Southwest Kansas Royalty Owners Association
209 East Sixth Street
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Testimony before the Senate Utilities Committee
Senate Bill 401
March 11, 2004

Chairman Clark and Members of the Committee:

My name is Erick E. Nordling, of Hugoton, Kansas. I am a lawyer and a member of the Hugoton law firm of Kramer, Nordling, & Nordling, LLC. I have practiced law since 1985 and have spent my entire legal career representing landowners. I am currently serving as Executive Secretary of the Southwest Kansas Royalty Owners Association (SWKROA). That Association's mission is the protection of the rights of royalty owners in the Hugoton Gas Field in southwest Kansas. The voluntary association has over 2,600 members and on behalf of its members and Kansas royalty owners supports the passage of Senate Bill 401.

For some time, royalty owners have been frustrated because they cannot determine the basis upon which their producers calculate royalty payments by reviewing their royalty remittance statements (royalty check stubs) received from their producers.

History of Royalty Owner Check-Stub Legislation in Kansas.

In 1996, Senator Stephen R. Morris, Hugoton, introduced Senate Bill 472 at the request of SWKROA. Many surrounding states had already enacted royalty owner check-stub statutes to address the deregulation of the natural gas industry. The Kansas legislation met with heavy resistance by the industry.

Excerpts from SWKROA Newsletters help to reveal the problems Kansas royalty owners were facing. I will attach these excerpts to my statement. The March, 1996 Newsletter, provided a good background of the issues caused by deregulation.

Another spin-off from deregulation involved the gathering of natural gas. With deregulation at the federal level, the states were forced to develop regulations for gas gathering facilities. As indicated by the attached SWKROA newsletters for June and August in 1996, the Kansas Legislature established a Gas Gathering Task Force consisting of 14 members.

At the SWKROA 1996 Annual Meeting, Senator Morris, as part of a legislative panel, briefly discussed SB472, which he introduced during the 1996 session. 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 was one of the issues to be discussed by the Gas Gathering Task Force.

I had the pleasure of serving royalty owner interests on the task force, having been appointed by Governor Graves. Among the sixteen specific gas gathering issues to be studied by the Task Force which greatly affected royalty owners and irrigators in the Hugoton Field were:

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 Kansas Legislature came to the royalty owners' aid in 1997, when it passed a bill referred to as "Truth In Royalty bill" and as "the royalty owner check-stub bill" (K.S.A. 55-1620, 55-1621 and 55-1622), requiring producers to provide royalty owners certain information in connection with their royalty payments.

Need for New Legislation: Senate Bill No.401.

The 1997 bill was presented as an industry compromise. For instance, the bill did not contain specific provisions to deal with "split stream sales" and sales to affiliated parties. However, as originally drafted, the bill did contain a provision, which allowed for the state district courts to have discretion to award costs, attorney's fees and expenses incurred by the royalty owner for enforcement of the law in the event that his or her producer would not provide the mandated information. Unfortunately, this critical provision was removed from the bill before passage, creating a law "requiring" producers to provide royalty owners information but leaving royalty owners without any means of enforcing the law.

With the passage of time, it has become apparent that major deficiencies within the current Kansas statutes continue to plague royalty owners. Our quest is simple, royalty owners just want to have adequate information to determine if they have been paid properly for production of their oil, gas and associated products.

In the latest issue of the Newsletter of the Southwest Kansas Royalty Owners Association, our general counsel has an article that discusses some of the shortcomings of the Kansas statutes. That article is attached to this statement. Senate Bill 401 is designed to cure those deficiencies. Among the major deficiencies are the following:

1. The current Kansas law does not require the producer to reveal the amount of production by well. One of the buzzwords producers have used in our meetings to discuss SB401 is "stewardship," which essentially means that a royalty owner should take efforts to be informed about their royalty payments by examining their remittance statements and utilize other sources to verify if they have been properly paid for the production of oil and gas.

Unfortunately, if adequate information is not available on the remittance stub, then it can make the task difficult, if not impossible, which leads to unnecessary expense, frustration, and a lack of trust.

One instance of frustration can be trying to track production and payments to an individual well. A royalty owner often only knows that they have a well, and that it produces gas, and maybe oil, and associated products, such as helium, propane, butane, etc. In order to try to verify production, a royalty owner tries to 'work back' their payments to each well. Some companies report royalties on a well by well basis, and as a couple of the proponents to follow me will testify, some report on a lease or unit basis.

