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STATE SCHOOL TRUST LANDS AND OIL AND GAS ROYALTY RATES

David Woodgerd* and Bernard F. McCarthy**

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I. INTRODUCTION

The recent oil shortage and the subsequent rise in the price of petroleum has increased interest in oil and gas exploration nationally and in Montana. The increased price and activity has raised questions and issues concerning the industry and its relationship with the mineral owner. One of the most important questions concerns the royalty rate which the mineral owner should obtain from the production of the minerals found on the land.¹

The State of Montana owns oil and gas mineral rights covering over 6 million acres across the state.² Substantial income is derived from these rights for the support of the public system in the state. The

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1. Oil and Gas are defined in MONTANA CODE ANNOTATED [hereinafter cited as M.C.A.] § 82-11-101(6) & (7) (1981). Gas is defined as “all natural gases and all other fluid hydrocarbons as produced at the wellhead and not defined as oil in subsection (6) [sic] of this section.” Oil is defined as “crude petroleum oil and other hydrocarbons regardless of gravity which are produced at the wellhead in liquid form by ordinary production methods and which are not the result of condensation of gas before or after it leaves the reservoir.” For a definition of other minerals, see the specific mineral in the index to the 1981 MONTANA CODE ANNOTATED.

2. Montana Department of State Lands, Statistical Report for Period Beginning July 1, 1978, to June 30, 1980. The lands the state of Montana owns are scattered across the state and come from a variety of sources including dispositions in private wills, land exchanges and land purchases. The report is available upon request from the Department of State Lands, Capitol Station, Helena, Montana 59620.

royalty rate received by the state for the production of the minerals on its land is important in two ways. First, the income subsidizes the funds raised by taxes for the support of Montana's educational system. Secondly, the rate sets a standard that private mineral owners may look to in determining what royalty they should receive for their own minerals.

This article will discuss the factors the state must consider in determining a fair royalty rate. Therefore, it will be necessary to discuss the historical background of school trust lands and the constraints on management of those lands. This article will not attempt to determine the optimum royalty rate for school trust land, but will analyze the factors which the state must consider in setting a fair royalty rate.³

This discussion of oil and gas leasing is nontechnical and is based largely on material gathered for a study currently being conducted by the Montana Board of Land Commissioners.⁴ The purpose of this study is to assist the Board in determining whether an increase in the oil and gas royalty rate is sufficient to meet the fiduciary duty required by Montana's 1972 Constitution.⁵

II. HISTORICAL PERSPECTIVE—MONTANA'S SCHOOL TRUST LAND

Montana, upon becoming a state in 1889, received from the federal government sections 16 and 36 of each surveyed township to be used for the support of its common schools. Section 11 of the Enabling Act⁶ provides:

That all lands herein granted for educational purposes shall be disposed of only at public sale, and at a price not less than ten dollars per acre, the proceeds to constitute a permanent school-fund, the interest of which only shall be expended in the support of said schools. But said lands may, under such regulations as the legislatures shall prescribe, be leased for periods of not more than five years, in quantities not exceeding one section to any one person or company; and such land shall not be subject to pre-emption, homestead entry, or any

3. V. Griffing, *The Significance of the Trust Concept in the Management and Administration of Montana School Lands* (Feb. 7, 1975) [hereinafter cited as Griffing]. The authors depend a great deal on this work for background and history of Montana's school lands. This work is unpublished but is available upon request from the Montana Department of State Lands, Capitol Station, Helena, Montana 59620.

4. The study is not complete as of this writing but is expected to be available to the Department in late Spring 1982. The study focuses on an overview of the school lands, the amount of return now realized and the potential which might be realized from various income sources such as leasing.

5. MONT. CONST. art X (1972).

6. 25 Stat. 679 § 11 (1889); 25 Stat. 679 § 10 grants the school lands (sections 16 and 36 of every township) to the State of Montana.

other entry under the land laws of the United States, whether surveyed or unsurveyed, but shall be reserved for school purposes only.

The historical background of the grant, which originally amounted to approximately 3,863,645.30 acres,⁷ is important in understanding the constraints on management of the land by the state and the factors and process involved in determining royalty rates.

