue settlement negotiations on pending assessments prior to June 30, 2003. Secretary Wagnon explained further that the Secretary of Revenue has the authority to waive penalty but never interest. **HB 2416** will provide legislative authority beginning on July 1, 2003, to implement Phase 2, which will involve a tax amnesty program to be conducted this coming fall to offer waiver of penalties and interest to taxpayers with accounts in collection or who are non-filers or under-reporters if the underlying taxes are paid in full in one payment rather than through a payment plan. The purpose of the amnesty program is to convert as many outstanding accounts receivable as possible into much needed revenue during the first half of Fiscal Year 2004. (Attachment 8) Secretary Wagnon noted that the revised positive fiscal impact on the State General fund resulting from the amnesty program is $19.5 million for Fiscal Year 2004. In addition, she pointed out that the bill does not create new taxes but rather deals with tax liabilities that are currently due and owing.

Following brief questions and comments from the Committee, the hearing on **HB 2416** was closed.

Senator Haley moved to recommend **HB 2416** as favorable for passage, seconded by Senator Lee. The motion carried.

The meeting was adjourned at 12:00 p.m.

No further meetings are scheduled.

SENATE ASSESSMENT AND TAXATION COMMITTEE
GUEST LIST

DATE: April 3, 2003

NAME	REPRESENTING
Ron Hein	Pioneer Natural Resources USA Inc
Scott Schneider	GBBA
Steve Johnson	KS Gas Service / ONEOK
Whitney Damron	KS Gas Service / ONEOK
Dennis Stell	Duke Energy Field Services
Jack Glaves	" " " " "
David Bleakley	EKOGA & Colt Pipeline LLC.
Bob Krehbiel	KIOGA
Tom Bruno	EKOGA
Ken Peterson	KS Petroleum Council
Natalie Bright	WIBA
Jackie Clark	Hallmark
Bill Brady	KS Gov't Consulting
John Frederick	Boeing
Tom Day	KCC
Marsha Strahm	CWA
[illegible]	KTLA
Karl Peterjohn	KS Taxpayers Network
Hal Hudson	NFIB/KS

SENATE ASSESSMENT AND TAXATION COMMITTEE
GUEST LIST

DATE: April 3, 2003

NAME	REPRESENTING
Steve Stotts	Revenue
Ron Gaches	GBBA

Before the Senate Assessment and Taxation Committee
SB 267
Testimony of Steve Johnson
Manager, Governmental Affairs
ONEOK, Inc.
April 3, 2003

Chairman Corbin and Members of the Committee,

Thank you for the opportunity to address your committee this morning about our understanding of SB 267 and how this could affect our businesses in Kansas.

ONEOK is a diversified energy company based in Tulsa, Oklahoma and is the parent company of Kansas Gas Service and ONEOK Field Services, the two divisions that have field operations in Kansas. ONEOK Field Services (OFS) is a midstream gas gatherer and processor that operate gathering and processing facilities in Kansas, Oklahoma, and Texas.

Senate Bill 267 as written, is unclear as to its intent and as a result probably impossible to implement. It is OFS' position there is considerable value to all parties in a Percent of Proceeds (POP) agreement. The advantage of a POP agreement is that the producer and the gatherer/processor share in both the rewards and risks associated with processing. The result of which is the producer and processor's interests are economically aligned. Under a POP agreement as gas and natural gas liquids prices increase, the revenues received by each party increase, as do taxes and royalty receipts. Conversely, as prices decrease so do the revenues, taxes and royalty receipts. POP agreements are one of the standard contract forms that have been used for many years to purchase natural gas from producers.

At this time, due the difficulty of making a definitive calculation using the language in SB 267 and our desire to leave the negotiation of contracts between the parties involved, we would request the opportunity to make further comment, at a later time, after we gain a more thorough understanding of the intent of this legislation.

Thank you for your continued attention to our Industry and I will be available for questions.

100 West Fifth Street • Tulsa, OK 74103-4298
P.O. Box 871 • Tulsa, OK 74102-0871

Senate Assessment & Taxation
4-3-03
Attachment 1

HEIN LAW FIRM, CHARTERED

5845 SW 29th Street, Topeka, KS 66614-2462
Phone: (785) 273-1441
Fax: (785) 273-9243

Ronald R. Hein
Attorney-at-Law
Email: rhein@heinlaw.com

Testimony re: SB 267
Senate Assessment and Taxation Committee
Presented by Ronald R. Hein
on behalf of
Pioneer Natural Resources U.S.A., Inc.
April 3, 2003

Mr. Chairman, Members of the Committee:

My name is Ron Hein, and I am legislative counsel for Pioneer Natural Resources USA, Inc. Pioneer is one of the largest independent exploration and production oil and gas companies in North America, with major natural gas production in the Hugoton field in Southwest Kansas.

Pioneer opposes SB 267. Although I am aware of the intent of the sponsor of this legislation, which I view as attempting to maximize value to royalty owners and to maximize value of severance tax receipts for the state of Kansas, I believe that this legislation would ultimately result in reduced revenue to both royalty owners and to the state.

Currently, a great deal of gas is sold at the wellhead and severance taxes and royalty payments are paid based upon the price of that natural gas at the wellhead. Pioneer and many other producers, however, in appropriate situations, do not sell large quantities of their gas at the wellhead, but transport gas to a processing plant and process it, thereby separating the raw natural gas as produced at the wellhead into several different types of fuel, including natural gas, methane, ethane, propane, helium, and other bi-products of the raw natural gas. This processing involves providing additional downstream services after severance of the gas, including gathering, transportation, and processing all performed at additional cost to the producer, for the purpose of adding value to the gas over and above its value at the wellhead. The severance tax was never intended at any point to tax oil or natural gas downstream, but was intended to tax the gas as it was "severed" from the ground.

Producers often enter into "percentage of proceeds" or "POP" processing contracts whereby they allow the processor to keep a percentage of the processed liquids, and/or a percentage of the liquids and a percentage of the residue gas, as payment for processing services rendered. When that is done, the producer receives at the tailgate of the processing plant reduced percentages of processed gas components and pays royalties and severance taxes on the proceeds received upon its sale of its reduced percentages of those components. Such contracts are entered into with the expectancy that the reduced percentages of liquids and residue gas available to the producer after processing will produce more net revenue than would have a sale of the gas at the wellhead without processing. On rare occasions, however, when the price of gas is disproportionately

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high relative to the price of liquids, the net revenue obtained from a POP contract can be less than the net revenue that would have been received from a wellhead sale.

