

HOW IMPORTANT IS THE ROYALTY OWNER TO YOUR COMPANY'S PROFIT?

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ABSTRACT

The purpose of this paper is to discuss and emphasize the importance of the royalty owner to the oil industry and the direct effect which unfavorable owner relations has on your company's profit.

This paper will be divided into six principle parts: (1) Introduction; (2) The importance of the royalty owner; (3) The landman's role in royalty owner relations; (4) The royalty owner's role as the company's constituent; (5) Ways of preventing adverse relations with royalty owners; (6) Summary.

INTRODUCTION

The perception of your company through your actions will affect your relations during the term of the leases and any future business you encounter with the royalty owner, his neighbor or his community. Unfavorable relations may result in cancelled leases or lawsuits which will in turn reduce your company's profit, thus affecting your shareholders, your future and your jobs. A satisfied royalty owner is the best public relation your company can have. These owners can persuade their neighbor or community leaders to deal with your company either favorably or unfavorably.

Every year millions of dollars and thousands of man hours are spent litigating oil and gas related problems in the courts around the country. There is a tendency in our present society to litigate at the first signal of conflict especially against the major corporations. Many of the costly court battles, which often result in bitterness, could be avoided by arbitration or by any of us going that extra step to prevent an explosive situation. Lawsuits are lengthy, costly, and can attract a lot of unwanted publicity. However, a clearer understanding of the responsibilities on both sides of an issue and more open communication could resolve many of the problems that now end in litigation.

ROYALTY OWNER IMPORTANCE

The royalty owners (leaseholders) are one of the oil industry's most important assets. The industry could not extract or market their product without the right to the royalty owner's land. We in the oil industry have the most advanced technology, the most efficient and productive engineers, and the money from our investors; however, without that valuable lease to explore, drill, and produce the oil/gas, we could not remain in business.

The importance of our royalty owners goes without saying, whether he is the landowner, the investor or the heir. They own the tract(s) of land we want to explore. The oil industry is not in the land purchasing business; therefore, we must lease to drill for our product. These leases set forth and provide the moral and legal obligations to the leaseholders:

- o develop the land prudently
- o protect the surrounding lives
- o settle for surface damages fairly
- o pay lease rental or drill a well
- o pay royalties in a timely and accurate manner
- o withhold federal and state severance taxes
- o respond to owner's inquiries promptly

Years ago Sun had a costly and frustrating experience in a field in Louisiana. A timber company was the holding company of a particular section we wanted to lease. For some reason the timber company was unhappy with Sun's previous handling of property development and the royalty payments. Therefore, they leased the section to Arco and stated in the lease, "In the event that the lease or any portion thereof has been assigned to Sun Oil Company or any of its subsidiaries, this entire lease shall be null and void". In this case, previous unfavorable relations prevented our company from leasing the desired section.

Fortunately, this situation does not happen often. In order to prevent dissatisfied royalty owners, our Division Order Department always tries to hold the basic Division Order. In this manner, Sun controls processing of royalty payments and the method of response to owner inquiries. Our staff tries to uphold an ethical and professional relationship with our owners. Our Division Order and Royalty Disbursements departments are keenly aware of our obligation to provide timely and accurate royalty payments. For this reason, we have a primary checkwrite on the 23rd of the month and a second checkwrite on the 25th of the month. The purpose of the second checkwrite is to provide for late run tickets or corrections to the previous calculations. We will also issue manual checks during the month as it is necessary.

One thought that we always try to instill in our staff is "nonpayment of royalty may shut our well down". The royalty owners have a very powerful agency in Texas - the Railroad Commission. The Commission could shut down the well for non-payment of royalty.