The concept of reserving land in each state for maintenance of public schools is often credited to Thomas Jefferson.⁸ Jefferson believed very strongly in an educated populace as the foundation for democracy. In 1784, after Virginia had ceded its Western lands to the United States,⁹ Jefferson chaired a committee in Congress which produced the Ordinance of 1784.¹⁰ The Ordinance provided for the division of the lands into Territories and then subsequent admission of the territories as states on an equal footing with the original thirteen colonies. The committee's work resulted in a series of ordinances called the Northwest Ordinances which contained provisions to encourage the education of the populace in the western lands.

The Northwest Ordinance of 1785¹¹ provided for the survey and sale of western land. The idea was spurred by Congress' contract with the Ohio Company to sell a large part of the Old Northwest Territory to the company. Jefferson conceived the idea of placing a gigantic grid of rectangular sections over the continent. New Englanders thought in terms of townships and thus the name was applied to the new units.¹² The result is the present method of survey of lands.

As a result of the Ordinance of 1785, three major land policies developed which have set the tone of national land policy even to the present day. Those policies were: 1) development of whatever income was possible as quickly as possible while placing any risk factors on the private speculator; 2) selling the lands in sizes comporting to the approximate size of family farms; and, 3) encouraging the education of the populace through substantive federal support.¹³ The continuation of that policy is the basis for Montana's land policy as derived from the Enabling Act and Montana's Constitution.¹⁴

7. *Supra*, note 3, at 2.

8. H. TAYLOR, *THE EDUCATIONAL SIGNIFICANCE OF THE EARLY FEDERAL LAND ORDINANCES* (1922); *HISTORY OF THE NORTHWEST ORDINANCE OF 1787 AND THE OLD NORTHWEST TERRITORY* (1937); V. CARSTENSON *THE PUBLIC LANDS: STUDIES IN THE HISTORY OF THE PUBLIC DOMAIN* (1968).

9. TAYLOR, *supra* note 9, at 15-40.

10. This ordinance was later repealed by the Ordinance of 1787.

11. 1 Stat. 51-53 (1789).

12. Griffing, *supra* note 4, at 4.

13. *Id.* at 6.

14. 25 Stat. 679 § 11 (1889) and MONT. CONST. art. X, § 1 (1972).

An important aspect of the early ordinances was the development of the contract theory of the relationship between Westerners and the federal government. The people in the western lands legally agreed to certain principles espoused by the federal government, such as support for education, in return for the benefits bestowed by the federal government, such as the granting of lands. Evidence of this contract is found in Montana's 1972 Constitution, Article X, sections 1 through 4.

Another concept which developed at about the same time was the establishment of a permanent trust fund to be used for the support of education. The concept first developed around 1785, when Connecticut took proceeds from the sale of its western lands and placed them in a fund for the support of its schools.¹⁵ The most important feature of the concept was setting aside a permanent fund for the sole purpose of supporting education. Congress later included this concept in the enabling acts of states subsequently admitted to the Union, including Montana's.¹⁶

As states were being admitted to the Union, various methods were used to reserve lands for educational purposes. These methods can be generally classified into three plans: 1) the Ohio Plan;¹⁷ 2) the Illinois Plan,¹⁸ and; 3) the Michigan Plan.¹⁹

The Ohio Plan provided that section 16 of every township was granted to its inhabitants to be used for schools. The idea behind the grant was to encourage particular localities within a state to utilize the land for educational purposes. Fatal flaws existed in the plan, however, that eventually proved the plan unworkable in the western states. The first thought, was that western townships would develop much the same as eastern townships with denser populations—a projection which, for the most part, did not come true. Furthermore, the acts committing the lands to the townships gave them to trustees, but later placed several restrictions on the trustees' ability to act. No provision was made to sell the land, so the trustees were relegated to leasing land at whatever price was available. Land was cheap and revenues could not be raised to support the schools.²⁰

The Illinois Plan was tied more to the land and granted section 16 of every township to Illinois for schools in the townships. In addition, the federal government gave 3 percent of the proceeds from sales of land for the same uses. The trust concept was used, though the state

15. Griffing, *supra* note 4, at 7.

16. 25 Stat. 679 § 11 (1889).

