

McPhail, Rochelle

From: Adamski, Richard
Sent: Monday, August 09, 2004 3:21 PM
To: Hamilton, Cathy; Izon, David; Cason, Carol; Bigelow, Janice
Subject: FW: 6Sales to Affiliates - draft.ppt

Importance: High



6Sales to Affiliates -
draft.p...

Hi All,

I called Shirley and she sent me a copy of the valuation training that sets out our policy in reaction to the FINA decision.

Enjoy,

Rich

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>

-----Original Message-----

From: Burhop, Shirley
Sent: Monday, August 09, 2004 11:27 AM
To: Adamski, Richard
Subject: 6Sales to Affiliates - draft.ppt

Sales to Affiliates: Gas, Oil & Coal

Outline of Training

- Purpose of training
- Fina Decision
- Federal Gas – NAL Valuation
- Indian Gas - NAL Valuation prior to January 1, 2000
- Federal Oil – NAL Valuation prior to June 1, 2000 and Indian
- Indian Oil
- Federal Coal – NAL Valuation

Purpose of Training

To provide you with information and guidance on how to value sales of oil, gas, and coal, which is not sold at arm's-length, produced from Federal and Indian lands. You will apply the concepts learned by working exercises.

Applicability

- When conducting an audit or compliance review, the auditor or analyst must determine which valuation regulations apply:
 - Indian or Federal oil?
 - If Federal oil, before or after June 1, 2000?
 - Indian or Federal gas?
 - If Indian gas, before or after January 1, 2000?
 - Processed or unprocessed gas?
 - Federal or Indian coal?
 - Are sales or dispositions at arm's-length or other than arm's-length?

Applicability

The concepts presented in this course are relevant for:

- Federal gas,
- Indian gas prior to January 1, 2000,
- Indian gas after January 1, 2000 and not in an index zone,
- Federal oil prior to June 1, 2000, and
- Federal coal

Acronyms

- AL = arm's-length (sales type code ARMS)
- NAL = not sold under an arm's-length contract (sales type code NARM)

Fina Decision

- *Fina Oil and Chemical Corp. v. Norton*, 332 F 3d 672 (D. C. Cir. 2003)
- Rejects the Secretary of the Interior's decision in Texaco Exploration and Production Inc., MMS-92-0306-O&G, May 18, 1999

Fina Decision

- Value gas sold to affiliates that are not marketing affiliates [as defined in 30 CFR 206.101 (oil) and 206.151 (gas)] based on the first applicable benchmark.
- The court overturned a portion of the Texaco decision which held that gross proceeds were based on a wholly-owned or wholly-commonly-owned affiliate's first arm's-length resale.

Fina Decision

- Under the current Federal gas rule [30 CFR 206.152 (h) and 153 (h)], Indian oil rule [30 CFR 206.52 (h)], and Indian gas rule for leases outside an index zone [30 CFR 206.174 (g)], the value for royalty purposes is no less than the lessee's gross proceeds under its NAL contracts, less applicable allowances, not the wholly-owned or wholly-commonly-owned affiliate's AL resale price.

Fina Decision

“If the affiliate of the lessee also purchases gas from other sources, then that affiliate presumably will have comparable arm’s-length contracts with the other parties which should demonstrate the acceptability of the gross proceeds accruing to the lessee from its affiliate.” (from the preamble to the 1988 gas valuation rule, 53 Fed. Reg. at 1243, January 15, 1988, as quoted in the Fina decision.)

Fina Decision

“Gas sold directly to unaffiliated entities is valued at the contract price, since that price reliably indicates objective value.”

Fina Decision

“In contrast, gas sold to marketing affiliates is valued not on the basis of the initial sale – obviously an unreliable indicator of objective value – but rather on the basis of the price at which it ultimately leaves the corporate family.”

Fina Decision

“...gas sold to non-marketing affiliates – where the objective value can be reliably approximated through comparable arm’s-length sales – is valued through the benchmarks at the initial sales price and not the subsequent resale price.”

Concepts - Affiliation

Marketing Affiliate – An affiliate of the lessee whose function is to acquire only the lessee's production and to market that production.

30 CFR 206.51, Indian Oil; 30 CFR 206.101, Federal Oil (pre-June 2000); 30 CFR 206.151, Federal Gas; 30 CFR 206.171, Indian Gas.

This definition does not apply to coal.

Concepts - Affiliation

Affiliate – means a person who controls, is controlled by, or is under common control with another person.

Affiliate is defined in 30 CFR 206.101 for Federal Oil, effective June 1, 2000, but is not defined in the regulations for other products.

Concepts - Affiliation

Affiliate – If the lessee transfers or sells production to an affiliate that also buys production from other sources, that affiliate is not a marketing affiliate.

Concepts - Affiliation

Arm's-Length [AL] – Contract arrived at in the market place between independent, non-affiliated persons with opposing economic interests.

- Ownership > 50% assume control
- Ownership between 10% and 50%:
consider various factors
- Ownership < 10% assume non-control:
MMS may rebut

Concepts - Affiliation

- The National Mining Association decision identified other factors to consider to determine whether there is control in situations where ownership is between 10 and 50 %.

National Mining Association, Appellant, v. United States Department of the Interior, et al., 177 F3d 1 (D. C. Cir., 1999)

Concepts - Affiliation

- Factors to be considered include:
 - The extent to which there are common officers or directors
 - The percentage of ownership and relative percentage of ownership of voting securities or other instruments of ownership
 - Operation of a lease, plant, or other facility or the extent of participation in management or operation
 - Other evidence of power to exercise control

Concepts - Affiliation

- Regardless of any percentage of ownership or common ownership, relatives, either by blood or marriage, are affiliates.

