SWKROA
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UNDERSTANDING ROYALTY REMITTANCE STATEMENT: COMMON PROBLEM FOR ROYALTY OWNERS

One of the most frustrating things experienced by royalty owners in dealing with their respective oil and gas companies is the inability to determine the basis upon which royalty payments are calculated as reflected by the royalty remittance statements (royalty check stubs) received with their monthly royalty statements. Deductions often appear on the statement for gathering, compression, or "other deductions," without explanation as to the authority or nature of the deduction. There also may be instances where the price used for payment of royalty is based on a net figure, after deduction of charges. Unfortunately, it is next to impossible to verify the pricing or deduction information.

From time to time, your Association attempted to alleviate the problem by securing legislation of a uniform royalty accounting bill but our efforts were challenged by the oil and gas industry as burdensome and unnecessary. **Finally, in 1997, the Kansas Legislature passed a bill referred to as "the royalty owner check-stub bill" (K.S.A. 55-1620, 55-1621, and 55-1622), requiring producers to provide royalty owners with information on production figures and to list deductions**.

The bill was presented as an industry/royalty owner compromise and, as originally drafted, contained a 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. However, this critical provision was removed from the bill before passage, leaving the royalty owners no means for enforcement. The legislation has helped to some extent but our members continue to have problems in understanding how royalties are calculated and why royalty prices vary so much from one producer to another.

We felt it would be most helpful for our members to discuss the differences between royalty remittance statements received from the various producers and the difficulty in comparing royalty "prices." We have asked **Gregory J. Stucky**, Association General Counsel and member of the Wichita law firm of Fleeson, Gooing, Coulson and Kitch, L.L.C., to prepare an article for this newsletter discussing these differences. His article, **"Reading Check Stubs,"** appears as follows:

READING CHECK STUBS

I (**Gregory J. Stucky**) have been representing royalty owners for over twenty-five years, and, during that time, the most frequent questions royalty owners posed to me relate to the monthly royalty check stubs they receive from their producers. They simply do not understand them, and, more basically, they do not understand how producers calculate and pay royalty. This lack of understanding is almost universal among royalty owners. In fact, some of the most sophisticated and knowledgeable royalty owners I know cannot completely comprehend their monthly check stubs.

In recent years, as a result of the deregulation of natural gas in the 1980s and 1990s, the task of deciphering the information on check stubs has become even more daunting. **Before deregulation, the sale of gas, upon which royalty was calculated, generally took place at or near the well.** (The fact the producer calculated royalty by reference to this sale, of course, does not mean that the producer correctly calculated royalty by employing that method, as evidenced by the Kansas "market value" cases, which were concluded by royalty owner victories in the mid-1980s.)

The use of an "at-the-well" sale made the computation of royalty relatively straight-forward and the check stub more comprehensible than today. **The royalty owner would usually receive, as royalty, his decimal fraction of the volume of gas produced from the well (sometimes adjusted for the BTU content of that gas), multiplied by the wellhead sales price of that gas, and then reduced by the applicable production taxes, such as the severance tax.**

Today, however, in a deregulated environment, the producer may sell its gas far downstream from the well – at the interconnection with an interstate pipeline, farther downstream at the city-gate, such as Detroit, or some location other than the wellhead. It is a common practice of producers, in calculating royalty in such instances, to deduct from sales proceeds they receive certain expenses they claim they have incurred to deliver the gas from the wellhead to those sales points. (The fact the producer calculates royalty by deducting such claimed expenses again does not mean that the producer has correctly calculated royalty. **The propriety of some of those deductions is the centerpiece of the presently pending "deduction" cases.**)

The first obstacle confronting a royalty owner is that each producer uses a different format on its check stubs. In other words, even if a royalty owner is somehow able to decipher the information on a check stub from one producer, his knowledge about that check stub is not transferrable to a check stub from another producer. The accountants working for the oil and gas companies – or more precisely the computer programs used by the oil companies – dictate the format and content of the information appearing on the check stubs.

Those check stubs are not designed to provide easily accessible and understandable information to the royalty owners. If the producers actually wanted to achieve the goal of providing understandable information, they would agree among themselves

on a universal format and content of a check stub. If they do not do that voluntarily, the Kansas legislature might be inclined to require them to do so by prescribing a format that must be followed.