17. 2 Stat. 173 (1802).

18. 3 Stat. 29 (1818).

19. 5 Stat. 59 (1836).

20. Griffing, *supra* note 4, at 12, 16.

acted as little more than an accountant. The 3 percent proceeds from sales seemed to indicate that the township which received more income on its land, received a greater amount from the sale of the lands. In addition, no provision was made for the sale of land. Thus, there was unequal distribution of income to the various townships, and no provision for gaining the greatest financial return for the land. Consequently, the Illinois Plan also proved unworkable.²¹

By 1836, the State of Michigan was applying to Congress for admission to the Union. Michigan applied for admission on the basis that school lands would be available for sale and would be given to the state for use of its schools. The new grant proposal meant that income from each section would not go to townships, but rather to a central state fund for the support of schools. Michigan also set a floor below which the price per acre of land could not fall. Congress approved the Michigan Plan and admitted subsequent states under similar plans.²²

In the 1850s, two cases arose which clarified the legal aspects of the school land grants in the various enabling acts. In *Trustees of Vincennes University v. State of Indiana*,²³ the United States Supreme Court was faced with the question of whether title to school land vested in the state or if the state merely held it in trust for the benefit of schools. The court held that the state held the land in trust for the benefit of its schools.²⁴

In *Springfield Township v. Quick*,²⁵ the Court faced the question of whether a state could control funds raised for township schools. The Court held that the state must utilize proceeds from school lands for the benefit of educational purposes, but at state discretion.²⁶

The Court, by these decisions, set out three important principles in the trust relationship: 1) that the enabling acts created a trust, similar to a private charitable trust, which could not be abridged by the state; 2) that the enabling acts would be strictly construed according to fiduciary principles, and; 3) that the requirements of the acts are superior to the requirements of state constitutions or statutes.²⁷ Thus, the states were told that they must act as trustees in managing school lands for the use of schools and that they could not manage these lands differently than contemplated by their enabling acts.²⁸

21. *Id.* at 13-14.

22. *Id.* at 13.

23. 55 U.S. 268 (1852).

24. *Id.* at 274.

25. 63 U.S. 56 (1859).

26. *Id.* at 69.

27. 55 U.S. 268, 274 (1852); 63 U.S. 56, 68-69 (1859).

28. 55 U.S. at 274 (1852) and 63 U.S. at 68-69 (1859).

In 1889, Congress passed the "Omnibus Enabling Act",²⁹ which admitted North Dakota, South Dakota, Washington and Montana to statehood. The admission of these states caused a great deal of political struggle for the control of Congress.³⁰ The two political parties could not agree on the admission of these states because of the possibility that one party would gain proportionately greater political strength. The legislative history of the Act is confusing for this reason, and it is therefore difficult to draw conclusions concerning the reasoning for certain provisions. However, it is true that the "Omnibus Act," which reserved sections 16 and 36 for the support of education, created a trust with very specific and strict safeguards for its preservation.

The plan and its safeguards is generally credited to General William H. Beadle, Superintendent of Public Education in the Dakota Territory.³¹ Beadle had studied school land grants in other states and understood problems which had occurred. The plan proposed by Beadle was adopted by the Dakota Constitutional Conventions and eventually found its way into the "Omnibus Act."³² Courts had already established that land grants were a trust; this trust would thereafter be more stringently controlled.

In *Lassen v. Arizona*,³³ the United States Supreme Court reversed a decision by the Arizona Supreme Court which held that the Arizona Highway Department could use school land for right of way purposes without compensating the school affected. The Arizona court was of the opinion that the value of the school land was enhanced by the building of a road along the boundaries of school property, and that monetary compensation to the school fund was not necessary. However, the United States Supreme Court held that the beneficiaries of the trust must be actually compensated for the taking of school lands for right-of-way purposes.³⁴

III. MANAGEMENT OF MONTANA SCHOOL TRUST LANDS

The discretion available to Montana in managing its school lands is controlled by the trust concept and the specific language of the Enabling Act.³⁵ The trust concept was recognized by the delegates to the first Montana Constitutional Convention; Article XVII of the 1889

29. 25 Stat. 679 (1889).