Concepts - Affiliation

- See the August 21, 2000, guidance paper, “Guidance for Determining Control for Ownership Between 10-50 Percent in Light of the National Mining Association (NMA) Decision”, signed by the Associate Director for Royalty Management.

FEDERAL GAS NAL VALUATION

Federal Gas Definitions

Lessee:

...any person to whom the United States issues a lease, and any person who has been assigned an obligation to make royalty or other payments required by the lease.

30 CFR 206. 151, Federal Gas, 30 CFR 206.101, Federal Oil (pre-June 2000)

Federal Gas Definitions

Lessee (cont'd):

This includes any person who has an interest in a lease as well as an operator or payor who has no interest in the lease but who has assumed that royalty payment responsibility.

Federal Gas Definitions

Gross Proceeds (for royalty payment purposes) means the total monies and other consideration accruing to an oil and gas lessee for the disposition of the gas, residue gas, and gas plant products produced.

30 CFR 206.151, Federal Gas

Federal Gas Definitions

Gross Proceeds (cont'd).

- Gross proceeds includes, but is not limited to, payments to the lessee for certain services such as
 - dehydration,
 - measurement, and/or
 - gathering
 - to the extent that the lessee is obligated to perform them at no cost to the Federal Government.

Federal Gas Definitions

Gross Proceeds (cont'd).

Tax reimbursements are part of the gross proceeds accruing to a lessee even though the Federal royalty interest may be exempt from taxation.

30 CFR 206.151, Federal Gas

Federal Gas Definitions

Gross Proceeds (cont'd).

Monies and other consideration,

- including the forms of consideration identified in this paragraph,
- to which a lessee is contractually or legally entitled
- but which it does not seek to collect through reasonable efforts

are also part of gross proceeds.

30 CFR 206.151, Federal Gas

Federal Gas Definitions

- *Marketable condition* means lease products that are sufficiently free from impurities and otherwise in a condition that they will be accepted by a purchaser under a sales contract typical for the field or area.
- 30 CFR 206.151, Federal gas; 30 CFR 206.51, Indian Oil; 30 CFR 206.101, Federal Oil (pre-June 2000); 30 CFR 206.171, Indian gas (pre-January 2000)

Federal Gas Definitions

Marketable Condition – (Cont'd)

- lessee must meet pressure and quality requirements (Btu, moisture content, H₂S, CO₂) for the pipeline that transports the gas to market.

Federal Gas Definitions

Like-quality lease products means lease products which have similar chemical, physical, and legal characteristics.

30 CFR 206. 151

Federal Gas - NAL Valuation Rules

Regulatory Authority

- 30 CFR § 206.152 (c) and (h) (2003) establishes value for unprocessed gas sold under NAL contracts.
 - The value shall be the reasonable value determined under the first applicable benchmark, but not less than gross proceeds.
- 30 CFR § 206.153 (c) and (h) (2003) establishes value for processed gas sold under NAL contracts.
 - The value shall be the reasonable value determined under the first applicable benchmark, but not less than gross proceeds.

Federal Gas – NAL Valuation

Unprocessed Gas - Rules

- First benchmark
- The gross proceeds accruing to the lessee pursuant to a sale under its non-arm's-length contract (or other disposition other than by arm's-length contract), provided that those gross proceeds are equivalent to the gross proceeds derived from, or paid under, comparable arm's-length contracts for purchases, sales, or other dispositions of like-quality gas in the same field (or, if necessary to obtain a reasonable sample, from the same area). 30 CFR 206.152 (c) (1) (underlining added)

Federal Gas – NAL Valuation

Unprocessed Gas - Rules

- First benchmark (cont'd.)
- In evaluating the comparability of arm's-length contracts for the purposes of these regulations, the following factors shall be considered:
 - Price
 - Time of execution
 - Duration
 - Market or markets served
 - Terms
 - Quality of the gas
 - Volume
 - And such other factors as may be appropriate to reflect the value of the gas

Federal Gas – NAL Valuation

Unprocessed Gas - Rules

- Second Benchmark
- A value determined by consideration of other information relevant in valuing like-quality gas, including
 - gross proceeds under arm's-length contracts for like-quality gas in the same field or nearby fields or areas
 - posted prices for gas
 - prices received in arm's-length spot sales of gas
 - other reliable public sources of price or market information
 - and other information as to the particular lease operation or the saleability of the gas
 - 30 CFR 206.152 (c) (2)

Federal Gas – NAL Valuation Unprocessed Gas - Rules

- Third Benchmark
- A net-back or any other reasonable method to determine value.
- 30 CFR 206.152 (c) (1)

Federal Gas – NAL Valuation Processed Gas - Rules

- First benchmark
- The gross proceeds accruing to the lessee pursuant to a sale under its non-arm's-length contract (or other disposition other than by arm's-length contract), provided that those gross proceeds are equivalent to the gross proceeds derived from, or paid under, comparable arm's-length contracts for purchases, sales, or other dispositions of like-quality residue gas or gas plant products from the same processing plant (or, if necessary to obtain a reasonable sample, from nearby plants). 30 CFR 206.153 (c) (1)

Federal Gas – NAL Valuation Processed Gas - Rules

- First benchmark (cont'd.)
- In evaluating the comparability of arm's-length contracts for the purposes of these regulations, the following factors shall be considered:
 - Price
 - Time of execution
 - Duration
 - Market or markets served
 - Terms
 - Quality of residue gas or gas plant products
 - Volume
 - And such other factors as may be appropriate to reflect the value of the residue gas or gas plant products

Federal Gas – NAL Valuation

Processed Gas - Rules

- Second Benchmark
- A value determined by consideration of other information relevant in valuing like-quality residue gas or gas plant products, including
 - gross proceeds under arm's-length contracts for like-quality residue gas or gas plant products from the same gas plant or other nearby processing plants
 - posted prices for residue gas or gas plant products
 - prices received in spot sales of residue gas or gas plant products
 - other reliable public sources of price or market information
 - and other information as to the particular lease operation or the saleability of such residue gas or gas plant products
 - 30 CFR 206.153 (c) (2)

Federal Gas – NAL Valuation Processed Gas - Rules

- Third Benchmark
- A net-back or any other reasonable method to determine value.
- 30 CFR 206.153 (c) (1)

Federal Gas – NAL Valuation

Benchmark One

- First Benchmark: Lessee's gross proceeds if equivalent to gross proceeds under comparable AL contracts in the field or area.
 - Two criteria: equivalency and comparability.
 - If the NAL gross proceeds are greater than or equal to AL gross proceeds under comparable contracts, then accept the NAL gross proceeds.