Exhibit I reflects a copy of our check stub and information provided to the owners. Sun, like the rest of the companies in the industry, is redesigning the current revenue and royalty disbursements system in order to provide better service to our owners and automate much of the manual effort brought on by the Winfall Tax. The comparative market and the ever-changing federal and state regulations have placed a great demand on our industry accountants and our computer systems. Most of our computer systems have been patched and repatched numerous times since DOE and IRS Winfall Tax regulations. Exhibits II and III reflect IRS Form 6248 and accompanying statements. These are required by the IRS to be issued by March 31 of each year.

The generation of IRS Form 6248 has caused an administrative nightmare. Prior to the Winfall Tax the only reporting that was required to the owner was an IRS Form 1099. This form strictly requires the reporting of gross earnings from royalties or rentals for the year. Now, in addition to Form 1099, the IRS requires Form 6248 for oil and condensate production. Form 6248 requires the reporting of Winfall Tax calculation for the year at the owner's decimal interest

and the reporting of withholding of the tax by production year and calendar year. As you can see, there is a tremendous amount of information that must be accumulated, generated and printed each year. We must also maintain the owner's tax withholding status, i.e. independent, exempt royalty interest, Indian, charity, etc. Needless to say, this tax has created the burden of maintaining and updating massive master files. Last year Sun printed over 146,000 IRS Form 6248's and over 800,000 detail statements.

THE LANDMAN'S ROLE IN ROYALTY RELATIONS

The landman's role is very important and delicate when dealing with the lessor or land owner. This is especially true when the land owner does not own the mineral rights. Your rig on his land reminds him daily that maybe years ago he made a bad business deal by not buying the mineral rights. The landman is the first contact or first link in a chain of employees that the owner will be in contact within the company. The landman will plant the first seed in a hopefully growing trust and confidence which can aid the growth in our dealings with the owners. It is imperative that the field and the administrative staff continue nourishing that seed.

As you are aware, a sure way of starting bad relations with the land owner is not closing his gates and for his cattle to get out. This action might prevent our company from further leasing with him or his neighbor, or create bad feelings when the landman comes by to get him to sign a unit agreement.

Many times the landman travels incognito and hires a brokerage firm to provide a front at the county court house. Nothing drives prices up faster than knowledge or even rumors that a major oil company is buying leases. This is especially true in small communities. However, it is very hard to be inconspicuous in a small town. Deep resentment for the oil industry is the case in some areas. This was especially the case in the Ranger Field for Sun. In the past, dozens of marginal operators had come looking for leases. The result had been a small token leasing fee, a dry hole, a wretched landscape, and sometimes lawsuits. Once the community in Ranger knew they were dealing with Sun, they were happy to be doing business with a major oil company at last. Many of the previously suspicious leaseholders signed up.

Once the search of title land ownership has been completed, the landman must search for the owners and convince them to sign a lease. Sometimes the landman has to convince them they own the mineral and leasing rights. We had a case in Ranger Field where our landman traveled to Lubbock to find a widowed heir of a large tract. She kept insisting, "but you must be mistaken, I don't own any oil". For approximately two hours she refused to accept our documentation, but finally gave in - "Okay, I own it", she said. "All right", said the landman, "now I would like to lease your land from you. I am paying fifteen dollars an acre for a five-year lease". "Oh, no", she said, "I can't do that. I can't tie up my land for five years". After using much diplomacy and charm the landman finally received his lease.

ROYALTY OWNER'S ROLE AS A CONSTITUENT

Another way we look at the interest owner is as our constituent. We have a common interest. They are our partners and must be treated accordingly. There are many royalty and working interest owners and numerous royalty owner associa-

tions, and we often seek their support when there is pending legislation affecting our industry. Sun, like many major companies, spends a great many hours keeping our interest owners abreast of the federal regulations affecting them and the industry. Sometimes we are successful; other times we are not. One example was the Windfall Profit Tax. When President Carter spoke about taxing the "big oil companies", he never made reference to millions of royalty and working interest owners who would also be affected. Even though we sent literature to inform our royalty owners telling what it would mean to them, numerous calls were received by our office once the tax was passed. The owners were shocked that it had reduced their monthly royalty checks approximately by one-third, a substantial income cut. Most owners still believed that the tax was strictly for the "big oil companies".

