



Legislative Research Council

MINUTES

Oil and Gas Study Interim Committee

First Meeting
2012 Interim
June 12, 2012

Room 413
State Capitol
Pierre, South Dakota

Representative Roger Solum, Chair called to order the first 2012 interim meeting of the Legislative Research Council Oil and Gas Study Committee at 8:30 a.m. (CT), June 12, 2012, in Room 413 of the State Capitol, Pierre, South Dakota.

A quorum was determined with the following members answering the roll call: Senators Ryan Maher, Bruce Rempelberg, Tim Rave, Larry Rhoden, and Billie Sutton; Representatives H. Paul Dennert, Spencer Hawley, Charles Hoffman, Melissa Magstadt, Betty Olson, and Tona Rozum; Senator Tom Nelson (Vice Chair), and Representative Roger Solum (Chair). Senator Craig Tieszen and Representative Dean Schrempp were absent. Legislative Research Council staff members present were Reuben Bezpaletz; Chief Legal Counsel; Fred Baatz, Principal Research Analyst; Amanda Reiss, Legislative Attorney; and Rena Ortbahn, Committee Secretary.

(Note): For the purpose of continuity, these minutes are not necessarily in chronological order. Also, all material distributed at the meeting is attached to the original minutes on file in the Legislative Research Council (LRC). This meeting was web cast live. The archived web cast is available at the LRC web site at <http://legis.state.sd.us> under "Interim Information – Minutes and Agendas." At this same site, under Committee Documents, several documents as presented are available.

Chair Roger Solum welcomed the committee and introductions were made. He said that per the LRC Executive Board, the committee would have four focus areas: Distinctive Ownership Configurations; Abandoned Mineral Interests Law; Taxation; and Tax Deeds: a key to encouraging exploration. He said the committee is not limited to these four focus areas.

Staff Presentations

Mr. Reuben Bezpaletz advised that LRC staff presentations would center around these four focus areas (Document 1); the purpose for this initial meeting should be to prioritize study areas; and the committee may meet up to three to five times during the summer.

Mr. Bezpaletz said the committee needs to understand some basic definitions to properly understand the testimony and topics that will be covered throughout the summer. He said a very good summary could be found in a document entitled "Everything You Wanted to Know About Oil and Gas Interests - But Were Afraid to Ask" (Document 2) found under Tab 2 in each committee member's binder. Mr. Bezpaletz then discussed real property interests at length.

Unless the mineral interest has some value, such as oil or gas it becomes so split up (fractionalized) that it is of “de minimis” or of little value. Most states, including South Dakota, don’t have a direct, serviceable, statutory method of extinguishing of “de minimis” mineral rights.

To promote oil exploration and development, dormant mineral fees should be extinguished. Mr. Bezpaletz talked about three ways to extinguish dormant mineral fees: 1. Tax Deed; 2. Abandonment; and 3. Adverse Possession. (Document 2 - page 10)

1. Tax Deed: Using the tax deed method of extinguishing dormant mineral fees, one doesn’t have to find the owners, only the property. With a tax deed, local official assess a value to the mineral interest. If the tax is not paid, the dormant mineral fees will be in delinquent tax status, the interest can be auctioned off and anyone can bid. The sale will extinguish all prior titles, rights, interests, and encumbrances and results in a deed.

2. Abandonment: In 1985 the SD legislature put into statute SDCL 43-30A allowing surface owners to claim abandoned property (mineral interests) after 20 years of abandonment (tab 5). Mr. Bezpaletz advised that the statute as it is now, oversteps constitutional boundaries. If the state decides to address dormant mineral fees using the abandonment statute, the statute will need to be reformulated to address constitutional issues.

3. Adverse Possession: Mr. Bezpaletz talked about adverse possession under common law. He said the big problem is that no deed is produced to back up that ownership by adverse possession. Adverse possession commonly comes into play with railroad easement abandonment.