Federal Gas – NAL Valuation

Benchmark One

- Equivalency:
 - If there are many comparable contracts, and the lessee's NAL gross proceeds are within the range of prices under those contracts, then those NAL gross proceeds are acceptable for value.
 - As long as there is at least one comparable AL contract that sets a price that is less than the lessee's NAL price, the lessee's NAL gross proceeds will be acceptable.

Federal Gas – NAL Valuation

Benchmark One

- **Comparability:**
 - **Price:** components of the contract price (transportation factors, marketing costs, etc.)
 - **Time of execution**
 - **Duration:** contract period, long-term or short-term
 - **Market or markets served**
 - **Terms**
 - **Quality:** methane content, NGL content, Btu content, non-hydrocarbon gas content (hydrogen sulfide, CO₂, etc.)
 - **Volume:** delivered quantity
 - **Other factors:** any other factors which affect value

Federal Gas – NAL Valuation

Benchmark One

Comparability of terms involves consideration of contract duration, whether short-term or long-term. While we cannot define either of these terms precisely, generally short-term is less than a year and long-term is a year or longer. Spot sales contracts are generally considered short-term.

Federal Gas – NAL Valuation

Benchmark One

Spot sales agreement –

“...a contract wherein a seller agrees to sell to a buyer a specified amount of unprocessed gas, residue gas, or gas plant products at a specified price over a fixed period, usually of short duration, which does not normally require a cancellation notice to terminate, and which does not contain an obligation, nor imply an intent, to continue in subsequent periods.”

(underlining added)

from 30 CFR § 206.151, Federal Gas

Federal Gas – NAL Valuation

Benchmark One

Example of Comparability Factors

The lessee being audited produces 200,000 Mcf and sells the production under a NAL contract for \$3.79 per Mcf.

We have been able to identify the following AL contracts for purchases or sales in the same field or area:

<u>Purchaser/Seller</u>	<u>Volume in Mcf</u>	<u>Price</u>
A & R Corp	150,000	3.65
BW Gas Inc	413,000	5.41
Cad Energy	200,000	5.29
Tee Corp	359,000	5.68
JW Petroleum	10,000	5.27

Is our price acceptable under the first benchmark?

Federal Gas – NAL Valuation

Benchmark One

Example of Comparability Factors

The lessee being audited produced 200,000 Mcf in July 2001 and sold the production under a NAL contract for \$4.29 per Mcf. The contract was for a 4-year term, effective 1/1/2000 through 12/31/2004.

We have been able to identify the following AL contracts for purchases or sales in the same field or area:

<u>Purchaser/Seller</u>	<u>Mcf</u>	<u>Duration</u>	<u>Effective</u>	<u>Price \$</u>
A & R Corp	200,000	1 month	1/7/01	4.20
BW Gas Inc	213,000	1 year	7/1/00	4.29
Cad Energy	255,000	6 years	7/1/96	5.68
Tee Corp	189,000	10 years	5/1/93	5.01
JW Petroleum	239,000	3 years	9/1/98	4.53
Hi Octane Corp	268,000	3 months	5/1/01	4.23

Is our lessee's price acceptable under the first benchmark?

Federal Gas – NAL Valuation

Benchmark One

Example of Comparability Factors:

The lessee being audited produced 150,000 Mcf of gas and sold it under a NAL contract for \$3.99 per MMBtu. The quality of the gas was: Btu – 1041; Gas composition - 0.89% inert gas; NGL % - 2.98.

We have been able to identify the following AL contracts for purchases or sales of gas in the field or area:

<u>Lease</u>	<u>Production</u>	<u>Btu</u>	<u>Inert gas%</u>	<u>NGL%</u>	<u>Price(\$)</u>
A	410,000	1034	0.63	2.54	4.19
B	368,000	1407	1.26	28.50	5.17
C	440,000	1321	2.01	22.91	4.88
D	288,000	1047	0.99	3.35	4.65
E	300,000	1281	2.19	20.26	4.27

Is our lessee's NAL price acceptable under the first benchmark?

Federal Gas – NAL Valuation

Benchmark One

Examples 1 - 4

Federal Gas – NAL Valuation

Benchmark Two

- Second Benchmark:
 - The gross proceeds determined under
 - AL contracts for like-quality gas in the same field or nearby fields or areas,
 - posted prices for gas,
 - prices received in AL spot sales of gas,
 - other reliable public sources of price or market information, and
 - other information relative to the particular lease operation or the saleability of the gas.

Federal Gas – NAL Valuation Benchmark Two

- Second benchmark (cont'd.)
- Used when benchmark one fails for any reason, including:
 - Lessee's gross proceeds are not equivalent to the gross proceeds paid under comparable AL contracts, or if
 - No comparable AL contracts exist in the field or area, or if
 - Lessee receives no consideration

Federal Gas – NAL Valuation

Benchmark Two

- Second Benchmark (cont'd):
Lessee must consider other relevant information in valuing like-quality gas produced from the field or area, or processed at the same plant or nearby plants
 - Gross proceeds under AL contracts
 - Published or posted prices
 - AL spot prices (note that the processed gas regulations do not require that spot prices be at AL)
 - Other reliable public sources
 - Any information unique to the property

These considerations do not need to be applied in any particular order.