Today's owners are more sophisticated and organized than in the past. Their political clout has been felt at the state and national levels. One example is the passage of the Windfall Tax two barrels a day exemption for royalty owners effective January 1, 1982 and the exemption of independent producers for stripper production. Therefore, last January we enclosed Exhibit IV with our royalty checks. Here, we are urging our owners to contact their congressman concerning gas regulations. Hopefully with their support, removal of price controls from natural gas may be achieved.

PREVENTING ADVERSE RELATIONS

The land owners will have more contact with the field personnel than probably anyone else in the company. Therefore, it is essential that the image of the company be upheld. As I am sure you have experienced, a mad land owner can make your job very difficult. We had a case where the land owner was not the mineral rights owner; therefore, he was already unhappy. We leased the surface for a warehouse; however, every time the survey crew would come in and survey the land and place the stakes down for the dimensions, etc., the land owner would come out and pull all the stakes and throw them away. As you can see, that was not only a frustrating situation but costly. Our landman went to see the land owner and bought a few bushels of corn that were probably a bit overpriced. The tension between the land owner and Sun was eased and the work continued. In the long run, Sun probably saved money in future damages.

One way of maintaining good relations is by paying the owners promptly and correctly. The field personnel might be doing an outstanding job to build good relations, but if the administrative staff does not pay the royalty in a timely manner, collect their taxes properly, or answer their inquiries professionally, this good foundation could be destroyed. There needs to be a lot of team effort between the field or district and headquarters personnel.

Be familiar with the proper names and members of your companies which handle royalty owner inquiries. We had an instance where the wrong information was given and it has resulted in extensive man hours spent and the royalty owner still has a feeling of being short changed. Never try to estimate what the owner's income will be or give him any kind of tax advice.

If you are in the field and the owner has a question or complaint, be sure to transfer that information to the proper party. If you are a landman, be familiar with your proper division order, contract and title, or royalty disbursement departments.

SUMMARY

The purpose of this paper is to emphasize that an ounce of prevention may prevent a lawsuit later. While on the owner's land, be a good citizen and treat that property better than if you owned it. We represent our companies; the owners are not going to be angry at us but with our company and our industry. Good relations start in the field and are maintained all the way through the corporation. Remember, working with royalty owners is a team effort, and most of all it is our leases that keep our companies in business.

FIGURE 1

Sun Exploration and Production Company Sun Production Division P O Box 2880 Dallas Texas 75221										Oil And/Or Gas Statement	
From	Thru	Property	Suc Sta	Q	Quantity	Windfall Profit Tax	Severance Tax	Net Value	Windfall Profit Tax and Net Value	Decimal	
Mo	Mo	Number	Tr	Q							
1082	669792	00002			2603		61328	766849	9992	001302	
1282	669792	00001			552727	5326717	777306	10771403	6936	001302	
1082	669792	00002			2602		61328	766844	9992	001302	
1282	669792	00001			769013	7411092	1081470	14986319	9651	001302	
YEAR-TO-DATE:		GROSS EARNINGS		54707		WINDFALL TAX		16987		NET EARNINGS	
										35941	
Check Date		Owner Number		3732435		<input type="checkbox"/> 1 Oil <input type="checkbox"/> 2 Gas <input type="checkbox"/> 3 CR <input type="checkbox"/> 4 P.P. <input type="checkbox"/> 13 Condensate <input type="checkbox"/> 2 RI		Total		355.41	
1-24-83		022904						Register		073243	
Keep this statement for tax purposes. duplicate will not be furnished Refer to Property No. and Owner No. when writing											
Royalty Account											
SUN				Sun Exploration and Production Company Sun Production Division Dallas Texas				RepublicBank Brownwood Brownwood Texas		Check Number 732435	
Pay *****355 Dollars				41Cents				88-155 1119			
Pay to the order of								Check Date		Owner Number	
								01-24-83		022904	
								Register		073243	