Currently, royalty owners and the state generally share in the increased value of the bi-products of processing and, concomitantly, share in the risk that the net value obtained from processing will not exceed the net value of the wellhead sale.

This legislation, as I understand it, is an attempt to try to insure that the royalty owner incurs no risk with such contracts, and will receive the value pursuant to the percentage contract **only if** that value is in excess of what the royalty owner might otherwise have received if the contract had been for purchase of the raw natural gas at the wellhead. But, if the producer is to take all the risk associated with POP contracts for only a proportionate part of the benefits, processing opportunities will not be taken and, ultimately, royalty owners and the state will receive less than they are currently receiving. It needs to be realized that producers are in the business of securing the maximum net value that can be obtained for their production, and producers enter into these arrangements only when they think it will produce additional revenue. While producers may not always be right, in the end, royalty owners and the state are best served by relying upon the judgment of the producers. Where that judgment is unreasonably or negligently exercised, royalty owners are not without remedy - they can always bring a suit for failure to reasonably market. It is not appropriate for government to substitute its business judgment for the business judgment of those in the gas marketing business on how best to market gas.

In the end, this legislation would place all the risk of POP contracts, even those entered into in good faith, and those reasonably determined to be beneficial and prudent at the time they were executed, upon the producer; and, by altering the risk/reward balance of these contracts, cause gas which could and probably should be processed, to not be processed, at a loss to producers, to royalty owners and to the state.

We understand that it is the intent of the chair to simply hold a hearing on this issue at this point, and to review this subject over the interim. We also understand that the sponsor is aware of some of the concerns about this legislation and is likewise willing to have this legislation be reviewed over the interim. We applaud the sponsor and the chairman for their understanding on the issue, and we look forward to working with the sponsor, this committee, and the interim committee on this issue.

Thank you very much for permitting me to testify, and I will be happy to yield to questions.

COMMENTS RELATED TO KANSAS SENATE BILL 267
Prepared by Dennis Stell
April 3, 2003

Good morning. My name is Dennis Stell, and I am the Vice President of the Western Mid-Continent region for Duke Energy Field Services (DEFS). As part of my current assignment, I am responsible for the natural gas gathering and processing activities of DEFS in Kansas.

DEFS is one of a number of Gathering & Processing (G&P) companies that are active in the state of Kansas. G&P companies handle most of the natural gas production in Kansas. We provide valuable and necessary services for moving the gas from the wellhead, processing and conditioning it to meet interstate pipeline and end user specifications, and providing connections for the gas and Natural Gas Liquids (NGLs) to end use markets.

Compensation for the services provided by Gathering & Processing (G&P) Companies normally is accomplished through one or more different agreement types as listed below:

Gas gathering contracts, where title to the gas remains with the Producer:

A. Gathering for a fixed fee
B. Gathering for a variable fee

Wellhead or lease gas purchase contracts, where the G&P Company takes title to the gas at the wellhead:

C. POI – Percent of Index, with the entire payment based on a gas index value.
D. POP – Two part payment Percent of Proceeds, with both a gas and NGL calculation. The gas side can be tied either to resale proceeds or to indices. We call these "POPI" when based on indices.

The contract type selected is based on our supplier's needs, preferences, and the level of risk the supplier is willing to accept. Their risk acceptance or avoidance is directly related to their unique financial position and their view of future supply and demand for natural gas and hence the price of the commodity.

Gathering for a fixed fee is the type of agreement that was used by the interstate pipelines when they provided bundled services. Historically, gathering rates may have been unduly low, due to

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subsidies provided by the pipeline long haul transportation services. Pipelines previously structured rates so that a considerable part of the cost of gathering was paid by transmission pipeline customers rather than gathering customers. Because of increased costs and production declines at the wells that further increase unit costs, fixed fee gathering agreements can be onerous for a G&P Company.

Gathering for a variable fee is frequently fairer to the G&P Company and to the producer. Fees will vary with changes in service, volume, processing economics, commodity prices, etc.

Under one part payment POI purchase agreements, G&P Companies are entitled to a margin equal to a small percentage of the gas produced (i.e. 5% to 20%) as compensation for services provided and 100% of the Natural Gas Liquids (NGLs) extracted from the gas stream. The G&P Company, however, has to pay for the Btus extracted as NGLs at the agreed gas value. Sometimes the producer retains the right to receive the gas in kind after processing, and the G&P company has to replace or make up the MMBtu's lost due to gathering and plant fuel and NGL extraction in kind. This make up gas is frequently referred to as Plant Btu Replacement (PBR).

Under POPI agreements (two part payment index based purchases), G&P Companies receive as their margin a small percentage of the gas produced (i.e. 5% to 20%) as compensation for services provided and a small percentage of the NGLs extracted from the gas stream (i.e. 5% to 20%). The Producers, however, have to share their portion of the PBR as part of residue gas and NGL allocations.

POI & POP-POPI type contracts are beneficial to G&P companies because they provide some upside opportunity when prices are favorable, and they benefit producers because when prices go down, so does the dollar amount retained by the G&P service provider.

In our opinion, Percent of Proceeds and POPI contracts are desired contracting forms because they provide the greatest protection from commodity price risk for both the G&P companies and producers. They align the interests of G&P companies and producer together when it comes to gas gathering, conditioning, and processing. Under Percent of Proceeds and POPI type contracts, producers share in the value of both the residue gas and the NGLs extracted from the natural gas that are attributable to his wellhead production.

Generally speaking, natural gas in its raw state has to be conditioned or "processed" before it is of end user quality and can be transported on interstate pipelines. This processing yields marketable products such as ethane, propane, and butanes that generally are of greater value on a Btu basis than the natural gas from which they are extracted. Since processing is often a necessary step in getting natural gas ready for end users, a problem arises if processing is not profitable. Under gathering-type contracts, the G&P company's processing economics are based solely on the upgrade of the NGLs value vs. the gas value. If gas prices increase significantly relative to NGLs, as they did recently in late February and early March, the G&P company's margin is severely eroded, and can even go negative. G&P companies are not obligated to process gas at a loss, but if most gas is not processed, the gas cannot be transported beyond the field area. POP-POPI type agreements eliminate this conflict and provide alignment between producers and the G&P companies, so that the focus for both producer and processor is on maximizing the total value of gas and NGLs instead of playing one commodity off against another. These types of agreements also largely eliminate the prospect of curtailments in production if processing is unprofitable for an extended period.

Banning percentage of proceeds type contracts will not increase wellhead netback prices, as the G&P companies and producers would have to switch to a different contract type to obtain mutually agreeable pricing levels.