30. For two of many excellent discussions on this period of Montana history, see C. SPENCE, *TERRITORIAL POLITICS AND GOVERNMENT IN MONTANA 1864-89* (1975); M. MALONE, and R. ROEDER, *MONTANA: A HISTORY OF TWO CENTURIES* (1976).

31. J. HICKS, *CONSTITUTIONS OF THE NORTHWEST STATES 25-27* (1928).

32. 25 Stat. 679 (1889).

33. 385 U.S. 458 (1967), *on rem'd*, 102 Ariz. 318, 428 P.2d 996 (1967).

34. 385 U.S. at 469-470 (1970).

35. 25 Stat. 679 § 11 (1889).

Montana Constitution stated the lands were "held in trust for all people."³⁶ The convention further recognized the contractual relationship with the federal government concerning these lands. The state of Montana accepted the lands given by the federal government via Ordinance No. 1 of the 1889 Constitution and promised to establish free public schools for the children of Montana. The actions of the Constitutional Convention in acknowledging the trust concept in its constitution, and creating a contract with the federal government, is of lasting importance in the management of school lands today.

The 1972 Montana Constitution, Article X, section 4, sets out the membership of the Board of Land Commissioners³⁷ and gives the Board the authority to manage school lands under such regulations and restrictions as may be provided by law.³⁸ The Enabling Act, Constitution, and Montana Code Annotated are the regulations and restrictions looked to in the management of school lands. The language of the Enabling Act, and the trust concept and contract it establishes, are the guiding force in school land management. Neither the Constitution nor the statutes can abrogate the requirements of the Act.

The Supreme Court of Montana has held to the view that school lands, their proceeds and income constitute a trust.³⁹ Further, the Enabling Act, according to the court, must be strictly construed and the grants of property must be used solely for the purposes stated.⁴⁰ The state must manage the land under general trust principles and therefore must seek to produce income from the land to support education, and must protect the body of the trust from diminishment.⁴¹

In 1976, Montana Attorney General Robert Woodahl, at the request of the Acting Commissioner of State Lands, issued an opinion concerning the Montana Natural Areas Act of 1974.⁴² The opinion

36. MONT. CONST. art. XVII, § 1 (1889).

37. MONT. CONST. art. X, § 4 (1972) states that the governor, superintendent of public instruction, state auditor, secretary of state and attorney general shall constitute the board.

38. M.C.A. § 82-10-101-82-10-511 (1981) are the laws on oil and gas leasing on the public lands. The rules promulgated under this section are found in Title 26, generally of Administrative Rules of Montana. The department distributes a booklet on oil and gas rules, regulations and procedures, which is available upon request from the department offices located in Helena, Dept. of State Lands, Capitol Station, Helena, Montana 59620.

39. *State ex rel. Galen v. District Court*, 42 Mont. 105, 114-16, 112 P. 706 (1910); *Rider v. Cooney*, 94 Mont. 295, 306-07, 23 P.2d 261 (1933); *Texas Pacific Coal & Oil Co. v. State*, 125 Mont. 258, 263-264, 234 P.2d 452 (1951).

40. *Texas Pacific*, 125 Mont. at 263, 234 P.2d at 455; *In re Beck's Estate*, 44 Mont. 561, 576, 121 P. 784 (1912).

41. *Texas Pacific*, 125 Mont. at 263, 234 P.2d at 44; *Beck's Estate*, 44 Mont. at 576, 121 P.2d at 788.

42. 32 Op. Att'y Gen. 511, No. 92 (1976). The opinion was requested by then acting Commissioner Leo Berry to determine whether the school lands must be compensated for when the lands are designated natural areas.

stated:

So that the state will not commit a breach of trust under the Enabling Act and Montana Constitution, the state must actually compensate its school trust in money for the full appraised value of any school trust lands designated as or exchanged for natural areas pursuant to the Montana Natural Areas Act of 1974. Such compensation can only be avoided by securing the consent of Congress.⁴³

Thus the trust concept and the responsibility of the state in managing its school land is well settled. It is clear that the primary goal, indeed the only goal of state level management, is the production of sustained income for the maintenance of the public schools. Any other objective, no matter how worthy, must give way to this purpose.