732435 111901551 484-077-1

Form **6248**Department of the Treasury
Internal Revenue Service**ANNUAL INFORMATION RETURN OF
WINDFALL PROFIT TAX--1981**Copy C--To
Be Filed With
the Producer or
Other Recipient

Producer or Other Recipient		Filer
Name, address, and ZIP code MT PLEASANT MI 48858		Name, address, and ZIP code SUN EXPLORATION AND PRODUCTION COMPANY P.O. BOX 2880 DALLAS TX 75221
Employer identification number	Social security number, if any	Employer identification number
	375141488	231743284
If the information on this return is based on a Form 6248 received from another person, check this box (see instructions) and provide the name and employer identification number of the person who furnished you Form 6248: <input type="checkbox"/>		
Name		Employer identification number

Part I Producer Or Other Recipient

Type of Producer ☐ Individual ☐ Partnership ☐ Corporation ☐ Estate ☐ Trust ☒ U.S. citizen or entity, or resident alien
(Check all applicable boxes) ☐ Resident of U.S. Possessions ☐ Foreign citizen or entity, or non-resident alien

Producer Status (check all applicable boxes) ☐ Independent producer ☐ Member of "related group" ☐ Producer with no withholding ☒ Royalty owner ☐ Integrated oil company ☐ Operator ☐ Working interest

Part II Exempt Oil

	Tier one (a)	Tier two (b)	Tier three		
			Newly discovered (c)	Incremental tertiary (d)	Heavy (e)
Number of barrels of exempt oil					
1 Qualified governmental interests	0	0	0	0	0
2 Qualified charitable interests	0	0	0	0	0
3 Exempt Indian oil	0	0	0	0	0
4 Exempt Alaskan oil	0	0	0	0	0
5 Exempt front-end oil	0	0	0	0	0
6 Total exempt oil (add amounts on lines 1 through 5, columns (a) through (e))					0

**Part III Information on Taxable Oil
Removed During 1981**

	Number of barrels of oil (a)	Aggregate removal value (b)	Aggregate adjusted base value (c)	Aggreg. state severance tax adjustment (d)	Tax liability (e)
1 Tier one, other than Sadlerochit oil:					
A Subject to 70% tax rate	16	583	247	14	225
B Subject to 50% tax rate	0	0	0	0	0
2 Tier one, Sadlerochit oil:					
A Subject to 70% tax rate	0	0	0	0	0
B Subject to 50% tax rate	0	0	0	0	0
3 Tier two oil taxed at 60%	0	0	0	0	0
4 Tier two, oil taxed at 30%	0	0	0	0	0
5 Tier three, newly discovered oil	0	0	0	0	0
6 Tier three, incremental tertiary oil	0	0	0	0	0
7 Tier three, heavy oil	0	0	0	0	0
8 Total (add lines 1 through 7)	16				225

Part IV Windfall Profit Tax Liability for Oil Removed During 1981

1 Amount of windfall profit tax liability for oil removed during 1981 (from Part III, line 8, column (e))	225.00
2 Amount of windfall profit tax withheld with respect to oil removed during 1981	225.00
3 If line 1 is greater than line 2, subtract line 2 from line 1. This is amount of underwithheld windfall profit tax	0.00
4 If line 2 is greater than line 1 subtract line 1 from line 2. This is the amount of overwithheld profit tax.	0.00

Part V Amount of Windfall Profit Tax Withheld from Payments Made in 1981

Windfall profit tax withheld from payments made in 1981 (regardless of when windfall profit tax liability arose)	215.00
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**WINDFALL PROFIT TAX STATEMENT--OIL REMOVED IN 1981
EMPLOYER I.D.**

FIGURE 3

PAGE: 1

(REVISED)
11/29/82

OWNER: 645128 SUN EXPLORATION AND PRODUCTION COMPANY

MT PLEASANT MI 48858

OWNER: 645128
DECIMAL INTEREST: .00312500
SOC. SEC. 375141488
OWNERS EMPL. ID.

