MEMORANDUM

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Louisiana State Mineral and Energy Board
Office of Mineral Resources

From: Cynthia A. Nicholson and C. Peck Hayne Jr.
Gordon, Arata, Montgomery, Barnett, McCollam, Duplantis & Eagan, LLC

Date: August 8, 2019

Re: Proposed changes to Louisiana State Lease form

In connection with the Board's July 31 draft, we submit these comments to Article 9 – Royalty and to certain other revisions included in this draft.

Article 9-Royalty

The provisions of the article are contained in the Article 6 of the current lease form. In general, the State has maintained the same concepts as the current lease form, but this form modified the production upon which royalty will be paid, and has further restricted deductions allowed in the determination of value of such production.

This proposed lease form now provides that royalty will be due on any oil, gas or NGLs produced, saved, sold, utilized, severed or are otherwise attributed to the leased premises. The current lease form limits such production to that produced, saved or utilized. By expanding this provision to include all production that is "severed", royalties will now be owed on any gas flared or oil lost. The only exception is that royalty shall not be due on any oil or gas while such production is used being used for lifting or is being injected to stimulate production or for secondary recovery on the leased premises.

Royalty is still determined based upon the value of the production; if production is sold to a non-affiliate by an arm's length contract, the value of such production shall be the price paid to the lessee under such contract. However, if the sale was not made subject to a prudent contact at the time of execution, the value will be calculated based upon the average of prevailing prices in adjoining fields in a similar fashion to what is now set forth in the current lease form.

This form does clarify and limit deductions that can be made. The following sets forth the treatment of the most common deductions:

a) Any costs or expense incurred to make the production marketable, cannot be deducted.

b) Gathering fee in or out of the filed cannot be deducted. In the current lease form, this prohibition appears to apply solely to gathering just within the field (but the State's auditors have disagreed with us on this).

c) Transportation in the field cannot be deducted.

d) Costs associated with pumps, lifts, recycling, handling, treating or separation cannot be deducted.

e) Costs associated with storage on the leased premises or in the field cannot be deducted.

f) Any costs associated with marketing fees cannot be deducted. This concept is not addressed in the current lease form and this term "marketing fees" is not defined in the proposed lease form. We are concerned that the State will try to claim that any deductions in the calculation of the price made to the lessee is a marketing fee and thus cannot be considered. See below discussion.

We have been informed that one or more members of the State Mineral and Energy Board are interested in revising this proposed form to include a "NO DEDUCTION" royalty clause. We completely disagree with this concept. For the most part, the current and proposed royalty provisions fairly address the determination of the royalty value to be paid to the State. This is a structure that has been in place for decades and is for the most part, understood by the State and the oil and gas industry. By not allowing any deductions, lessees would have to lower the royalty percentages in their bids to take this change into account for their economics.

To make sure everyone is talking about the same thing, here is how we understand a "no deduction clause" would work. In addition to the dis-allowed deductions specified above, we understand that this concept may also include the following described circumstances. For several decades now, most arms-length oil sales in the country by a producer/lessee to an unaffiliated third-party purchaser have been along the following lines. The producer/lessee sells its oil in an arms-length transaction to the unaffiliated third-party under an arms-length contract; the contract references a specified/published fluctuating index price with respect to some other geographical location (e.g., a published index price for oil sales at Cushing, Oklahoma), but the contract further provides that the sales price is to be adjusted up or down from such fluctuating index price by some fixed dollar amount per barrel accepted to both parties. As we understand it, with a "no deduction" clause, the State would compute royalties on this index price without considering whether the arms-length contract price is in fact less than this index price. Thus, for example, if the specified index price for a particular month is $50/barrel but the sale contract provides for a $2/Barrel downward adjustment, the State would require the lessee to pay royalties on oil as if the lessee were paid $50/barrel, when in truth and fact under its arms-length sales contract, the lessee receives only $48/barrel for that same oil.

We strongly urge the Board not to include any such language in the new lease form. We believe it is unfair and inappropriate for several reasons—and, ultimately, would strongly disincentivize parties from wanting to develop and explore state lands.

As counsel for the Board can confirm, the courts have rejected the State's recent efforts to compute severance taxes on this same "no deductions" basis. Earlier this year, the Board of Tax Appeals rejected the State's approach, and the Louisiana Third Circuit in *Avanti Exploration v. Robinson* likewise rejected the Department of Revenue's treatment on price adjustments in oil-sales contracts. Rather than seek to have the Supreme Court review that decision, the State let that ruling stand as the "law of land in Louisiana" and thus is no longer pursuing this approach. See the court's decision for further explanations why the State's approach is wrong.