The current feeling seems to be that POP type contracts are reducing the severance taxes paid in the State of Kansas. Depending on the pricing environment, POP contracts can actually increase the severance taxes that are paid (Table).

The intent of the bill may be to extract additional taxes and royalty payments from producers. We are concerned, however, that the result of the bill may be to further discourage new drilling and investment by producers in extending the lives of existing wells in Kansas. Over time, this will contribute to premature abandonment of wells and the loss of recoverable reserves. We are also concerned that the Bill would outlaw a type of contract that best aligns the interest of producers and G&P companies.

Thank you for your time this morning and the opportunity to address this group.

VALUE AT THE LEASE UPON WHICH SEVERANCE TAX IS CALCULATED

	Gathering Fee $.40	POP at 10%
Producer and G&P company enter into an agreement with gas at $4/MMBtu	$3.60	$3.60
Same agreement with gas at $6/MMBtu	$5.60	$5.40
Same agreement with gas at $2/MMBtu	$1.60	$1.80

JON R. VIETS
ATTORNEY AT LAW

SHARING OFFICES WITH
DANA L. GORMAN

SUITE 604, PROFESSIONAL BUILDING
P.O. BOX 1176
INDEPENDENCE, KANSAS 67301
PHONE 620-331-0144
FAX 620-331-1808

By David Bleakley

April 1, 2003

Senate Tax Committee
Topeka, KS

VIA FAX: 785-296-6718

RE: S.B. #267

Honorable Senators:

Your Committee is considering the above referenced bill, which would prohibit persons from entering into "percentage of proceeds gas purchase agreements".

I have practiced law in Eastern Kansas for 25 years, with emphasis on energy resource law. Also, I have served as the Governor's Advisor on the Legislative Task Force on Post De-Regulation Gas Gathering Issues.

I have recommended to many royalty owners, producers and gas gatherers the use of "percentage of proceeds" agreements. The wisdom of such contracts arises from the recognition that all interested persons are engaged in a speculative business subject to wild gyrations in demand and product prices.

Over the years, we have experienced great difficulty, and much litigation, over long term, fixed price contracts. When the fixed price proves too low, royalty owners and producers suffer. When fixed prices are too high, gatherers and end users suffer.

In response, most of the industry has moved to flexible priced contracts, usually as a function of spot prices.

With "percentage of proceeds" agreements, royalty owners, producers and gatherers function on a cooperative basis. If prices are strong, all benefit. If prices are weak, all parties share the burden. Over time, both scenarios are likely to play out on the continuum between low and high value proceeds.

S.B. 267 reflects a potential policy concern that "percentage of proceeds" agreements may operate to understate the value of royalty or the amount of severance tax due. As drafted, S.B. 267 addresses only one end of the continuum, during those fleeting times when prices are high and all

stakeholders are benefiting, but the royalty owner and State would claim a "super" share of the benefit. The bill makes no provision for the bad times, when volumes are slack and prices low, and producers and gatherers are unable to cover their costs.

Moreover, S.B. 267 begs the question of the value of gas for purposes of royalty and severance tax. Presumably, an aggrieved royalty owner, or the Department of Revenue, would look for evidence of market price at the wellhead in any given span of time to make a case for underpayment. At least in Eastern Kansas, the market price at the wellhead is determined almost exclusively by "percentage of proceeds" agreement.

The legislation, if adopted, will operate to override the emerging wisdom of the market which addresses price and volume volatility on a cooperative (percentage sharing) basis. Inherent is the assumption that the legislature can better determine market value at the wellhead than can thousands of actual participants in the marketplace.

If the legislature believes the severance tax scheme needs to be fixed, then it should enact a tax on the volume of gas, without reference to price. If the legislature believes royalty owners should receive higher royalty shares than those specified in the underlying oil and gas leases, it should do so by open fiat. Whatever the political viewpoint and policy objectives, the legislature should not attempt to implement policy by the indirect means of tinkering with the useful and reasonable commercial tool of "percentage of proceeds" agreements.

Very Truly Yours,

Jon R. Viets

JRV:nf

KANSAS SENATE
COMMITTEE ON TAXATION

APRIL 3, 2003
HEARING ON
SENATE BILL 267

INFORMATION PROVIDED BY
ROBERT E. KREHBIEL, EXEC VP
KANSAS INDEPENDENT OIL & GAS ASSOCIATION

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PRICE PROVISION FOR SALE AT WELLHEAD @ 98% OF AVE INDEX PRICE WITH 5.52% FL&U AND 29¢ GATHERING FEE

Contract #450210

B. The price for Gas, Plant Products and Processing Rights delivered and purchased during any Month hereunder shall be equal to 98% of the arithmetic average of the "Index" prices posted in the first issue of each corresponding month's Inside F.E.R.C.'s Gas Market Report published by *McGraw Hill* in the table entitled "Prices of Spot Gas Delivered to Pipeline" for Northern Natural Gas Company (Texas, Oklahoma, Kansas), Panhandle Eastern Pipeline Co., and Williams Natural Gas Pipeline, less $0.29 per MMBtu of wellhead volume for gathering, before any adjustment for fuel. All delivered volumes shall be thermally reduced by the then attributable 'Fuel, Loss, and Unaccounted-for Gas" factor, currently 5.52%, on Buyer's Gatherer's pipeline system (i.e., the volume measured at Buyer's Gatherer's Receipt Point(s) will be adjusted on a pro rata basis with all gas volumes delivered into Buyer's Gatherer's pipeline system; such apportionment calculated by dividing the Seller's meter volume by the sum of all metered volumes delivered into Buyer's Gatherer's pipeline system, and then multiplying the quotient times the total volume delivered from Buyer's Gatherer's pipeline system.)

C. For pricing purposes, all Btu's shall be determined on a gross, wet, ideal basis, at fourteen and sixty-five one-hundredths (14.65) Psia and sixty degrees Fahrenheit (60°F).

EX I 5-2

PERCENT OF PROCEEDS PRICE PROVISION FOR SALE OF RESIDUE GAS AND NATURAL GAS LIQUIDS AT TAIL GATE OF PROCESSING PLANT

5. PRICE.

5.1 Consideration. (a) As full consideration for the gas and all its components delivered to Buyer each month, Buyer shall pay Seller (a) ~~86%~~ 87% of the net proceeds determined under Paragraph 5.2 below received from the sale of residue gas attributable to Seller's gas, and (b) ~~86%~~ 87% of the net value determined under Paragraph 5.3 below for any NGL's saved and sold in liquid form at Buyer's plant or plants attributable to Seller's gas. The compensation payable under this contract includes the value of all raw gas components from which Buyer might derive revenue, including helium, sulfur, CO_2, and other non-hydrocarbons even though no separate value calculation for those components is to be done.