Although the formats of producers' check stubs differ, they usually contain much of the same information, which is discussed below:

1. **Identification of the Property.** The producer normally identifies the property from which production is being measured, either by well name, unit name or by merely the producer's own internal numbering code. **Depending on the producer, the property identified may actually refer to multiple wells.** For example, BP America's (formerly Amoco Production Company) check stub identifies properties by production units, and, in most instances with respect to production from the Hugoton formation, BP America's identification includes both the original Hugoton wells as well as the newer infill well.

2. **Date of Production.** The next column to the right after the column which identifies the property generally provides the period of time during which the natural gas production was measured. **The production period is almost always one month and that period is generally for the month that was two months earlier than the month in which the royalty owner receives payment. (In other words, the check stub received in March generally is payment for January production.)** A Kansas statute, K.S.A. 55-1615, provides that, except when small amounts are involved, the producer essentially has 60 days to make royalty disbursements to its royalty owners before interest accrues.

3. **Type of Production.** The next column to the right after the column containing the date of production typically identifies the type of production for which royalty payments are being made. **These types could include gas production, oil production, helium production, casinghead gas production, and production of liquids extracted from the gas stream.** These types of production are usually identified by numbers in that column, and **on the bottom or reverse side of the check stub, there is a legend identifying the type of production by reference to that number.**

4. **Volume of Production.** The next column typically identifies the amount of product for which royalty is being calculated. **With respect to gas production, it is important to first determine whether the measurement is on a volumetric basis (MCFs) or on an energy basis (BTUs).** The check stub normally indicates the basis of the measurement. **With respect to helium, the measurement is normally by MCFs of helium. With respect to liquids extracted from the gas stream, producers use various types of measurements; typically, however, the volume is shown on a volumetric or BTU basis.**

   When there is liquid extraction – which is almost always done with respect to gas produced in the Hugoton Field – the producer will sometimes make calculations to determine the amount of the gaseous stream, on a volumetric or energy basis, converted into liquids and that part which is sold as residue gas after the liquids are extracted.

   The results of those calculations will then appear in that column. Royalty owners often try to compare the amount of gas production appearing on the proration reports published by the Kansas Corporation Commission (KCC) to the amount appearing on the check stub. **Those amounts often do not correspond because (1) the check stub may determine the amount by energy content (BTUs), while the KCC proration reports identify volumes by MCFs; (2) the check stub may include more than one well in its property identification, while the KCC proration reports list production by well; and (3) the check stub may allocate production between residue gas and liquids extracted from the gas stream, while the KCC proration reports do not make that allocation, but merely note the volume flowing from the wellhead before extraction of liquids.** In many instances, it is almost impossible to verify that the producer is properly crediting to your interest the correct amount of production.

5. **Price.** The next column on the check stub normally shows the "price" applied against the volume of production. With respect to gas, oil and casinghead gas production, that "price" is usually shown in terms "MMBTU's," while for helium, the "price" is shown in terms of "MCF's." With respect to gas, the original of that "price" is sometimes deceptive. **Royalty owners assume that the "price" represents the price the producer receives from an unaffiliated third-party purchaser. In fact, K.S.A. 55-1620 requires that the producer must show the price the producer receives from its purchaser on its check stubs. Some producers, however, either do not follow that law or avoid compliance with it.** For example, BP America shows a "price," which is not its sales price, but rather a calculated price after it has deducted from its sales price gathering and compression expenses it has incurred before making its sale. Anadarko Petroleum Company shows a "price," which is actually the amount it receives for its gas from a sale to its affiliate, which then sells the gas to a third party. **There is simply no way for the royalty owner to know the origin of the "price" by looking at the check stub.**

6. **Taxes.** The check stubs typically shows the amount of production taxes paid on the volume of gas produced. **Under the Kansas tax structure, there would be two types of taxes which could potentially be calculated and then deducted from payment: The Kansas severance tax, which is usually 8% percent of the value of the production, and the KCC conservation fee, which is very modest.** (The ad valorem tax is not deducted by the producer. Royalty owners pay that tax separately.)