If you try to verify production with 'third' party sources, such as the Kansas Corporation Commission (KCC), the Kansas Geological Survey (KGS), or Kansas Department of Revenue, where the reports are generally made on a well by well basis, the volumes don't necessarily match your sales volumes. Which value do you use to verify production? (This also may raise questions how severance and ad valorem tax volumes are calculated and reported.)

The volumes can be affected by where the gas is measured for royalty purposes, such as at the wellhead, or at the tailgate of a processing plant. The gas volumes can also be affected if they have been adjusted for the heating value of the gas (Btu), which may also be affected by where the Btu value is measured. Which value do you use to verify production?

For a royalty owner, verification means matching production to sales. SB 401 addresses the concerns for produced volumes and sales volumes. Ultimately, without production volumes for each, there is no way to verify if full payment has been received for the sale of such production.

2. The current Kansas law does not require the producer to disclose affiliate transactions. We believe that producers will urge your opposition of Senate Bill 401 because it requires disclosure of the price the producer receives for its production. What the producers do not tell you is that the current law already requires that disclosure. Senate Bill 401 expands that "price" disclosure requirement in one specific area. Under current law, producers have sometimes used as the disclosed "price" the price they receive from an affiliate purchaser. Senate Bill 401 requires that the producer provide the price received from a third-party sale, as opposed to the price received from an affiliate sale.

3. The current Kansas law does not address split-stream sales. As mentioned in the attached SWKROA newsletters, split-stream sales were a concern in 1996 and 1997, but one which the producers were unwilling to address as part of the compromise bill. SB401 addresses split-stream sales.

My simple definition of a split-stream sale, is when there are more than one payor for production from a particular well. Let's say each payor is entitled to a share of the production from the well and they have to pay the royalty owners for such production. Problems arise when one of the payors pays royalty based on 100% of the production from the well, and adjusts the royalty owner's decimal interest in the well based on what it actually sold. On the other hand, the other payor pays the 'full' decimal interest (based on the royalty owner's interest in the minerals), but they pay only for their production from the well. As witnesses to follow me will testify, it is a battle of wills to get adequate information to confirm that the owner has been paid properly.

The royalty owner often has no explanation on their remittance stub, or after inquiry, to reveal a split sale. By requiring each payor to provide the volume of total production from the well, and the sales volumes, the royalty owner can start to piece it together. Likewise, if the payor has to reveal when they would pay on a decimal interest which is less than their legal ownership interest, it

will also help to verify the information. There are a few companies that provide this type of detail on their remittance stubs, but payors are not consistent.

The information required by SB401 would also reveal if the payors are 'out of balance' with each other by selling more than their entitlement to production. If unchecked, it might be possible for some of the production to 'fall through the cracks' and the royalty owner might not be paid on some volumes.

4. The current Kansas law has no enforcement provisions. If a producer fails to provide the required information under K.S.A. 55-1620, et seq., there is no enforcement mechanism. The 1996 and 1997 bills, as originally introduced, included provisions for enforcement, which granted the district courts of this state the power to award damages, including attorney fees. These provisions were important because attorney fees are generally not allowed, absent statutory authority. However, these provisions were deleted, leaving royalty owners with no means to enforce the disclosure requirements.

Ideally, the payors would provide the needed information on the remittance stub and there would be no need for enforcement. However, in reality, disputes do arise. As payors generally have control over production, gathering, affiliate transactions, sales, and royalty payments, they should be held to a high standard.

Meetings with Industry on proposed SB401.

We have met with producer representative several times since SB401 was introduced. The last meeting took place exactly three weeks ago, on February 19th, for a good part of a day to see whether we could agree on legislation to address the shortcomings of the current law. At the conclusion of the meeting, the producer representatives said that they would redraft Senate Bill 401 to be acceptable to them. This Monday evening we finally received their proposal. Except for an ineffectual enforcement provision, it completely failed to address any of the major shortcomings of the current law. Because our efforts to work with the producers have failed, we now have to turn to you for your assistance.

By supporting this legislation, we do not want to suggest that the producers are engaged in any Enron-like shenanigans in connection with their royalty payments. We do believe that royalty owners should be entitled to a full explanation from their producers about how they calculate their royalty payments. Senate Bill 401 requires the producers to give royalty owners that information.

We urge your adoption of Senate Bill No. 401.

Respectfully submitted,

/s/ Erick E. Nordling

Erick E. Nordling
Executive Secretary, SWKROA

Attachments