IV. OIL AND GAS LEASING—PRIVATE MINERAL OWNER PERSPECTIVE

To a mineral owner, the most important aspect of oil and gas leasing is the compensation he receives. A mineral owner is compensated, under most leases, in three ways. First, he is usually compensated by being paid a bonus. This is the amount of money per acre which the lessee agrees to pay to the mineral owner simply for executing the lease. This is the most variable form of compensation. In highly speculative areas no bonus will be paid. But in areas where there is a high potential, the bonus can be hundreds of dollars per acre.

The second form of compensation is the rental. This is the amount of money per acre per year which the lessee pays in order to hold the lease. The lessee pays this amount whether or not he conducts any activity on the lease, although it is often true that no rental is paid once the lease begins to produce. This can vary from a few cents to several dollars per acre.

The third usual form of compensation is the royalty. This is a percentage of the production which the lessee must deliver to the mineral owner. The mineral owner's share is normally sold by the lessee at the same time he sells his share and thus the mineral owner receives an amount of money equal to the value of his share. The normal oil and gas royalty is $\frac{1}{8}$ or 12½%.⁴⁴ This is commonly known in the industry as a landowner royalty.

In some leases a delay drilling penalty, as the name implies, is paid to the lessor as penalty because the lessee has not drilled a well on the property. These penalties normally occur during the second five year

43. *Id.* at 514.

44. *Supra* note 3, at 13-14.

period of a ten year primary term lease.⁴⁵

The bonus and rental payments are payments to the mineral owner for the opportunity to drill a well. The royalty is a share of the actual production and the delay drilling penalty is a payment for not developing the property in a timely manner. The royalty is the most important form of compensation not only because it represents the most money but also because it represents payment for the removal of the mineral. Once the mineral is removed, the tract usually can no longer be leased for mineral development of that specific kind. The other payments are or can be recurring since they represent payments for the mere opportunity to drill.

As a general rule, mineral owners do not create a demand for their mineral rights but rather must wait until they are approached by a potential lessee. Much of the initial leasing of mineral rights is done by "land men."⁴⁶ These people specialize in leasing property from several

45. Mont. Admin. R. 26.3.210 provides penalties as follows for failure to drill in a timely manner:

The lessee shall commence the drilling of a well for oil or gas upon the leased premises within five (5) years of the date of approval of the lease or pay in advance a delay drilling penalty as follows: for the sixth year of the lease one dollar and twenty-five cents (\$1.25) per acre covered by the lease, and for the remainder of the primary term of the lease an amount per acre per year as the Board may, in its discretion, determine. The delay drilling penalty for the seventh and succeeding years of the primary term of the lease shall continue at the rate of \$1.25 per acre per year, unless the Board notifies the lessee not less than sixty (60) days before the commencement of the next year of the lease that payment at a different rate is required or permitted; provided that if the lessee shall apply for a hearing thereon within ten (10) days after receipt of notice, the determination of a different delay drilling penalty rate shall become final only after such hearing has been held, and the rate determined by the Board has been affirmed.

Upon failure of the lessee to either commence the drilling of a well for oil and gas upon the leased premises or to pay the required delay drilling penalty, the Board shall have full power and authority to declare termination of the lease as of the end of the annual period of the lease in which the failure to so commence drilling or to so pay occurs. Any such termination of the lease shall be after notice to the lessee of the Board's proposed action, and after hearing thereon if the lessee so requests in writing.

If the first well drilled on the leased premises is a dry hole, and if a second well is not commenced on the land covered by the lease before the next anniversary of the lease following the completion of the well, the lease may be terminated by the Board, unless the lessee, on or before such anniversary date, resumes the payments of penalties in the amounts provided in this section. Upon the resumption of the payment of such delay drilling penalties and their continued payment, the lease continues to in force during the primary term as though there had been no interruption in the delay drilling payments.