Federal Gas – NAL Valuation

Benchmark Two

Examples 5 and 6

Federal Gas – NAL Valuation

Benchmark Three

- Third Benchmark: A net-back method or any other reasonable valuation method.
 - Applied in any case where benchmarks one and two fail (cannot be applied)
 - Determined on a case-by-case basis
 - A net-back method is intended for use primarily where the form of the lease product has changed, and it is necessary to start with the sales price of the changed product and deduct transportation and processing costs.

(from the preamble to the 1988 gas regulations, *Federal Register*, Vol. 53, No. 10, Friday, January 15, 1988, page 1243.)

Federal Gas – NAL Valuation

Audit/Compliance Approach

Federal Gas – NAL Valuation Audit/Compliance Approach

- Determine the first applicable benchmark value.
- If benchmark one applies, then the lessee's NAL gross proceeds are accepted for determining royalty value.

Federal Gas – NAL Valuation

Audit/Compliance Approach

- The benchmarks must be applied in order.
- You cannot move on to benchmark two (or three) unless benchmark one (or two) fails for some reason.
- The fact that benchmark two (or three) might be easier to apply to your situation is not a reason to skip over benchmark one (or two).

Federal Gas – NAL Valuation Audit/Compliance Approach

- To determine gross proceeds:
 - Add back any costs deducted for putting the production into marketable condition
 - Add any reimbursement received for costs incurred in putting the production into marketable condition
 - Increase value by any costs incurred by any other party to put the production into marketable condition

Federal Gas – NAL Valuation Audit/Compliance Approach

- To determine gross proceeds:
 - Add back any marketing costs expressly deducted from the lessee's gross proceeds
 - Add any reimbursement expressly identified as for marketing the product.
 - Increase value by costs incurred by any other party to market the production.
 - The gain derived from an affiliate's marketing efforts is not part of the lessee's gross proceeds.

Federal Gas – NAL Valuation Audit/Compliance Approach

- Determine lessee's gross proceeds:
 - Add any tax or other reimbursements

Federal Gas – NAL Valuation Audit/Compliance Approach

- Access to records
 - Any Federal or Indian lessee will make available upon request to the authorized MMS or State or Indian representatives, to the Office of the Inspector General of the Department of the Interior, or other person authorized to receive such information, arm's-length sales and volume data for like-quality production sold, purchased or otherwise obtained by the lessee from the field or area or from nearby fields or areas.
 - From 30 CFR 52 (e) (2), 102 (d), 152 (e) (2), 153 (e) (2), 172 (e) (2) (1999), 173 (e) (2) (1999)

Federal Gas – NAL Valuation Audit/Compliance Approach

- Access to records
 - We have authority to get records from anyone, per FOGRMA, which says:
 - Sec. 103. (a) A lessee, operator, or other person directly involved in developing, producing, transporting, purchasing, or selling oil or gas subject to this Act through the point of first sale or the point of royalty computation, whichever is later, shall establish and maintain any records, make any reports, and provide any information that the Secretary may, by rule, reasonably require for the purposes of implementing this Act or determining compliance with rules or orders under this Act.

30 USC 1713, Federal Oil and Gas Royalty Management Act of 1982

Federal Gas – NAL Valuation Audit/Compliance Approach

- Access to records (con't.)
 - Upon the request of any officer or employee duly designated by the Secretary or any State or Indian tribe conducting an audit or investigation pursuant to this Act, the appropriate records, reports, or information which may be required by this section shall be made available for inspection and duplication by such officer or employee, State, or Indian tribe.

30 USC 1713, Federal Oil and Gas Royalty Management Act of 1982

Federal Gas – NAL Valuation Audit/Compliance Approach

- Access to records
 - See 132 IBLA 354, May 11, 1995, Shell Oil Co. (which reversed 130 IBLA 93, August 1, 1994, Shell Oil Co.)
 - This case dealt with access to records of an affiliate in order to determine gross proceeds applicable to the lessee.

Federal Gas – NAL Valuation Audit/Compliance Approach

- Access to records
- 132 IBLA 354 (Cont'd.)
- “MMS had statutory and regulatory authority to require production of documents concerning crude oil sales contracts made by an affiliate of a Federal oil and gas lessee that were needed to insure there had been compliance with the gross proceeds rule established by Departmental regulation 30 CFR 206.102 (h) (1989).”

INDIAN GAS NAL VALUATION

Indian Gas Definitions

Lessee:

...any person to whom an Indian Tribe, or an Indian allottee issues a lease, and any person who has been assigned an obligation to make royalty or other payments required by the lease.

Indian Gas Definitions

Lessee: This includes any person who has an interest in a lease as well as an operator or payor who has no interest in the lease but who has assumed the royalty payment responsibility.

30 CFR 206. 51 Indian Oil and 30 CFR 206.171 Indian Gas

Indian Gas Definitions

Gross Proceeds (for royalty payment purposes) means the total monies and other consideration accruing to an oil and gas lessee for the disposition of unprocessed gas, residue gas, and gas plant products produced.

30 CFR 206.171, Indian Gas

Indian Gas Definitions

Gross Proceeds (cont'd).

- Gross proceeds includes, but is not limited to, payments to the lessee for certain services such as
 - compression,
 - dehydration,
 - measurement, and/or
 - field gathering
 - to the extent that the lessee is obligated to perform them at no cost to the Indian lessor, and payments for gas processing rights.