When a producer/lessee is selling its oil to an unrelated third-party, it has the strongest financial incentive to get the best price for its oil. To the obvious chagrin of the producer/lessee, this best price is often less than some specified fluctuating index price. There is no basis in logic, the law or fairness to say that an oil company should pay royalties based on some theoretic price that is neither the price received by the lessee/seller nor a price that anyone in the area could get. Obviously, special attention and rules are appropriate when the sales are between related parties and this lease form addresses these situations. But where a lessee/producer sells to a wholly unrelated third-party in an undeniably arms-length transaction, it is wholly inappropriate to value the lessee's royalty obligations on some theoretical price that is more than what the lessee (or anyone else selling oil from the same lease) could get.

State leases have been in use for about a century now. But until the State's recent failed efforts ultimately rejected in Avanti, the State has never required lessees to pay royalties on a price higher than any actual, arms-length price received by the lessee. To impose such a requirement

would only serve to accelerate the decline in oil and gas exploration on State lands. Any additional money the State might possibly get from such contract provisions could easily dwarf in comparison to the lost-opportunities the State would suffer from companies throwing in the towel on further development of State lands. The Board should be encouraging the development of the State's resources; such a provision, however, would be a nail in the State's coffin—and coffers. Although we have not done a complete review of the state lease forms used in other states, we are not aware that any state uses, directly or indirectly, any kind of "NO DEDUCTION" clause or concept.

The new lease form now provides that deductions for "marketing fees" (which is an undefined term) are not allowed. First, it is never prudent for a lease to include a term that is neither defined in the lease nor has a common usage or meaning in the industry. It appears that this term may have been added to the lease form to capture these above-described fluctuating prices provisions contained in almost all standard sales contracts. We urge the Board to delete this proposed new concept from the new lease form.

Other Provisions

The July 31 version also includes several changes from the draft considered at the Board's last meeting. We disagree with several of these changes. Although we do not detail each of these changes, we point out the following provisions:

1. In Section 3E (the deep rights release provision), the rights to be released are defined by the true vertical depth of the deepest depth where casing is set. As we have explained, we suggest that this is not an appropriate depth and may cause leases to expire to portions of producing horizons. The expiration should instead reference the stratigraphic equipment of the bottom of the deepest depth drilled. Also, not all wells always include casing down to the depths where there is production.

2. The language in Section 4C does not properly consider partial assignments. As reflected in Mineral Code article 128, an assignee's obligations should be solely "to the extent of the interest acquired." For example, if an assignee is assigned only the west half of a lease, it should not have obligations for the east half of the lease.

3. Section 11A addresses the right of the public to access waterways, but such access should be subject to the lessee's right to use the surface for drilling and related surface operations under the lease.

4. We have several concerns with the form of Section 13 as set forth in the July 31st draft.

a. A(2) holds the lessee to "the highest degree of care" concerning the use of the surface. We believe that this standard will discourage leasing and that the appropriate standard should instead be that of a reasonable prudent operator.

b. Section 13 would now require the lessee to quickly remove equipment and facilities that may be needed for other wells or facilities elsewhere on the leased premises or land pooled therewith. Furthermore, we suggest that these provisions are inconsistent.

c. Lessee is required to maintain the entirely of the leased premises, yet (as authorized by both the terms of the lease and the law) the State can and does authorize other parties to use the leased premises during the pendency of the lease. Lessee's rights are exclusive only for the exploration and development of oil and gas. The lessee should not have an obligation to restore any lease premises from unrelated parties' operations and activities; the lessee's surface restoration obligations should be limited just to the extent the lessee's operations affect the surface.

5. In Section 15 (a new provision on insurance required to be carried by the lessee), a few provisions concern us.

a. Subpart D requires that the insurance company be qualified to do business in Louisiana. Several prominent insurers that insure operations in Louisiana (e.g., various Lloyds of London syndicates) are not qualified to do business here. We suggest that this language be revised to provide that an insurer be qualified so ***to the extent required by Louisiana law***.

b. Subpart specifies insurance minimums, but a provision was included that allows the State to increase these minimums. We are concerned that any provision that allows the State to impose greater obligations at any time will further discourage leasing of State lands in Louisiana. We suggest instead that, whenever the State deems it necessary to increase the required insurance, it issues a notice that these insurance limits will be increased in new leases issued after a specified future date; that way, lessees will have notice of such change in future leasing.

c. Subpart E proposes for the State to the right at any time to require additional endorsements to the insurance in place. Again, lessees cannot have their leases in jeopardy because of additional requirements that they were not aware of when the lease was executed and may not otherwise be able to satisfy.

[End of Memorandum]