7. **Deductions.** On the check stubs, there is normally a column for "deductions." This is a catch-all column, and the producer usually "describes" the "deduction," as, for example, "gathering," "compression," and "transportation." It is many of these deductions which are the subject of the pending class-action lawsuits against PB America, Pioneer, Anadarko, OXY and Exxon-Mobil. As explained above, **a royalty owner cannot assume that because the "deduction" column shows no deductions that no deductions have been taken from the sales price to a non-affiliated third party because the "price" shown on the check stub may already be reduced by those deductions.** Perhaps due to the pendency of the above lawsuits, producers sometimes appear to mask the true activities related to deductions by assigning a label to them, such as "transportation," when, in fact, that activity is more properly described as "gathering." As in the case of "price," the "deductions" information may be misleading to royalty owners.

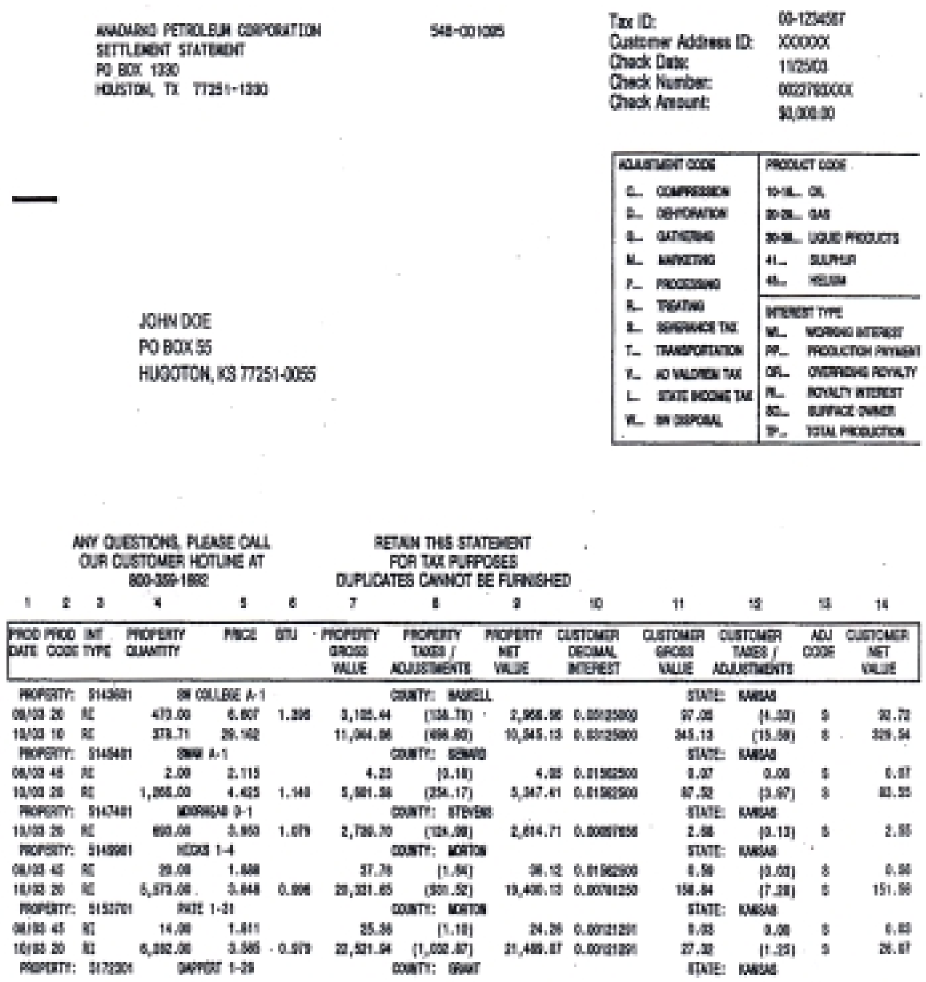
The above data appear on the check stub for the full "8/8ths" of the measured production. At some location on the check stub, the royalty owner's decimal percentage is applied to that data and displayed on check stub.