30 CFR 206.171, Indian Gas

Indian Gas Definitions

- Gross Proceeds (cont'd).
 - Gross proceeds, as applied to gas, also includes, but is not limited to reimbursements for severance taxes and other reimbursements.

30 CFR 206.171, Indian Gas

Indian Gas Definitions

- Gross Proceeds (cont'd).
 - Tax reimbursements are part of the gross proceeds accruing to a lessee even though the Indian royalty interest may be exempt from taxation.

30 CFR 206.171, Indian Gas

Indian Gas Definitions

Gross Proceeds (cont'd).

Monies and other consideration,

- including the forms of consideration identified in this paragraph,
- to which a lessee is contractually or legally entitled
- but which it does not seek to collect through reasonable efforts

are also part of gross proceeds.

30 CFR 206.171, Indian Gas

Indian Gas Definitions

- *Marketable condition* means lease products that are sufficiently free from impurities and otherwise in a condition that they will be accepted by a purchaser under a sales contract typical for the field or area.
- 30 CFR 206.151, Federal gas; 30 CFR 206.51, Indian Oil; 30 CFR 206.101, Federal Oil (pre-June 2000); 30 CFR 206.171, Indian gas (pre-January 2000)

Indian Gas – NAL Valuation Rules

- Former regulations: 30 CFR 206.172-173 (1999)
 - The same benchmarks discussed under Federal gas valuation apply
- Current regulations: 30 CFR 206.172-173 (2000)
 - Effective January 1, 2000
 - NAL production not in an index zone
 - valued at the higher of NAL gross proceeds, benchmark value or major portion price

FEDERAL OIL NAL VALUATION

Federal Oil Definitions

Lessee:

...any person to whom the United States issues a lease, and any person who has been assigned an obligation to make royalty or other payments required by the lease.

30 CFR 206.151, Federal Gas, 30 CFR 206.101, Federal Oil (pre-June 2000)

Federal Oil Definitions

Lessee (cont'd):

This includes any person who has an interest in a lease as well as an operator or payor who has no interest in the lease but who has assumed that royalty payment responsibility.

30 CFR 206. 151, Federal Gas, 30 CFR 206.101, Federal Oil (pre-June 2000)

Federal Oil Definitions

Lessee:

...any person to whom the United States issues an oil and gas lease, an assignee of all or a part of the record title interest, or any person to whom operating rights in a lease have been assigned.

30 CFR 206. 101, Federal Oil (after June 1, 2000)

Federal Oil Definitions

Gross Proceeds (for royalty payment purposes) means the total moneys and other consideration accruing to an oil and gas lessee for the disposition of the oil produced.

30 CFR 206.101, Federal Oil (pre-June 2000)

Federal Oil Definitions

Gross Proceeds (cont'd).

Gross proceeds includes, but is not limited to, payments to the lessee for certain services such as dehydration, measurement, and/or gathering to the extent that the lessee is obligated to perform them at no cost to the Federal Government.

30 CFR 206.101, Federal Oil (pre-June 2000)

Federal Oil Definitions

Gross Proceeds (cont'd).

Gross proceeds, as applied to oil, also includes, but is not limited to, reimbursements for harboring or terminaling fees.

30 CFR 206.101, Federal Oil (pre-June 2000)

Federal Oil Definitions

Gross Proceeds (cont'd).

Tax reimbursements are part of the gross proceeds accruing to a lessee even though the Federal royalty interest may be exempt from taxation.

30 CFR 206.101, Federal Oil (pre-June 2000)

Federal Oil Definitions

Gross Proceeds (cont'd).

Moneys and other consideration, including the forms of consideration identified in this paragraph, to which a lessee is contractually or legally entitled but which it does not seek to collect through reasonable efforts are also part of gross proceeds.

Federal Oil Definitions

- *Marketable condition* means lease products that are sufficiently free from impurities and otherwise in a condition that they will be accepted by a purchaser under a sales contract typical for the field or area.
- 30 CFR 206.151, Federal gas; 30 CFR 206.51, Indian Oil; 30 CFR 206.101, Federal Oil (pre-June 2000); 30 CFR 206.171, Indian gas (pre-January 2000)

Federal Oil Definitions

- Marketable Condition (con't.)
- “The lessee is required to place oil in marketable condition at no cost to the Federal Government unless otherwise provided in the lease agreement or this section.”
- 30 CFR 206.102(i), Federal Oil

Federal Oil Definitions

- Marketable Condition (cont'd.)
- “Where the value established under this section is determined by a lessee’s gross proceeds, that value shall be increased to the extent that the gross proceeds have been reduced because the purchaser, or any other person, is providing certain services the cost of which ordinarily is the responsibility of the lessee to place the oil in marketable condition.”
- 30 CFR 206.102(i), Federal Oil

Federal Oil Definitions

Like-quality lease products means lease products which have similar chemical, physical, and legal characteristics.

30 CFR 206. 101

Federal Oil Definitions

Posted price means the price specified in publicly available posted price bulletins, offshore or onshore terminal postings, or other price notices net of all adjustments for quality (e.g., API gravity, sulfur content, etc.) and location for oil in marketable condition.

30 CFR 206.101

Federal Oil Definitions

Sale – A contract between two persons (parties) where:

- the seller unconditionally transfers title to the oil to the buyer and does not retain any related rights such as the right to buy back similar quantities of oil from the buyer elsewhere
- the buyer pays money or other consideration for the oil
- the parties' intent is for a sale to occur

30 CFR 206.101 (2003), Federal Oil,

Federal Oil – NAL Valuation (pre-June 2000)

- Regulatory Authority
 - 30 CFR 206.102
 - Valuation standards for Federal oil (prior to June 1, 2000)
 - (c) The value of oil production from leases subject to this section which is not sold pursuant to an arm's-length contract shall be the reasonable value determined in accordance with the first applicable of the following paragraphs [the benchmarks]:
 - (h) ...under no circumstances shall the value of production, for royalty purposes, be less than the gross proceeds accruing to the lessee for lease production, less applicable allowances...