(b) Seller's gas will be handled in gas gathering facilities connected to processing plants owned by parties unaffiliated with Buyer or Buyer-operated plants. Regardless, residue gas and NGL allocations for all processed gas will be based on the fixed efficiencies stated in the NGL and residue gas allocation definitions of Paragraph 5.5.

5.2 Residue Gas Value. The net residue gas value shall be determined by multiplying the MMBtu's of residue gas allocable to Seller times the "Index Price," which shall be the price per MMBtu published in *Inside F.E.R.C.'s Gas Market Report* in its first publication of the month in which the gas is delivered for "Prices of Spot Gas Delivered to Pipelines" for Panhandle Eastern Pipe Line - Texas, Oklahoma (mainline).

5.3 NGL Value. The net value of any recovered NGL's allocable to Seller shall be determined by multiplying the quantity of each NGL component allocable to Seller's gas by the average price per gallon for each NGL component f.o.b. Buyer's plant or plants. The term "average price" as to each NGL component shall mean the simple average of the midpoint of the daily high/low spot price for (i) ethane in E-P mix, (ii) propane, (iii) isobutane, (iv) normal butane, and (v) natural gasoline (pentanes and heavier) during the month as reported for Conway/Group 140 Spot Gas Liquids Price (Mapco), Kansas by the Oil Price Information Service (or in its absence, a comparable successor publication designated by Buyer) less a transportation, fractionation, and storage ("TF&S") fee of five and four hundred fifty eight thousandths cents ($0.05458) per gallon. The TF&S fee for NGL components shall be adjusted as follows, but shall never be less than the initial fee. The TF&S fee shall be adjusted at the beginning of each calendar year beginning with 2004 by an amount equal to the annual percentage change in the preliminary estimate of the implicit price deflator, seasonally adjusted, for the gross domestic product ("GDP") as computed and most recently published by the U.S. Department of Commerce, or in its absence, a similar successor adjustment factor designated by Buyer.

5.4 Low Volume Delivery Points. The price for gas delivered at any Delivery Points at which the volume delivered to Buyer has been less than ~~450~~ 300 Mcf per month for three consecutive months shall be reduced to one-half (1/2) of that computed under Sections 5.1, 5.2, and 5.3 effective the first day of the month following the three month period. The price for gas from the affected Delivery Points shall remain so reduced until the quantity delivered from the Delivery Point is again at least 450 Mcf per month for three consecutive months effective as of the first day of the following month.

5.5 Allocation of Residue Gas and NGL's. Buyer will determine the residue gas and NGL's allocable to Seller on a proportional basis by component using the following definitions and procedures. Additional definitions are in Section A of Exhibit A. From time to time Buyer may make changes and adjustments in it allocation methods to improve accuracy or efficiency.

EX II

EX III 5-4

INSIDE F.E.R.C. INDEX

5-Mar-03

DATE	CIG	EPNG PERMIAN	NGPL MIDCON	NGPL LA	NGPL TX OK	NGPL S - TX	RELIANT EAST	RELIANT WEST	NNG T, O, K	NNG DEMARC	OGT	TW PERM	WNG	TENN 500 Leg	TENN 800 Leg	TENN Zone 0
Jan-02	$2.26	$2.57	$2.49	$2.53	$2.50	$2.48	$2.51	$2.46	$2.40	$2.58	$2.51	$2.49	$2.51	$2.53		$2.52
Feb-02	$1.70	$1.83	$1.89	$1.94	$1.91	$1.89	$1.92	$1.87	$1.86	$1.97	$1.90	$1.84	$1.90	$1.96		$1.90
Mar-02	$1.85	$2.18	$2.28	$2.32	$2.29	$2.28	$2.30	$2.25	$2.17	$2.34	$2.29	$2.17	$2.31	$2.32		$2.29
Apr-02	$2.71	$3.18	$3.28	$3.30	$3.31	$3.30	$3.31	$3.26	$3.19	$3.32	$3.29	$3.17	$3.29	$3.32		$3.30
May-02	$2.18	$3.12	$3.17	$3.26	$3.24	$3.21	$3.23	$3.19	$3.10	$3.21	$3.19	$3.07	$3.20	$3.26		$3.20
Jun-02	$1.56	$2.86	$3.04	$3.27	$3.25	$3.22	$3.23	$3.16	$2.90	$3.11	$3.05	$2.85	$3.08	$3.27		$3.23
Jul-02	$1.20	$3.16	$3.00	$3.18	$3.16	$3.16	$3.17	$3.07	N/A	$3.03	$3.02	N/A	$3.08	$3.18	$3.16	$3.15
Aug-02	$1.59	$2.72	$2.73	$2.88	$2.89	$2.84	$2.87	$2.83	$2.61	$2.79	$2.77	$2.69	$2.84	$2.87	$2.87	$2.85
Sep-02	$1.09	$3.05	$2.95	$3.18	$3.18	$3.17	$3.18	$3.03	$2.83	$3.04	$2.99	$2.92	$2.98	$3.18	$3.19	$3.17
Oct-02	$1.20	$3.27	$3.31	$3.60	$3.58	$3.57	$3.51	$3.38	$3.12	$3.44	$3.34	$3.15	$3.32	$3.64	$3.64	$3.56
Nov-02	$2.96	$3.88	$4.03	$4.08	$4.07	$4.07	$4.02	$4.00	$3.96	$4.13	$4.03	$3.86	$4.06	$4.05	$4.05	$4.02
Dec-02	$3.33	$3.91	$3.98	$4.08	$4.06	$4.05	$3.95	$3.93	N/A	$4.10	$3.96	$3.94	$3.98	$4.07	$4.06	$4.01
2002 AVG	$1.97	$2.98	$3.01	$3.14	$3.12	$3.10	$3.10	$3.04	$2.81	$3.09	$3.03	$2.92	$3.05	$3.14	$3.50	$3.10

Prepared by: [illegible]lin
[illegible]rgy Services
[illegible]1 Telephone
[illegible]eminoleenergy.com

	NNG TOK INDEX	PEPL INDEX	WILLIAMS INDEX	AVE INDEX
Jan-02	2.40	2.51	2.51	2.4733
Feb-02	1.86	1.90	1.90	1.8867
Mar-02	2.17	2.30	2.31	2.2600
Apr-02	3.19	3.29	3.29	3.2567
May-02	3.10	3.18	3.20	3.1600
Jun-02	2.90	3.02	3.08	3.0000
Jul-02	2.90	3.00	3.08	2.9933
Aug-02	2.61	2.70	2.84	2.7167
Sep-02	2.83	2.97	2.98	2.9267
Oct-02	3.12	3.34	3.32	3.2600
Nov-02	3.96	4.05	4.06	4.0233
Dec-02	3.895	3.97	3.98	3.9483
				2.9921