Mr. Bezpaletz explained that mineral rights are legally considered real property. If they had been taxed from the very beginning there would not have been problems of severed mineral interests.

Mr. Fred Baatz, LRC Principal Research Analyst continued with a presentation on the fundamentals of a severance tax. He also discussed property assessment and taxation on severed mineral rights (Document 1).

Mr. Baatz said presently at least thirty-one states, including South Dakota, impose a severance tax when minerals are extracted from the earth. These taxes are based on the volume or value of minerals extracted or a hybrid of both. Additionally, several states, including South Dakota impose a conservation tax to regulate and monitor natural resource development. Some states, including South Dakota allocate a portion of the revenue to the local governments.

He said taxation rates vary greatly from state to state. While some states impose a low rate for the severance tax or don’t impose the tax to encourage development; Wyoming and other states have done studies finding oil construction and development is more dependent upon the reserves than the tax philosophy.

Mr. Baatz brought out that a good mineral severance tax system taxes at a rate that effectively pays for the short-term and long-term costs of drilling; distributes tax revenue between state and local governments; and limits deductions and exemptions.

States and local governments often find it difficult to establish assessed values and current ownership of severed mineral rights, but many states have done so. They treat mineral rights as real property; they assess a value to those interests and levy a property tax on the severed mineral rights. Mr. Baatz detailed how twelve states deal with taxing severed mineral interests. Each of these states does it differently and he said with fifty states there will be fifty taxing systems.

Mr. Baatz briefly reviewed the South Dakota statutes defining real property and tax deeds. He ended his presentation by saying if the Legislature would decide to adopt legislation in the 2013 session requiring assessment of mineral rights, it would be six or seven years before any action on tax deeds could be taken.

Senator Rhoden commented that he felt that biggest issue before the committee was that of severed mineral rights and he encouraged a legal solution to this problem. There is rationale to attach severed mineral rights back to surface owners. After listening to Mr. Baatz's presentation, he said the way Colorado handles severed mineral rights might be a methodology to pursue. Mr. Bezpaletz reviewed legislation he has drafted in the past attempting to address these problems including a bill introduced by Senator Maher in the 2012 session.

At 10:25 a.m. the committee broke for 10 minutes and resumed at 10:35 a.m.

Briefing by the Department of Environment and Natural Resources

Mr. Steve Pirner, Secretary of the Department of Environment and Natural Resources, presented a PowerPoint entitled "Where's the Oil" (Document 3 - found under Tab 5 in the committee binders). He said the Department has compiled all existing information relating to past and current oil and gas development in South Dakota and made it available online, all in an effort to facilitate future oil and gas development. He encourages people to access the DENR site.

Mr. Pirner described the existing and potential oil-producing geological formations in South Dakota. He explained how to use the DENR online interactive maps that contain the data bases for nearly 100,000 drill holes including locations of oil and gas permits and wells, Geophysical Logs from the SDGS Database; test hole and well drilling; and Water Rights Observation Wells; along with records of water well completions. One can click on any of these some 100,000 interactive points and obtain detailed information about that specific location. He also reviewed information on public drinking water systems and municipal water systems in northwest South Dakota and talked briefly about state and federal assistance programs available for those systems.

In response to a question concerning fracking and water use and availability; Mr. Pirner indicated that water is indeed a problem in northwestern South Dakota, but to date fracking

hasn't been required for oil development in the shallow Red River formation therefore DENR hasn't been pursuing fracking rules.

Mr. Bob Townsend, Administrator of the Minerals and Mining Program within DENR presented a power point presentation entitled "Oil and Gas Rules and Permitting" (Document 4 - found under Tab 5 in the committee binders). He explained how oil and gas rules and legislation have been changed and streamlined since 2004 in an effort to promote oil and gas development. He also reviewed Oil and Gas Permitting basics including: Drilling Permits, Well Construction, Well Plugging, Well Spacing, Unitization, Underground Injection Control, Permit Processing Procedures and Timelines, and Hydraulic Fracturing.