Federal Oil – NAL Valuation Rules (pre-June 2000)

- First Benchmark:
 - The lessee's contemporaneous posted prices or oil sales contract prices used in arm's-length transactions for purchases or sales of significant quantities of like-quality oil in the same field (or, if necessary to obtain a reasonable sample, from the same area);
 - 30 CFR 206.102 (c) (1) (pre-June 2000)

Federal Oil – NAL Valuation (pre-June 2000)

- First Benchmark:
 - provided, however, that those posted prices or oil sales contract prices are comparable to other contemporaneous posted prices or oil sales contract prices used in arm's-length transactions for purchases or sales of significant quantities of like-quality oil in the same field (or, if necessary to obtain a reasonable sample, from the same area.)
 - 30 CFR 206.102 (c) (1) (pre-June 2000)

Federal Oil – NAL Valuation (pre-June 2000)

- For purposes of this paragraph [all of 206.102], the term lessee includes the lessee's designated purchasing agent, and the term contemporaneous means postings or contract prices in effect at the time the royalty obligation is incurred.

30 CFR 206.102 (c) (6) (pre-June 2000)

Federal Oil – NAL Valuation (pre-June 2000)

- First Benchmark:
 - In evaluating the comparability of posted prices or oil sales contract prices, the following factors should be considered:
 - Price
 - Duration
 - Market or markets served
 - Terms
 - Quality of oil
 - Volume, and
 - Other factors as may be appropriate to reflect the value of the oil.

Federal Oil – NAL Valuation (pre-June 2000)

- First Benchmark:
 - If the lessee makes arm's-length purchases or sales at different postings or prices, then the volume weighted average price for the purchases or sales for the production month will be used.

30 CFR 206.102 (c) (1) (pre-June 2000)

Federal Oil – NAL Valuation (pre-June 2000)

- Significant Quantities:
 - “...the term significant quantities” is variable depending on the sales volumes from the field and the volume of production. What constitutes significant production from an onshore field may not be significant for an OCS field. Therefore, “significant quantities” will vary case by case. (From the preamble to the 1988 oil valuation regulations, *Federal Register*, Vol. 53, No. 10, Friday, January 15, 1988, page 1202.)

Federal Oil – NAL Valuation

Significant Quantities

Example

Significant quantities has no precise definition and depends on the circumstances of a particular field or area.

Happy Canyon Field: Production = 500,000 barrels per month.

<u>Buyer</u>	<u>Quantity</u>
Purchaser A	400,000 (80%)
Purchaser B	35,000 (7%)
Purchaser C	35,000 (7%)
Purchaser D	20,000 (4%)
Purchaser E	10,000 (2%)

Purchaser A buys significant quantities of production from Happy Canyon Field. Do B & C? What if B, C, D, and E (total of 20%) all purchase from the same producer? Is that production significant? What if only the quantity purchased by B is of like-quality to that of the lessee?

Federal Oil – NAL Valuation

Significant Quantities

Example

Giant Dome Field: Field produces 100,000 barrels per month.

<u>Buyer</u>	<u>Quantity</u>
Purchaser A	1,000 (1%)
Purchaser B	5,000 (5%)
Purchaser C	15,000 (15%)
Purchaser D	18,000 (18%)
Purchaser E	22,000 (22%)
Purchaser F	25,000 (25%)
Purchaser G	14,000 (14%)

Purchasers C, D, E, F & G all buy significant quantities of production from this field. Is B significant? What if B has the only AL sales or purchases in the field?

Note: What is significant in one field or area might be insignificant in another.

Federal Oil – NAL Valuation (pre-June 2000)

- First Benchmark:
 - The first benchmark for oil is not a question of the acceptability of the lessee's NAL gross proceeds, as it is for gas.
 - It is, instead a comparison of the lessee's AL "contemporaneous posted prices or oil sales contract prices" to comparable AL prices.

Federal Oil – NAL Valuation (pre-June 2000)

Oil Example 1 and 2

Federal Oil – NAL Valuation (pre-June 2000)

- First Benchmark:
 - If the first benchmark fails because:
 - The lessee has no comparable AL transactions
 - AL transactions are not of significant quantities
 - Or there are no AL sales or purchases of like-quality production in the field or area to compare the lessee's prices to,
 - Go to benchmark two

Federal Oil – NAL Valuation (pre-June 2000)

- Second Benchmark:
 - The arithmetic average of contemporaneous posted prices
 - Used in arm's-length transactions
 - By persons other than the lessee
 - For purchases or sales of significant quantities
 - Of like-quality oil
 - In the same field (or, if necessary to obtain a reasonable sample, from the same area)

30 CFR 206.102 (c) (2) (pre-June 2000)

Federal Oil – NAL Valuation (pre-June 2000)

Oil Example 3 and 4

Federal Oil – NAL Valuation (pre-June 2000)

- Second Benchmark:
 - If there are no
 - Contemporaneous posted prices
 - Used in arm's-length transactions
 - By persons other than the lessee for purchases or sales
 - Of significant quantities
 - Of like-quality oil
 - In the same field (or, if necessary to obtain a reasonable sample, from the same area)
 - Move on to benchmark three

Federal Oil – NAL Valuation (pre-June 2000)

- Third Benchmark:
 - The arithmetic average of other contemporaneous arm's-length contract prices for purchase or sales of significant quantities of like-quality oil in the same area or nearby areas.
 - 30 CFR 206.102 (c) (3) (pre-June 2000)

Federal Oil – NAL Valuation (pre-June 2000)