EX IV 5-5

OPIS - Group 140					
			Normal	Iso	
	Ethane	Propane	Butane	Butane	Nat Gasoline
1/02	0.15860	0.26598	0.38065	0.48970	0.46821
2/02	0.17043	0.27914	0.34250	0.44742	0.50454
3/02	0.23775	0.35925	0.40556	0.59953	0.63559
4/02	0.26128	0.40073	0.44713	0.60330	0.68935
5/02	0.25392	0.38085	0.44688	0.54969	0.62381
6/02	0.21366	0.35250	0.43078	0.57000	0.57438
7/02	0.20676	0.35467	0.45170	0.55095	0.56458
8/02	0.23114	0.41526	0.50389	0.58466	0.60602
9/02	0.27809	0.45953	0.55622	0.64650	0.66853
10/02	0.28938	0.47122	0.56891	0.67266	0.71579
11/02	0.26776	0.48007	0.56214	0.63316	0.66352
12/02	0.32048	0.52322	0.63908	0.71807	0.73253
2002 YTD Ave	0.24077	0.39520	0.47795	0.58880	0.62057

Estimated POP Calculations

		Mcf	MMBtu	Btu Factor
Wellhead Volumes		600	651	1.085
Less Fuel and FL&U Deductions:				
Gathering Fuel and FL&U	7.500%		49	
Calculated Inlet		555	602	
Plant Fuel	1.500%		9	

Gallons/Shrink	GPMs	Recoveries	Gallons	Gal/MMBtu	Shrink MMBtu
Ethane	1.2055	20.000%	134	0.0063610	1
Propane	0.5355	72.000%	214	0.0915960	20
Iso-Butane	0.1044	70.000%	41	0.0996500	4
Normal Butane	0.2273	83.000%	105	0.1037220	11
Natural Gasoline	0.0768	83.000%	35	0.1134377	4
Total	2.1495		528		39

Values	Index Price	MMBtu	Total Dollars	
Residue Gas Price	$ 2.9921	554	$ 1,657	
POP Percent	85%		$ 1,408	
Compression (per wellhead)	$ 0.0500		$ 33	$ 1,376

Plant Products	Frac Deduct	Prices	Gallons	Total Dollars	
Ethane	$ 0.0350	$ 0.2408	134	$ 28	
Propane	$ 0.0350	$ 0.3952	214	$ 77	
Iso-Butane	$ 0.0350	$ 0.5888	41	$ 22	
Normal Butane	$ 0.0350	$ 0.4780	105	$ 46	
Natural Gasoline	$ 0.0350	$ 0.6206	35	$ 21	
				$ 194	
POP Percent	85%				$ 165

	POP Values
Total Dollars to Producer	$ 1,541
Dollars per Wellhead mmBtu	$ 2.3670

Comparison

Wellhead Volumes	600	651
Fuel (5.52%)		36
Net mmBtu		615
Index	98% $	2.9323
		1,803.53
Less gathering per mmBtu	0.29	188.79

100% = 2.9921

	Current Values
Gross Value	$ 1,615
Per Wellhead mmBtu	$ 2.4804

Less than current contract per wellhead mmBtu	$ 0.1134
Dollars per month	$ 74
Dollars per year	$ 886

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EX VI

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EX VIII

ANAYLSIS OF EFFECT OF POP OFFER ON MONTHLY GROSS VALUE RECEIVED

Well Name	Est W/H MCF	Est W/H MMBtu	Est Btu	Est Gross Value Under Current Agmt	Est Gross Value Under [illegible] Offer	Diff	
[illegible]	1,100	1,199	1.090	2,974.00	2,999.31	(25.31)	(0.0211)
[illegible]	600	651	1.085	1,614.74	1,540.90	73.84	0.1134
[illegible]	285	304	1.068	754.93	715.29	39.69	0.1304
[illegible]	400	440	1.101	1,092.37	1,045.79	46.58	0.1058
[illegible]	850	935	1.100	2,319.17	2,221.96	97.21	0.1040
[illegible]	1,800	2,014	1.119	4,996.01	4,769.04	226.97	0.1127
[illegible]	1,800	2,038	1.132	5,054.06	4,849.41	204.64	0.1004
[illegible]	1,000	1,102	1.102	2,733.40	2,609.87	123.53	0.1121
[illegible]	950	1,018	1.072	2,526.04	2,386.64	139.40	0.1369
[illegible]	1,550	1,672	1.079	4,148.34	3,930.02	218.32	0.1305
[illegible]	900	965	1.072	2,393.09	2,263.75	129.33	0.1341
[illegible]	5,700	6,122	1.074	15,653.51	14,357.81	1,295.70	0.2117
[illegible]	3,500	3,854	1.101	9,878.95	9,163.71	715.24	0.1856
[illegible]	1,400	1,582	1.130	4,066.35	3,761.15	305.20	0.1929
[illegible]	575	641	1.114	1,644.10	1,509.75	134.35	0.2097
[illegible]	1,000	1,246	1.246	3,232.46	3,088.52	143.94	0.1155
[illegible]	1,600	1,784	1.115	4,579.41	4,232.28	347.14	0.1945
[illegible]	800	888	1.110	2,278.40	2,092.60	185.80	0.2092
[illegible]	1,000	1,127	1.127	2,896.06	2,665.19	230.87	0.2049
[illegible]	2,100	2,327	1.108	5,968.92	5,529.20	439.73	0.1890
[illegible]	2,000	2,168	1.084	5,549.00	5,062.61	486.38	0.2243
[illegible]	1,050	1,221	1.163	3,147.72	2,923.77	223.95	0.1834
[illegible]	3,500	4,172	1.092	10,693.49	9,788.35	905.14	0.2169
MONTHLY TOTAL	35,760	39,470	1.104	100,194.56	93,506.92	6,687.64	
ANNUAL TOTAL						80,251.73	
	Price per mmBtu			2.5385	2.3690		
				0.4536	0.6231		
Weighted Average Increase in Fees per MMBtu						0.1694	37.35%

Residue Netback	85.0%	
Liquids Netback	85.0%	
Compression Fee	$ 0.05	
Gas Price	$ 2.9721	Based on 2002 Ave NNG-TOK, NTL, WNG
Ethane	$ 0.24077	Based on 2002 OPIS average
Propane	$ 0.39520	Based on 2002 OPIS average
Iso-Butane	$ 0.58880	Based on 2002 OPIS average
Normal Butane	$ 0.47725	Based on 2002 OPIS average
Natural Gasoline	$ 0.62037	Based on 2002 OPIS average

Revenue Ruling

Ruling Number: 92-1998-01
Tax Type: Mineral Severance Tax
Brief Description: Gross Value
Keywords:
Effective Date: 12/31/98

Body:

REVENUE RULING 92 - 1998 - 01

December 31, 1998

Issue: How is the "gross value" of gas, for use in the calculation of the mineral severance tax, determined by the Department of Revenue if no sale occurs at the time gas is severed?