Mr. Townsend responded to committee questions. He said that under the surface damage statute, the drilling company notifies the landowner prior to drilling; indicated that the state does have a couple of tools for the inspection of the well casing process; and said that the fracking fluid containing diesel fuel is the only element in fracking that is regulated. EPA is reviewing fracking regulations.

Staff Presentations, continued

Ms. Amanda Reiss, LRC Legislative Attorney provided information on the following areas: the Impact on Physical Infrastructure; the Impact on Enterprise Services; and the Impact on Government Services (Document 1).

Ms. Reiss said that physical infrastructure problems such as housing cannot be entirely dealt with legislatively and should generally be taken care of by the private sector based on demand. State roads impacted would have to be addressed through the state budget. Impacted county roads would be addressed by county governments which might need increased budget reserves which the Legislature could address. She said sewer infrastructure inadequacies would need to be addressed by local and state governments.

Ms. Reiss said that the impact on enterprise services also cannot be wholly alleviated by the legislature, and it would be up to businesses to meet consumer demand, employment disruption, cost of living escalation, health care services, etc. However, there is potential for the Legislature to address some of these problems, such as expanding health care programs to bring health professionals into the area.

Ms. Reiss said increased demand for law enforcement, court systems, schools, and emergency services would mainly be addressed at the county government level. She said there might be possibly some grants for facility development and that possibly state jobs or county jobs could be addressed by the Legislature.

Ms. Reiss responded to a question by indicating this interim committee will identify issues and make recommendations beyond which the Legislature and the Governor's Office will address.

In response to a question by Representative Rozum, Mr. Bezpaletz recommended two videos available online:

<http://watch.montanapbs.org/video/2236174487/> - "Boom? Behind the Bakken"
<http://www.cnbc.com/id/46167125> - "America's Oil Rush: Boom or Bust"

In response to a question from Representative Hawley, Mr. Bezpaletz indicated that surface fee issues are one of the more insolvable problems but to the extent the Legislature can address this issue, it would be a purposeful thing. He said basically the surface fee owner of land where mineral rights are being accessed would be involved in an entry contract and easements. The terms of the contract would address liquidation of damages, arbitration of differences, and cleanup and restoration. Owners of neighboring surface fees have no contractual rights and will suffer the consequences of traffic, dust, and noise. He said with an oil boom, some people get very wealthy while others do not; when people suffer the consequences, but not the benefits, ill feelings result.

The meeting recessed for lunch at noon and reconvened at 1:15.

Briefing by the Governor's Office

Mr. Nathan Sanderson, Policy Advisor with the Governor's Office gave a brief overview of the Governor's Office Task Force on Oil and Gas Development. The task force has two working groups: Oil and Gas Development and Oil and Gas Preparedness. The development group has three objectives: 1. the potential scope of oil including timelines for various scenarios; 2. incentives are including tax structures to promote development; and 3. effect on the environment. The preparedness group is studying infrastructure, emergency services, and schools.

In response to questions Mr. Sanderson said the task force hopes to have a complete summary in August. As for questions on overlap between the LRC interim committee and the Governor's task force, Representative Solum said the legislative interim committee is looking at statutory issues while the governor's office is looking at policy. Mr. Sanderson said the two staffs have been working together for the last six weeks.

Briefing by the Department of Revenue

Mr. Jason Evans, Deputy Director of Property and Special Taxes, Department of Revenue appeared before the committee (Document 5 - found under Tab 4 in the committee binders). He outlined the South Dakota existing severance tax law (SDCL 10-39A). He said the revenue allocation is 50% state/50% county, with the state portion being credited to the general fund and the county portion set aside for school and road purposes. Mr. Evans spoke of an additional conservation tax that has been imposed since 1983 and placed in the environment and natural resources fee fund. He briefly described the severance tax collected from 2007 to 2011, reversions by county, and the conservation tax. For a comparison of South Dakota's 4.5% severance tax rates with surrounding states he referred the committee to a NCSL chart entitled "Oil and Gas State Severance Taxes as of 2012" (Document 6 - found under Tab 4 in the committee binders).