In case of any commencement of drilling in lieu of payment of a delay drilling penalty as above provided, the drilling of such well shall be prosecuted with due diligence and dispatch to such depth as is necessary to make a reasonable test for oil or gas. Failure of the lessee to do so shall subject the lease to termination by the Board as though the lessee had neither commenced the drilling of the well nor paid the required delay drilling penalty. The lessee shall, within five (5) days of spudding in, notify the Department of the commencement of drilling of any well.

46. "Land men" is a term the industry uses to describe someone who buys up a series of leases and re-sells the rights to the lease to someone else.

different owners and putting it together in one large block and then selling the leases as a block to potential developers. The potential of producing oil and gas from the area as a whole will normally dictate the price that the potential lessee will pay for individual leases in the block. In most cases the royalty rate is not negotiable.⁴⁷ However, the bonus and sometimes the rental rate can be negotiable.

When approached by a land man, most mineral owners are faced with a difficult decision. If the area involved is a "wildcat area,"⁴⁸ which means that the potential is largely unknown, the mineral owner has little choice—he can accept the terms offered or refuse to lease. If the area has better potential, the mineral owner can do some negotiating concerning the bonus and rentals. If the area has known potential, the mineral owner may even be able to negotiate the royalty rate to some extent.⁴⁹ A mineral owner who refuses to lease at the terms offered runs the risk that exploration in the area will reveal that no potential for mineral production exists. In this case no further offers to lease will be received.

V. OIL AND GAS LEASING ON STATE SCHOOL LAND

The State, as a landowner with mineral rights on approximately six million acres across Montana,⁵⁰ has considerably more leverage in dealing with potential lessees than the average private landowner. The state uses an oral auction procedure to lease its land for oil and gas production.⁵¹ This procedure is based upon statutes enacted by the state legislature⁵² and administrative rules adopted by the Board of Land Commissioners.⁵³ The statutes are fairly general and allow the

47. This rate is non-negotiable because the state sets the rate for state lands by state law and the industry will operate around that set rate. If a private owner sets his rate too high, the lessee will be reluctant to drill because of the lack of feasibility. Thus simple economics may tend to keep the royalty rate low.

48. "Wild cat" areas are areas where the potential for finding oil and gas is largely unknown. The effect of this lack of knowledge is a lower price for the lease because the potential cannot be assured. Montana has some wild cat areas where the potential is an unknown factor but those areas are few since the recent large scale interest in oil and gas development.

49. The private owner can find out for himself, the potential of oil and gas development by hiring a seismic exploration company to "sound" the area. This is done through a series of explosions recorded on electronic equipment. However, this expensive method is usually done by the company who obtains the lease. A number of surveys of this type have been done by the federal government and oil companies. A private owner who might be interested in the potential of their land might contact the nearest United States Geological Service office in their area.

50. *Supra* note 3, at 14.

51. Mont. Admin. R. 26.3.201 - 3.206.

52. M.C.A. § 77-1-113.

53. Mont. Admin. R. 26.3.201 - 3.232.

Board to exercise a fair amount of discretion in determining how leasing will occur. The Board exercises its discretion as a trustee to insure that the beneficiaries of the trust receive a fair return.⁵⁴

The State specifies certain minimum terms which apply to all oil and gas leases on state land. These provisions are contained in the state oil and gas lease form which all lessees must accept.⁵⁵ If a lessee is not willing to accept the terms of the state lease form, no lease will be issued.⁵⁶ The form specifies the rental rate and the royalty rate which must be applied.