Relevant Statutes: K.S.A. 79-4201 et. seq.

This Ruling is intended to clarify how the Department of Revenue determines the gross value of gas which is subject to the mineral severance tax. To this end, this Ruling will clarify the Department's interpretation of the definitions of "gas" and "gross value" that are found in the current statute. These definitions illuminate the Department's practice regarding the calculation of gross value. They are not a departure from historic policy.

K.S.A. 79-4216(c), defines "gas" as ". . . natural gas taken from below the surface of the earth or water in this state, regardless of whether from a gas well or from a well also productive of oil or any other product." In order for the Department to properly administer this statute, this Ruling clarifies that "natural gas" means a "complex mixture consisting essentially of hydrocarbons of the paraffin series but including in certain instances and in varying proportions nitrogen, carbon dioxide, sulfur components and helium." (Council of Petroleum Accountants Societies, Gas Accounting Manual, Bulletin Number 7, April 1993.) This is the most recent definition of natural gas recognized by industry accountants and represents the generally held meaning of natural gas (also see Northern Natural Gas Company v. Grounds, 441 F. 2d 704 (10th Cir. 1971), cert den. 404 U.S. 951 (1971)).

Since natural gas liquids and helium are components of natural gas and are measured as part of the full volume of gas as it is severed (see K.S.A. 79-4217(a)(2)), both the liquids and helium contribute to the gross value of gas at the well-head. [This is true for market determined

well-head prices or gross value. Prices determined under regulation accounted for only the value of the residue gas.] Since natural gas liquids and helium are components of natural gas and contribute to its market determined well-head sale price, both have been and remain subject to the mineral severance tax.

In K.S.A. 79-4216(d), "gross value" is defined as:

> . . . the sale price of oil or gas at the time of removal of the oil or gas from the lease or production unit and if oil or gas is exchanged for something other than cash, or if no sale occurs at the time of removal . . . then the director shall determine the value of the oil or gas subject to tax based on the cash price paid to one or more producers for the oil or gas or based on the cash price paid to producers for like quality of oil or gas in the vicinity of the lease or production unit at the time of the removal of the oil or gas from the lease or production unit.

This Ruling clarifies that when no sale occurs at the time of removal from the lease or production unit, royalty statements will continue to be reviewed for an indication of "the cash price paid to [the] producers". The gross value of gas production in Kansas will be determined using the following method:

Sum of net royalty proceeds (as paid by the taxpayer, as lessee, to the owners of the mineral interests from which the taxpayer's production occurs in Kansas).

DIVIDED BY

Sum of the royalty interest owners share of gross well-head (less any in-kind gas) production volume, expressed in MCFs for gas or BBLs for oil, for which a royalty is paid.

MULTIPLIED BY

Actual gross well-head production volume, from the same lease/well (less any in-kind gas to any other party except the taxpayer) expressed in MCFs for gas or BBLs for oil

EQUALS

Gross value of oil or gas produced from the lease/well in Kansas for the purposes of the Kansas Mineral Severance Tax, as applied in K.S.A. 79-4201 et. seq.

The following is an example of the application of the above formula to calculate the taxable gross value from a hypothetical gas lease located in the State of Kansas. This example is provided for illustrative purposes only. Actual calculations of gross value may or may not resemble the outcome of this hypothetical case.

The Sum of Royalty Proceeds	
Residue Gas	$192.56
Plant Products	$102.96
Helium	$ 15.57
Sum of Gross Royalty Proceeds	$311.09
Less Expenses*	$(62.01)
Net Royalty Proceeds	$249.08
Divided By:	
Sum of Royalty Owner's Share of Gross Well-head Production Volume (MCFs for gas or BBLs for oil)	187 MCF
Equals Value Per MCF	$1.33
Multiplied By:	
Actual Gross Well-head Production Volume (MCFs for gas or BBLs for oil)	8,989 MCF
Equals Taxable Gross Value	$11,955.37

* Expenses are amounts deducted from the royalty owner's gross proceeds from leasehold production (the nature of which have been previously allowed by the Department) which are attributable to the post production costs associated with the sale of the gas to the first purchaser. These amounts are prorated using the same percentage as that used in allocating the royalty owner's share of the gross production volume.

Royalty owners are included in this statute's definition of "producer" (see K.S.A. 79-4216(h)) and royalty statements reflect payments made to the owners for all components of the gas or oil production at the time of severance. Therefore, it is reasonable to continue following the above method of calculating gross value when a sale does not occur at the well-head. Royalty statements reflect an unbundled view of the contributions to gross value made by each component of natural gas. Because the net royalty proceeds are reviewed, the royalty method of calculating gross value reasonably captures the well-head value of all components of natural gas.

Karla Pierce
Secretary of Revenue

TESTIMONY TO THE
SENATE ASSESSMENT AND TAXATION COMMITTEE
IN OPPOSITION TO SENATE BILL 267
APRIL 3, 2003
BY DOUGLAS L. LAMB, PRESIDENT
QUEST RESOURCE CORPORATION

Honorable Senator Corbin and Members of the Committee:

Personal Background. I am president of Ponderosa Gas Pipeline Company, Inc., a Kansas corporation that is involved in the gas gathering business. I have been in the oil and gas business in southeast Kansas since 1977.

Nature of Business. Ponderosa Gas Pipeline Company, Inc. operates approximately 340 miles of gas gathering pipelines in southeast Kansas and northeast Oklahoma. Ponderosa gathers primarily coal bed methane gas from individual wells and delivers the gas to interstate pipeline terminals or to regional gas consumption facilities. Ponderosa is a subsidiary of Quest Resource Corporation. Quest also owns subsidiaries that own and operate oil and gas leases in southeast Kansas.

Use of "Percentage of Proceeds of Gas Purchase Agreement". Our industry (the gas gathering industry) utilizes "percentage of proceeds of gas purchase agreements" (as defined in S.B. 267) in its operations in southeast Kansas. The nature of the gas gathering industry in southeast Kansas makes a percentage of proceeds agreement the only feasible way to charge our customers for several reasons.