Oil Example 5

Federal Oil – NAL Valuation (pre-June 2000)

- Third Benchmark:
 - If there are no
 - Contemporaneous AL contract prices for purchases or sales
 - Of significant quantities
 - Of like-quality oil
 - In the same area or nearby areas,
 - Move on to benchmark four

Federal Oil – NAL Valuation (pre-June 2000)

- Fourth Benchmark:
 - Prices received for arm's-length spot sales of significant quantities of like-quality oil from the same field (or, if necessary to obtain a reasonable sample, from the same area),
 - And other relevant matters, including information submitted by the lessee concerning circumstances unique to a particular lease operation or the saleability of certain types of oil
- 30 CFR 102 (c) (4) (pre-June 2000)

Federal Oil – NAL Valuation (pre-June 2000)

Oil Example 6

Federal Oil – NAL Valuation (pre-June 2000)

- Fourth Benchmark:
 - If there are no
 - **AL spot sales**
 - **of significant quantities**
 - **of like-quality oil**
 - **from the same field (or, if necessary to obtain a reasonable sample, from the same area),**
 - **And you cannot determine other relevant matters, including information submitted by the lessee concerning circumstances unique to a particular lease operation or the saleability of certain types of oil by which to value this oil,**
 - Move on to benchmark five

Federal Oil – NAL Valuation (pre-June 2000)

- Fifth Benchmark:
 - A net-back method or any other reasonable method to determine value.
 - A net-back method is intended for use primarily where the form of the lease product has changed, and it is necessary to start with the sales price of the changed product and deduct transportation and processing costs.

30 CFR 206.102 (c) (5)

(from the preamble to the 1988 oil valuation regulations, *Federal Register*, Vol. 53, No. 10, Friday, January 15, 1988, page 1196.)

Federal Oil – NAL Valuation (pre-June 2000)

- 30 CFR § 206.102 (h):
 - Under no circumstances shall the value of production, for royalty purposes, be less than the gross proceeds accruing to the lessee for lease production, less applicable allowances.

Federal Oil – NAL Valuation Audit/Compliance Approach

- Determine the first applicable benchmark value and compare to gross proceeds. Value for royalty purposes is the higher of the two.
- See the “NAL Gas Valuation – Federal, Audit/Compliance Approach” section of this presentation for more discussion of gross proceeds, duty to market, and marketable condition.

INDIAN OIL NAL VALUATION

Indian Oil Definitions

Lessee:

...any person to whom an Indian Tribe, or an Indian allottee issues a lease, and any person who has been assigned an obligation to make royalty or other payments required by the lease.

30 CFR 206. 51 Indian Oil and 30 CFR 206.171 Indian Gas

Indian Oil Definitions

Lessee: This includes any person who has an interest in a lease as well as an operator or payor who has no interest in the lease but who has assumed the royalty payment responsibility.

30 CFR 206.51 Indian Oil and 30 CFR 206.171 Indian Gas

Indian Oil Definitions

Gross Proceeds (for royalty payment purposes) means the total monies and other consideration accruing to an oil and gas lessee for the disposition of the oil produced.

30 CFR 206.51, Indian Oil

Indian Oil Definitions

Gross Proceeds (cont'd).

Gross proceeds includes, but is not limited to, payments to the lessee for certain services such as dehydration, measurement, and/or gathering to the extent that the lessee is obligated to perform them at no cost to the Indian lessor.

Indian Oil Definitions

Gross Proceeds (cont'd).

Gross proceeds , as applied to oil, also includes, but is not limited to, reimbursements for harboring and terminaling fees.

30 CFR 206.51, Indian Oil

Indian Oil Definitions

Gross Proceeds (cont'd).

Tax reimbursements are part of the gross proceeds accruing to a lessee even though the Indian royalty interest may be exempt from taxation.

30 CFR 206.51, Indian Oil

Indian Oil Definitions

Gross Proceeds (cont'd).

Monies and other consideration, including the forms of consideration identified in this paragraph, to which a lessee is contractually or legally entitled but which it does not seek to collect through reasonable efforts are also part of gross proceeds.

Indian Oil Definitions

- *Marketable condition* means lease products that are sufficiently free from impurities and otherwise in a condition that they will be accepted by a purchaser under a sales contract typical for the field or area.
- 30 CFR 206.151, Federal gas; 30 CFR 206.51, Indian Oil; 30 CFR 206.101, Federal Oil (pre-June 2000); 30 CFR 206.171, Indian gas (pre-January 2000)

Indian Oil Definitions

- Marketable Condition (con't.)
- “The lessee is required to place oil in marketable condition at no cost to the Indian lessor unless otherwise provided in the lease agreement or this section.”
- 30 CFR 206.52(i), Indian Oil

Indian Oil Definitions

- Marketable Condition (cont'd.)
- “Where the value established under this section is determined by a lessee’s gross proceeds, that value shall be increased to the extent that the gross proceeds have been reduced because the purchaser, or any other person, is providing certain services the cost of which ordinarily is the responsibility of the lessee to place the oil in marketable condition.”
- 30 CFR 206.52(i), Indian Oil

Indian Oil – NAL Valuation Rules

- Regulatory Authority
 - 30 CFR 206.52 (c) and (h) Valuation standards for Indian oil
 - The value shall be the reasonable value determined under the first applicable benchmark, but no less than gross proceeds.
 - 30 CFR 206.52 (a) (2) (i) Major Portion requirement may apply to Indian oil
 - MMS will compare the value determined under the benchmarks to NAL gross proceeds. The higher of these two values will be compared to the major portion value and the value for royalty purposes shall be the higher of these two.