Ms. Jan Talley, Director of the Business Tax Division, Department of Revenue continued the presentation (Document 4) with a description of oil and gas field services subject to sales tax, including services performed at the well site and services, equipment, and products brought

into South Dakota for use in oil and gas purposes. She concluded by describing how the Department of Revenue works with DENR to make sure the operators are properly licensed for tax purposes. Royalty fees are exempt from sales tax.

Ms. Talley responded to questions. Equipment brought into South Dakota that is seven years old or less is taxed differently than older equipment and even if equipment is here for only a short amount of time, it is still subject to taxation. If the operator has paid taxes in states with which South Dakota has reciprocity, then no South Dakota tax is charged; although if the equipment is brought into a South Dakota municipality, that equipment may be subject to the municipal sales tax. She said that if water used in oil and gas production is purchased locally, such as from a domestic water supply, it is not subject to sales tax; but if it is purchased from an individual or distributor it is subject to sales tax.

Briefing by the Office of School and Public Lands

Mr. Jarrod Johnson, Commissioner of School and Public Lands appeared before the committee. He presented a handout entitled "Legislative Interim Study on Oil and Gas Development in South Dakota" (Document 7 - found under Tab 6 in the committee binders). He said his office administers 5.2 million acres of mineral rights. When state lands are sold, the state retains the mineral rights. He gave an overview of oil and gas lease auctions, detailing payment amounts and describing the one-time bonus offer and talked about oil and gas lease terms including royalty rates. He presented information on the oil, gas and mineral acres by county in South Dakota; the top 10 oil, gas and mineral leaseholders; and mineral acres leased by year from 1954 to 2012. He provided details on the existing oil and gas wells in South Dakota and information about oil and gas revenues received by year from 2007 to 2012. He said that although oil leasing activity has increased in recent years, it is nothing compared to what it was in the early 80's.

Public Testimony

Mr. Tim Brown, a rancher from Buffalo, South Dakota said he has a number of oil wells and related water construction wells on his property along with miles and miles of roads, estimating that 160 acres of his property is covered one way or another. He expressed that he and other ranchers that have and are suffering a loss of income from oil development on their property deserve to be compensated. He said the lease he is under contract with does not touch the loss he is experiencing and feels that the surface owners not having the mineral rights should receive a percentage of the working income in compensation for their loss. In response to a question Mr. Brown said he thought that mineral rights are private property therefore giving the surface owner part of the mineral royalties wouldn't work.

Mr. David Niemi, a rancher from Buffalo, South Dakota passed out a notice he received dated June 7, 2011 (Document 8) in which an oil company has notified him that within 30 days of the notice they will be replacing a pipeline that is on his property. The company included a copy of the South Dakota surface damage statute, but believes the replacement is not covered by this statute. Mr. Niemi advises that he estimates that 230 acres of his pastureland is taken out of production annually and he agrees with Mr. Brown that if the surface owner could receive some sort of small annual compensation for the damage incurred by oil development, it would be a huge help. He said oil companies make a one-time offer to the landowner which does

not touch the damage incurred. Senator Maher questioned the reclamation process. Mr. Niemi advised that there is minimal reclamation, such as minor grass seeding and since at best Harding County has one to two inches of topsoil, reseeding can be a problem. To do a good job, oil companies have to come back several times, and once they've left, it's hard to get them to come back.