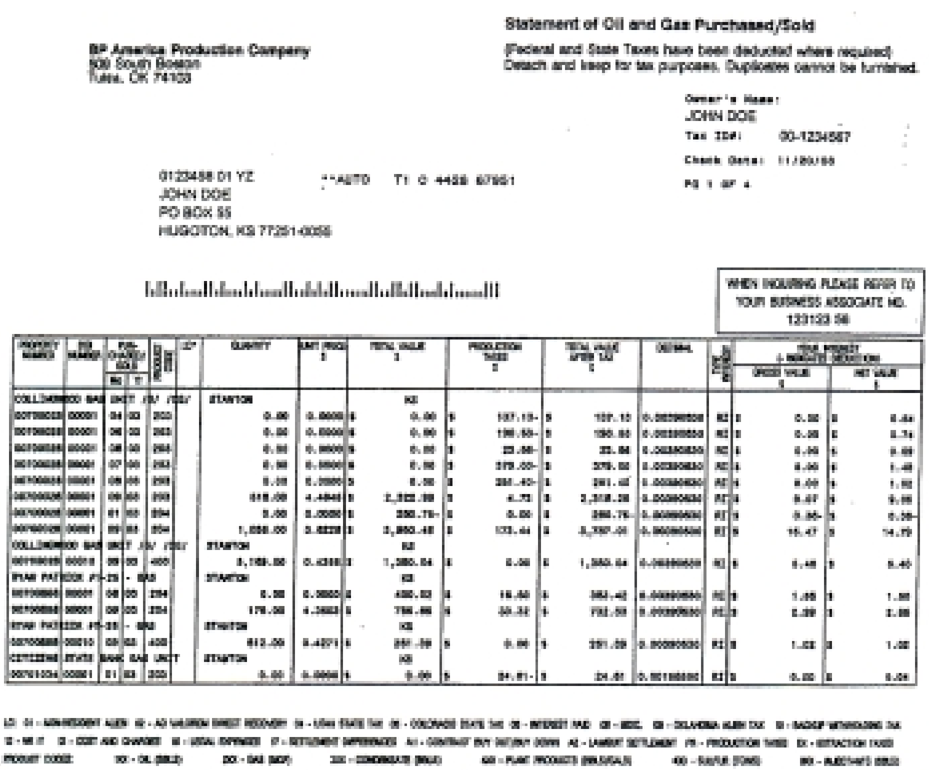
As explained above, even the most sophisticated royalty owners cannot assure themselves that they are receiving the correct amount of royalty payments by scrutinizing the information on their check stubs. **At the right are examples of check stubs from Anadarko and BP America, which are provided to illustrate the explanations described above.**

Although the information on the above Anadarko check stub appears rather straight-forward, as explained above, **the "Price" with respect to gas (which carries a product code of "20") is actually deceptive because that "Price" represents the sales price between Anadarko Petroleum Corporation and its affiliate – not a third-party sales price. That "Price" actually is computed by deducting from the third-party sale by the affiliate certain expenses, such as gathering and compression.** Because the amount of deductions from the third-party sales price is not shown, it is impossible to compare that "Price" to prices on check stubs of producers which show the third-party sales price and then the deductions from that price.

The BP America check stub (at the right) has a deficiency similar to the Anadarko check stub. **The BP America check stub "Unit Price" is actually not the sales price but represents an amount after deductions for expenses, such as gathering and compression.** The BP America check stub also contains examples of accounting entries, which I do not understand. Those are the second-to-last entry under "Collingwood Gas Unit /G/" and the first entry under "Ryan Patrick #1-25 - Gas. If a royalty owner would want some explanation for those entries, he or she would have to try to get answers by contacting BP America. After examining the first five entries under "Collingwood Gas Unit /G/" for several minutes, I finally determined that those entries appear to be correcting entries for overpayments of "Production Taxes" by BP America, but I cannot explain why those overpayments were made in the first place. Again, if a royalty owner would want an explanation, he or she would have to contact BP America.

I have presented these sample check stubs to demonstrate that the royalty owner cannot know how his or her royalty payment is determined in many instances through examining the check stubs. The royalty owners is basically at the mercy of his or her producer to correctly calculate royalty payments without the royalty owner having any meaningful way of checking the calculations.





The Kansas legislature has attempted to partially address that inability by enacting K.S.A. 55-1620 et seq., which attempts to prescribe the information contained on check stubs sent to royalty owners. However, that legislation contains "loopholes," and its enforcement provisions are almost non-existent. The Kansas legislature should strengthen the statute so that Kansas royalty owners are able to understand how their producers pay them their royalties.

Secretary's Note: We appreciate this excellent explanation by Greg Stucky of information contained on royalty check stubs and hope our members better understand, among other things, the differences between royalty remittance statements and the problem in comparing "prices." Hopefully, the Association will be able to convince the Kansas Legislature in the upcoming legislative session to adopt a uniform accounting bill or at least strengthen the current statute, as Greg suggests, so that Kansas royalty owners are able to understand how their producers calculate royalties.