First, gas gathering pipelines are not a typical utility with long-lived assets. Gas gathering assets are only useful and productive as long as the wells they serve remain productive. Operating costs per unit of gas are greater for gas gathering pipelines than for transmitting utilities due to the lower gas volumes.

Gas gathering pipelines provide a market for gas at the wellhead on the producing properties. The gas is purchased at the wellhead. The first purchaser of the gas pays the owners of the production (lessee, mineral interest owner) based upon the market price at the wellhead. In southeast Kansas this market price at the wellhead is typically 70% to 75% of the benchmark price available at the interstate pipeline terminals, which is a separate downstream marketplace often many miles away from the individual producing wells.

The gas gathering industry consists of companies that have constructed the pipeline infrastructure necessary to gather gas from individual wells and deliver this wellhead gas to a downstream gas market. The compensation received by gas gathering pipelines is typically 25%

Senate Assessment + Taxation
4-3-03
Attachment 6

to 30% of the price available at the interstate pipeline terminals. This "Percentage of Proceeds" pricing method is necessary because gathering lines are only useful as long as the wells they are connected to are producing gas. The risk of the gas gathering industry is similar to the risk incurred by a gas producer.

Another reason for the percentage of proceeds method is due to price volatility. The price of gas fluctuates significantly and a fixed gathering charge could become a prohibitive percentage to the gas producer when the gas price drops, or unfairly low to the gathering entity when the gas price goes up.

Effect on Royalty Interests. The legislation [section 1(b)] prohibits the making of a percentage of proceeds agreement if such agreement would cause the royalty paid by the producer to be less than the royalty that would be paid "based on the amount and quality of the gas as produced and measured at the wellhead, priced per unit of volume or heating value".

The quoted language is unworkable. A royalty that is paid based on sales proceeds from a percentage of proceeds contract is already a royalty based on the amount and quality of gas produced and measured at the wellhead. Section 1(b) would require a first purchasing gas gathering company to calculate a unit price. A gas gathering company cannot make that calculation in advance of the sale of the gas. It would be possible to estimate variable costs for each mcf of gas purchased from a lease but to attempt to allocate fixed costs and profit of the gathering system in southeast Kansas among all leases would be impossible.

Most oil and gas lease agreement provide that a royalty is calculated based on price at the wellhead. This legislation would require revising the leases by inserting the quoted language into the lease agreements. This would, in effect, impair existing oil and gas leases which are contractual legal documents.

The legislation is misguided if it intends to legislate the payment of royalty income based on downstream markets instead of wellhead markets. The gas gathering pipeline delivery point comprises a different marketplace than the wellhead marketplace. The only way a royalty or working interest owner can market their gas at the wellhead is if a gas gathering company was willing to risk the significant investment required to build a gathering line to a downstream marketplace. The royalty and working interest owners of a producing gas well have no right to participate in the downstream marketplace created by the gas gathering company. Their marketplace is at the wellhead, in accordance with the oil and gas lease, unless different terms have been negotiated.

In the case of our company, millions of dollars have been invested by Ponderosa Gas Pipeline Company, Inc. for the construction of its gas gathering pipeline network to provide a wellhead market for numerous gas producing properties in southeast Kansas. The viability of our gas gathering entity depends greatly upon an appropriate level of income, and the percentage of proceeds method has been the most appropriate means of determining our gas gathering income.

<u>Effect on Severance Tax.</u> The legislation [section 1(c)] prohibits the making of a percentage of proceeds agreement if such agreement would cause the severance tax owed on gas to be less than the severance tax that would be owed "on the volume of gas as produced and measured at the wellhead".

The quoted language is unworkable. A percentage of proceeds agreement already establishes the value of the production at the wellhead based on volume. This amount is subject to the severance tax. The two amounts discussed in section 1(c) of the bill [value of production under percentage of proceeds and value of gas produced and measured at the wellhead] are the same number.

<u>Summary-System is not Broke.</u> The system is not broke. A percentage of proceeds agreement results in royalty and severance tax payments that are based on the market value of production at the wellhead. Gas gathering systems in southeast Kansas compete for business. If a gas gathering system is charging an above market rate at the wellhead by using a percentage of proceeds agreement, then another system will invest the capital, offer a lower percentage, and take the business. The market is competitive and it works.

Even if the lessee is a related party to the gas gathering company, the contracts with non-related producers provide a yardstick for the market and such discrimination is not practiced. In our business, I estimate that approximately 40% of our contracts are with non-related entities.

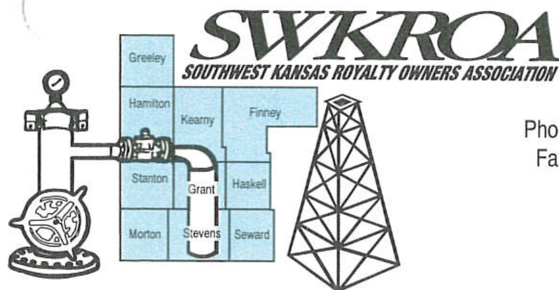
The bill says that the percentage of proceeds agreement is against public policy. What about the fundamental policy of freedom of contract?

There is no need for this bill and I ask you to vote "no" in this committee. Thank you.

Sincerely,

Douglas L. Lamb
Quest Resource Corporation
P. O. Box 100
Benedict, KS 66714
620-698-2250

WICDOCS 86638v1



Phone (620) 544-4333
Fax (620) 544-2230

E-mail: SWKROA@pld.com
http://users.pld.com/swkroa

209 E. 6th St. / P.O. Box 250
Hugoton, Kansas 67951

PHIL DICK, PRESIDENT
ERICK NORDLING, EXECUTIVE SECRETARY
B.E. NORDLING, ASS'T. SECRETARY

ERICK E. NORDLING, EXECUTIVE SECRETARY

SOUTHWEST KANSAS ROYALTY OWNERS ASSOCIATION

HUGOTON, KANSAS 67951

April 3, 2003

To the Honorable Members of the Senate Committee Ways and Means:

RE: Senate Bill 267 relating to percent of proceeds gas purchase agreements

Chairman Corbin and Members of the Committee:

My name is Erick E. Nordling of Hugoton. I am Executive Secretary of the Southwest Kansas Royalty Owners Association (SWKROA). I am appearing on behalf of members of our Association.

DISCUSSION OF SB 267

SWKROA has had little opportunity to consider the implications of Senate Bill No. 267. The bill should be carefully reviewed to determine its impact on the payment of gas royalties and on the collection of severance taxes.