Responding to a question from Representative Solum, Mr. Bob Townsend, DENR explained that under oil and gas rules reclamation is required; bonds are issued; and if reclamation is not adequate, the bonds are not released. However, other than for pit storage reclamation; there is no time frame in rules for surface damage reclamation. By statute bonds for well plugging are set at \$5000/well or \$20,000 statewide and for surface reclamation \$2,000 per well or \$10,000 statewide. Generally in Harding County the statewide bonds are provided to comply with statute. He indicated DENR is monitoring bonding amounts used by other states.

Mr. Bezpaletz advised that the law requires that landowners be fully compensated for damages.

Mr. Ron Slaba, a Harding County rancher from Ludlow, South Dakota spoke to the committee. He stated as a surface landowner he received a one-time payment from the oil companies of \$7,500 and that's it, while the county and state and oil companies are making millions. He said he and other ranchers, some of the most conservative people in the state are asking the government for regulations to help them. They are asking for a small percentage of the oil well revenue.

Mr. Colle Nash, Bison, South Dakota representing Grand River Electric said his company is willing to host a meeting of this committee in the Grand River Electric area.

Committee Discussion, Debate, and Staff Direction

Representative Solum said that the issue of friendly environment between the surface owners and the oil companies should be at the top of the committee's priorities.

Representative Rozum is seeing two issues: 1) that of surface damage which perhaps the legislature can address and 2) income replacement for the long term.

Mr. Bezpaletz advised that there are two issues 1) Incidental damage for which there can be a fixed compensation; and 2) Constructive damage which diminishes the surface land value. The law allows for a one time constructive damage payment in the nature of an eminent domain taking, it can't be turned into an annual payment. If the company does not negotiate in good faith, the landowner must go to court.

Representative Rampelberg said it appears the ranchers are given a one-time payment, after that they must sue. Are they looking for something other than the right to sue such as a mediator? He thought that would require language in the contract. Senator Rhoden said they have skipped a step – the power of negotiation when the oil company first knocks on the door. This could lead to eminent domain, which opens another door.

Representative Rampelberg agreed - do it with the initial contract, but he questions dealing with estate contracts and mineral rights severed years ago. If the oil company is not fair, it seems the only recourse is to sue and the companies have big pockets when it comes to lawyers versus the ranchers.

Mr. Bezpaletz spoke to the committee. He doesn't feel liquidated damages, which he spoke of earlier are the answer. It would establish minimum amounts, which the oil companies would likely attempt to turn into maximums. Possibly legislation could be drafted so that when the landowners sue the oil companies, they would be entitled to legal fees. He then referred to a bill introduced in last year's session by Senator Maher. The bill would give surface owners a percentage of the production revenue. In parts of the country oil companies do this to promote good will, but there is a difference between the oil company gifting a percentage of their production revenue to the landowner versus them being mandated by statute to do so. Also, such legislation is complicated in that the oil reserves may be under many ranches, and it would make a difference where the oil well is drilled as to who would get reimbursed.

Senator Rave presented the following: 1) LRC staff put together possible ideas for solutions; 2) an onsite visit or visits to get a full grasp of issues; and 3) surface area rights are definitely an issue. Senator Rave said another part would be continued staff preparedness to have a draft plan in place for each of the stages.

Representative Solum repeated the Legislature's E-board priorities: 1. Distinctive Ownership Configurations; 2. Statutory Restraints: South Dakota's Abandoned Mineral Interests Law; 3. Taxation; and 4. Tax deeds: a key to encouraging exploration.

Representative Dennert said even though DENR is working on it, there should be a follow-up on bonding requirements, and Representative Solum encouraged DENR to do so.

The committee decided the next meeting will be in Harding County, probably Lemmon, in order to see firsthand what's going on; and that nearby North Dakota legislators will be invited or that perhaps a webinar will be set up. They decided to look at two dates for the next meeting, either July 16 and 17 or July 31 and August 1.

Adjournment - Senator Rave moved, seconded by Senator Rhoden to adjourn. The motion prevailed unanimously on a voice vote.

The committee adjourned at 3:45 p.m.



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