Indian Oil – NAL Valuation

- First Benchmark:
 - The lessee's contemporaneous posted prices or oil sales contract prices used in arm's-length transactions for purchases or sales of significant quantities of like-quality oil in the same field (or, if necessary to obtain a reasonable sample, from the same area);
 - 30 CFR 206.52 (c) (1)

Indian Oil – NAL Valuation

- First Benchmark:
 - provided, however, that those posted prices or oil sales contract prices are comparable to other contemporaneous posted prices or oil sales contract prices used in arm's-length transactions for purchases or sales of significant quantities of like-quality oil in the same field (or, if necessary to obtain a reasonable sample, from the same area.)
 - 30 CFR 206.52 (c) (1)

Indian Oil – NAL Valuation

- For purposes of this paragraph [all of 206.52], the term lessee includes the lessee's designated purchasing agent, and the term contemporaneous means postings or contract prices in effect at the time the royalty obligation is incurred.

30 CFR 206.52 (c) (6)

Indian Oil – NAL Valuation

- First Benchmark:
 - In evaluating the comparability of posted prices or oil sales contract prices, the following factors should be considered:
 - Price
 - Duration
 - Market or markets served
 - Terms
 - Quality of oil
 - Volume, and
 - Other factors as may be appropriate to reflect the value of the oil.

Indian Oil – NAL Valuation

- **Second Benchmark:**
 - The arithmetic average of contemporaneous posted prices
 - Used in arm's-length transactions
 - By persons other than the lessee
 - For purchases or sales of significant quantities
 - Of like-quality oil
 - In the same field (or, if necessary to obtain a reasonable sample, from the same area)

30 CFR 206.52 (c) (2)

Indian Oil – NAL Valuation

- Third Benchmark:
 - The arithmetic average of other contemporaneous arm's-length contract prices for purchase or sales of significant quantities of like-quality oil in the same area or nearby areas.
 - 30 CFR 206.52 (c) (3)

Indian Oil – NAL Valuation

- Fourth Benchmark:
 - Prices received for arm's-length spot sales of significant quantities of like-quality oil from the same field (or, if necessary to obtain a reasonable sample, from the same area),
 - And other relevant matters, including information submitted by the lessee concerning circumstances unique to a particular lease operation or the saleability of certain types of oil
- 30 CFR 52 (c) (4)

Indian – NAL Valuation

- Fifth Benchmark:

- A net-back method or any other reasonable method to determine value.

30 CFR 206.52 (c) (5)

- A net-back method is intended for use primarily where the form of the lease product has changed, and it is necessary to start with the sales price of the changed product and deduct transportation and processing costs.

(from the preamble to the 1988 oil valuation regulations, *Federal Register*, Vol. 53, No. 10, Friday, January 15, 1988, page 1196.)

FEDERAL COAL VALUATION

Federal Coal

Fifth benchmark:

- A net-back method or any other reasonable method.

30 CFR 206.257 (c) (2) (v)

- “The MMS will use a net-back valuation method only when other methods of determining value, such as those specified in the rules, are inapplicable. In doing a net-back, MMS will start at the first point at which a market value for the product can be determined, and will deduct costs of transportation, washing, handling, etc. to reach a value for royalty purposes.”

(from the preamble to the 1989 coal valuation regulations, *Federal Register*, Vol. 54, No. 9, January 13, 1989, page 1506.)

Federal Coal

- 30 CFR 206.257 (g) Valuation standards for ad valorem leases
 - For royalty purposes the value may not be less than the gross proceeds accruing to the lessee for coal production. Less applicable provisions of 206.257 (b)(5) and less applicable allowances.

Federal Coal

- 30 CFR 206.257 (b) (5)
- The value of production for royalty purposes shall not include payments received by the lessee pursuant to a contract which the lessee demonstrates, to MMS's satisfaction, were not part of the total consideration paid for the purchase of coal production.

Federal Coal Gross Proceeds

30 CFR 206.251:

- Definition of gross proceeds for royalty purposes:
 - Total monies and other consideration accruing to the lessee for the production and disposition of the coal produced.

Federal Coal Gross Proceeds

30 CFR 206.251:

- Gross proceeds includes, but is not limited to, payments to the lessee for certain services such as
 - crushing,
 - sizing,
 - screening,
 - storing,
 - mixing,
 - loading,
 - treatment with substances including chemicals or oils,
 - and other preparation of the coal to the extent that the lessee is obligated to perform them at no cost to the Federal Government.

Federal Coal Gross Proceeds

30 CFR 206.251:

- Definition of gross proceeds for royalty purposes:
 - Also includes, but is not limited to
 - Reimbursements for royalties, taxes, or fees
 - And other reimbursements
 - Tax reimbursements are part of the gross proceeds accruing to a lessee even though the Federal royalty interest may be exempt from taxation.

Federal Coal Gross Proceeds

30 CFR 206.251:

- Definition of gross proceeds for royalty purposes:
 - Monies and other consideration, including the forms of consideration identified in this paragraph, to which a lessee is contractually or legally entitled but which it does not seek to collect through reasonable efforts are also part of gross proceeds.

Federal Coal Gross Proceeds

- **Gross proceeds may include:**
 - **Sales proceeds (including contract entitlements not collected)**
 - **Price adjustments**
 - **Payments made on behalf of the purchaser**
 - **Non-cash consideration – including:**
 - **mining equipment/facilities**
 - **marketable condition services and marketing services**
 - **discounted electricity rates**
 - **water rights**
 - **any other thing of value (my personal favorite)**
 - **Added-value of marketable condition**
 - **Pre- and post-production payments**

Federal Coal

Gross Proceeds

- Gross proceeds does NOT include:
 - Ash haulage to pit
 - Limestone haulage to power plant
 - Chemical alteration
 - Beneficiation
 - Force Majeure
 - Liquidated damages (contract breach)
 - Buyout