An oil and gas lease is the agreement between the mineral owner (lessor) and an oil and gas company (lessee) for the right to explore and develop the mineral rights on the leasehold. In return, the lessor is entitled to royalty for the gas and oil that is produced and sold. Most leases provide for the royalty owner to be paid on a fractional basis, such as 1/8th or 3/16ths, for the royalty share of production. The proposed legislation could effect the payment of royalties under the terms of the lease.

We appreciate the sponsoring Senators efforts to protect royalty owners from percent of proceeds gas purchase contracts. However, because of the potential implications of the bill, we respectfully request that the ramifications of this bill on royalty owners and severance tax collections be fully explored. We would like to be able to supplement our comments and recommendations about the proposed legislation.

Thank you for this opportunity to present these concerns to your honorable committee.

Respectfully submitted,

Erick E. Nordling,
Executive Secretary, SWKROA

KANSAS

JOAN WAGNON, SECRETARY

DEPARTMENT OF REVENUE
OFFICE OF THE SECRETARY

KATHLEEN SEBELIUS, GOVERNOR

Testimony to Senate Committee on Assessment and Taxation
Joan Wagnon
Secretary of Revenue

April 3, 2003

House Bill 2416—Tax Amnesty

Chairman Corbin and Members of the Committee:

The Department is implementing a two-phased tax amnesty program, with Phase 1 having started in early February. Phase 1, which does not require authorizing legislation, involves an aggressive campaign to pursue settlement negotiations on pending assessments, with the goal of resolving those that should be settled prior to the end of this fiscal year. House Bill 2416 will provide the Department legislative authority to implement Phase 2, which will involve a tax amnesty program to be conducted this coming fall, and will offer waiver of penalties and interest to taxpayers with accounts in collection or who are non-filers or under-reporters upon payment in full of the underlying taxes, if payment is received between October 1, 2003 and November 30, 2003.

Phase 1—Accelerated Settlement Program

In Phase 1, the Department is exercising its existing authority to settle disputed matters. This involves an effort to accelerate reasonable settlement of assessments on a non-principled basis, including those pending before the Office of Administrative Appeals, the Board of Tax Appeals (BOTA) or in the judicial review process.

Purpose

The purpose of Phase 1, the accelerated settlement program, is to bring in as much revenue as possible before the end of FY 03 from disputed assessments, in order to help alleviate the current fiscal situation.

Goal

The goal of the accelerated settlement program is to bring in additional tax revenue in excess of $12.5 million in FY 03.

Tax Types Included

The Department is focusing on assessments for individual and corporate income tax, as well as state and local sales and compensating use tax, but would welcome inquiries from taxpayers with

disputed assessments for privilege tax, estate tax, liquor taxes, cigarette and tobacco taxes, employer withholding and mineral taxes. Included taxes are those owed for tax periods ended by December 31, 2002, except that for income tax and privilege tax, included taxes are only those owed for tax periods ended by December 31, 2001. This would specifically exclude income and privilege taxes for tax year 2002, the returns for which are now being processed.

Assessments Included
The assessments to be included in the accelerated settlement program include: those in dispute and pending before the Office of Administrative Appeals, BOTA or under judicial review; and assessments or proposed assessments (under audit).

Matters not included
Not included in the accelerated settlement program are: assessments under appeal or subject to appeal that are not candidates for settlement; assessments for which appeal rights have expired or have been exhausted (in collections); and tax liability from underpayment or nonpayment of amounts declared due on returns.

Settlement Procedures
For assessments that can be reasonably settled, the taxpayer will have the opportunity to resolve the assessment on a non-principled basis, if the negotiated amount is paid in full within a stated time period but prior to June 30, 2003. The taxpayer must agree to waive any further appeal rights with respect to the assessment and must further waive any right to seek a refund of the amount paid. If the taxpayer makes payment on or before the given deadline and pursuant to the settlement terms, then the assessment will be deemed paid in full and resolved. The taxpayer's account with respect to the assessment will be adjusted to reflect the settlement under the accelerated settlement program.

Tracking Procedures
Revenue attributable to acceptances of settlement offers made under the accelerated settlement program will be separately tracked, so that a determination can be made as to whether the $12.5 million FY 03 goal has been met.

Phase 2

House Bill 2416 authorizes Phase 2, the tax amnesty program for the fall of 2003. Under this proposal, the Department would be given authority to waive penalties and interest for taxpayers with accounts in collection and taxpayers who are non-filers or under-reporters if the unpaid taxes due and owing for tax periods ended by December 31, 2002 (except for income and privilege taxes, the tax must be due and owing for tax periods ended by December 31, 2001), are paid between October 1, 2003 and November 30, 2003. Assessments issued by the Department's audit staff, which are pending as of February 6, 2003 or issued after that date, will not be eligible for Phase 2. Taxpayers under audit on or after February 6, 2003 will not be eligible for Phase 2. Assessments under review or affirmed by BOTA or a reviewing court are not eligible for Phase 2. A taxpayer who had the opportunity to participate in Phase 1, the accelerated settlement program, will not be eligible for Phase 2.

Purpose
The purpose of Phase 2, the tax amnesty program, is to convert as many outstanding accounts receivable as possible into much needed revenue during the first half of FY 04.

Goal
The goal of the tax amnesty program is to bring in additional tax revenue of $19.5 million during the first half of FY 04.

Tax Types included
State and local sales and compensating use tax, employers withholding tax, privilege tax, estate tax, liquor taxes, cigarette and tobacco taxes, and mineral taxes due and owing for tax periods ending on or before December 31, 2002; individual and corporate income taxes and privilege taxes due and owing for tax periods ending on or before December 31, 2001. This would specifically exclude income and privilege taxes for tax year 2002, the returns for which are now being processed. Taxpayers owing compensating use tax on out-of-state catalog or Internet purchases will have the opportunity to participate in Phase 2 as non-filers.

Timetable
Assuming House Bill 2416 is enacted, during June through August 2003, the Department will identify all taxpayers with delinquent accounts in collection under the above tax types and attempt to notify them that the Department will waive all penalties and interest due with respect to delinquent tax liability, if the underlying taxes due are paid between September 1, 2003 and October 31, 2003. The notices will include payment vouchers marked as part of the amnesty program and return envelopes. Also during that time, the Department will post downloadable information on its website about the tax amnesty program and will seek to publicize the program as much as possible.

Revenue Tracking
Once the notices to delinquent taxpayers are sent, the Department will track payments received under the tax amnesty program through the vouchers.