A person desiring an oil and gas lease on state land makes an application to the Department of State Lands on a form provided by the department for that purpose. The application is an offer to lease the tract at the minimum terms.⁵⁷ Once each quarter, on the first or second Tuesday of March, June and December and on a day in September that will not conflict with the Labor Day weekend, the state holds an oral auction sale at a place and time designated by the department.⁵⁸ A list of the tracts available for sale is made available at the department offices in Helena.⁵⁹ When each individual tract is offered, if there are no other bids, the original applicant is awarded the lease at the minimum terms.⁶⁰ If other bids are received, the party making the highest bid per acre at the auction is awarded the lease. The amount per acre bid applies to the first year of the lease. The rental of the remainder of the term of the lease is \$1.50 per acre per year.⁶¹

The minimum terms of a lease are important because they determine whether or not an applicant will apply for a lease. In areas of unknown potential, lessees may not wish to pay \$1.50 per acre as a rental. Currently the royalty rate is not an important factor inhibiting lease applications since it is at the standard rate. However, the state does charge a higher royalty rate on oil if production from a well exceeds certain levels.⁶²

The leasing system used by Montana is also used by other Western

54. M.C.A. § 77-1-103 (1981) provides for the administration of state lands by the Board of Land Commissioners.

55. The state oil and gas lease form is a lengthy document which sets forth all the rules the lessee must comply with. Copies may be obtained by writing Dept. of State Lands, Capital Station, Helena, Montana, 59620.

56. The terms of the lease are non-negotiable and are the minimum the state must obtain to insure a constant income from the lessees of state lands. *See* Mont. Admin. R. 26.3.201 - 3.232 for those terms.

57. Mont. Admin. R. 26.3.206.

58. Mont. Admin. R. 26.3.206(1).

59. Mont. Admin. R. 26.3.204.

60. Mont. Admin. R. 26.3.209 dealing with rentals.

61. Mont. Admin. R. 26.3.209.

62. Mont. Admin. R. 26.3.209 and 26.3.211 which deal with rentals and royalties.

states. An exception is Wyoming, which like the federal government, uses a lottery system to sell its leases. [see Appendix "A"]

Although comparing lease terms between states is useful, it is not determinative since the situation in each state is different. The tax rates which companies must pay and the potential of discovering reserves differs considerably from state to state.

VI. FACTORS IN SETTING A ROYALTY RATE

The royalty rate set by the state is important because it represents payment for a trust asset which will be gone forever once the mineral is removed from the ground. Therefore, the requirements of the Enabling Act and the trust concept are the most important factors to consider in determining an optimum royalty rate. If the rate is too low the state will be committing a breach of trust by diminishing the trust. Royalty payments are placed in a permanent trust fund, the corpus of which is invested; the trust is kept whole if fair market value is received.⁶³ If the royalty rate is too low, the trust will not be kept whole.

In addition to making certain that the trust is kept whole, the state is also required to obtain income for the beneficiaries.⁶⁴ The rental and bonus payments represent income to the beneficiaries. The royalty rate has an effect on the amount of this income. A large royalty rate would prevent persons from applying for leases and thus reduce the income to the beneficiaries. A small royalty would increase income but would mean that the trust would not be kept whole. The major factors the state will consider in determining whether or not to increase the royalty rate will be the effect on future oil and gas leasing, the reaction of the industry, and what other states in the area are gaining from their own royalty rates.

VII. CONCLUSION

The Board of Land Commissioners is faced with a difficult decision. It must determine a royalty rate that will strike a balance between income to the beneficiaries and protection of the trust. This determination is wholly within the discretion of the Board of Land Commissioners exercising its best business judgment. For that reason, the Board acts more or less as a board of realtors, utilizing the services of the State Board of Investments to protect the trust.

63. MONT. CONST. art X, §§ 2, 3 (1972) established a fund for public education. The money is invested by the Board of Investments, who are essentially the same members as those on the Board of Land Commissioners, and the fund is maintained for public education.

64. *Id.*

In exercising its discretion, the Board must be aware that the trust was created by a compact between the federal government and the State. The State has obligated itself to maintain the trust for the benefit of education in Montana. The trust cannot be diminished. As a trustee obligated to protect the body of the trust, the Board of Land Commissioners must act cautiously. It cannot forsake the trust for income over the short term, and it must be ever mindful that the trust must be preserved to produce income over the long term.

If the major responsibility of the Board is to make certain that the trust is not diminished, and this appears to be the case, then the royalty rate must be set at a level which will assure the trust's continued existence, regardless of the short term effects upon income to the beneficiaries.