PROPERTY: 49090000010
PROPERTY NAME:
ENTERPRISE FIELD UNIT
OPERATOR NAME:
SUN OIL COMPANY

REM. DATE		VOLUME AND VALUES REFLECT ONLY YOUR DECIMAL INTEREST									
MO	DY	TAX TIER	BARRELS REMOVED	REMOVAL VALUE	ADJUSTED BASE VALUE	SEVERANCE TAX ADJUSTMENT	WINDFALL PROFIT	WINDFALL PROFIT TAX LIABILITY	WINDFALL PROFIT TAX WITHHELD		
01	00	56	53	966	771	07	185	129	22		
01	00	96	78	2992	1148	76	1765	1236	1344		
02	00	56	43	1648	632	42	973	681	681		
02	00	96	78	2983	1144	77	1761	1232	1231		
03	00	56	40	1531	587	39	904	633	633		
03	00	96	89	3409	1308	88	2013	1409	1409		
04	00	56	33	1268	495	32	739	517	517		
04	00	96	93	3535	1382	90	2062	1443	1443		
05	00	56	28	1076	428	27	620	434	434		
05	00	96	103	3860	1538	97	2224	1557	1557		
06	00	56	20	724	301	17	405	284	284		
06	00	96	97	3490	1450	85	1954	1368	1368		
07	00	56	15	527	229	12	285	199	199		
07	00	96	104	3656	1590	86	1979	1385	1387		
08	00	56	10	363	158	08	196	137	137		
08	00	96	119	4183	1819	99	2264	1585	1585		
09	00	56	04	162	70	03	87	61	61		
09	00	96	131	4613	2006	109	2497	1748	1748		
10	00	96	152	5361	2366	125	2868	2007	2004		
11	00	96	171	6015	2655	144	3215	2251	2251		
12	00	96	168	5890	2600	141	3149	2204	2204		
TOTAL			1629					22500	22499		

TAX TIER AND TYPE

TAX RATES

0 TIER 1--LOWER
1 TIER 1--UPPER
2 TIER 2--STRIPPER/NPR
3 TIER 1--FRONT-END TERTIARY
4 TIER 3--INCREMENTAL TERTIARY

5 TIER 1--MARGINAL
6 TIER 3--HEAVY
7 TIER 1--ALASKA N.S.
8 TIER 3--NEWLY DISCOV
9 TIER 1--MKT NEW/HEAVY

0 EXEMPT--QUAL GOVT INT
1 EXEMPT--QUAL CHAR INT
2 EXEMPT--INDIAN
3 EXEMPT--ALASKAN OIL
4 EXEMPT--FRONT-END

5 EXEMPT--OTHER
6 TAXABLE 70%
7 TAXABLE 60%
8 TAXABLE 50%
9 TAXABLE 30%

RETAIN FOR TAX PURPOSES
DUPLICATES CANNOT
BE FURNISHED

FIGURE 4

Everyone agrees: "The Natural Gas Policy Act Is Not Working"

Problems

- Premature abandonment of old gas wells.
- Higher than market prices being paid by some pipelines for new gas results in lost gas markets.
- Gas surpluses in some regions; potential of severe shortages in others.
- Encourages imports.
- Producers encouraged to develop higher cost gas first — an inefficient way to allocate capital.

Solution

Removal of price controls from natural gas will:

- Provide for the development of the most cost-efficient reserves first.

- Eliminate distortions among markets and between inter- and intra-state pipelines.

- Provide for the maximum production of reserves from existing fields.

Your Congressman and Senators need to hear from you on this issue. To date, they have been hearing mostly from people who believe more regulation is the solution.

Regulation got us in this mess; removing regulations can get us out.



**Sun Exploration and
Production Company**