Barton, Jayne

From: Burhop, Shirley
Sent: Wednesday, January 07, 2004 4:48 PM
To: Kirumakki, Nagaraja
Cc: Conway, Karen
Subject: FINA DECISIONnew.ppt

Attachments: FINA DECISIONnew.ppt

FINA
:ISIONnew.ppt (77

This is not up-to-date, but perhaps some of it might be useful in the training.

FINA DECISION

FedCAM Information Sharing Meeting,

July ??, 2003

Background

- **Seagull Decision**
- May 6, 1999
- IBLA 98-25

Seagull
Factual Background

- Seagulls' first sales of gas were wellhead sales to its affiliate, Seagull Marketing Services (SMS).
- SMS then sold the gas to various purchasers under arm's-length contracts, receiving a higher price than it paid Seagull and other producers at the wellhead.
- Seagull based it's royalty payments on the price it received from SMS.

Seagull

Factual Background, cont'd.

- The auditors concluded that Seagull should have valued the gas based on the proceeds received by SMS, its affiliate.

Seagull Decision

- “MMS has urged the board to find that the affiliate relationship between Seagull and SMS is a sham created to avoid paying royalties. However, it has offered no facts to support its theory.”

Seagull Decision

- “In determining value for royalty purposes…MMS is properly guided by the first applicable benchmark identified in 30 CFR 206.152(c), dealing with non arm’s-length sales, to which it must superimpose consideration of the gross proceeds rule under 30 CFR 206.152 (h) to arrive at the minimum value of the lease production for royalty purposes.”

Seagull Decision

- “The record indicates that the gross proceeds received by SMS in its non-arm’s-length contracts with Seagull is equivalent to the gross proceeds received under comparable arm’s-length sales of like quality production.”

Key Definition

- Marketing Affiliate
- Defined at 30 CFR 206.151
- "Marketing affiliate means an affiliate of the lessee whose function is to acquire only the lessee's production and to market that production."

Application of the Definition

- 30 CFR 206.152(b) (1) (i)
- The value of gas sold under an arm's-length contract is the gross proceeds accruing to the lessee except as provided in paragraphs (b) (1) (ii), (iii), and (iv) of this section…For purposes of this section, gas which is sold or otherwise transferred to the lessee's marketing affiliate and then sold by the marketing affiliate pursuant to an arm's-length contract shall be valued in accordance with this paragraph based upon the sale by the marketing affiliate."

Seagull Decision

- "…it was not necessary for Seagull to bear the costs of downstream marketing where the gas sold at the wellhead was in marketable condition and where a market existed there."

Seagull Decision, cont’d.

- “Thus, absent some allegation that the sale is determined not to be the reasoned equivalent of an arm’s-length sale at the wellhead, Seagull is not required to include the costs incurred by SMS in its ‘gross proceeds’ for purposes of computing royalty.”

Texaco Decision

- MMS-92-0306-O&G
- May 18, 1999 (less than two weeks after Seagull)
- Signed by Sylvia Baca, Acting Assistant Secretary, Land and Minerals Management
- Concurred by Bruce Babbitt, Secretary of the Interior

Texaco
Factual Background

- Texaco Inc. was the parent of Texaco E&P
- Texaco E & P was the lessee
- Texaco Refining and Marketing ("Texaco Marketing") was a wholly owned subsidiary of Texaco Inc.
- Texaco E&P sold its oil production to its affiliate, Texaco Marketing, in non-arm's-length transactions at posted prices
- Texaco Marketing and TTTI moved the oil to a downstream location and resold it at arm's-length to third party purchasers at a higher price

Texaco

Factual Background

- Texaco paid royalties based on the posted prices used in the non-arm's-length sales to Texaco Marketing
- Texaco Marketing also purchased oil from other producers in the fields at the same posted prices that it used in the transfers from Texaco E&P

Texaco

- The auditors (California State Controller's Office) believed that Texaco should have based royalties on the affiliate's arm's-length resale price, if greater than the non-arm's-length transfer price.

Texaco Decision

- Issue 1 - What is "gross proceeds"?
- "Because "gross proceeds" is the <u>minimum</u> value of production…MMS must determine the gross proceeds and compare that value to any other value that may be applicable under section 206.102."
- "What is the correct measure of gross proceeds? Is it the non-arm's-length transfer price or is it the marketing entity's arm's length sale price?"

Texaco Decision, cont'd.

- Texaco argues that the proper measure of gross proceeds is the arm's-length transfer price between Texaco E&P and Texaco Marketing (the posted price, in this case).

Texaco Decision, cont'd.

- "The fundamental flaw in Texaco's position is that it allows any lessee to avoid the gross proceeds requirement by the simple and facile devise of creating a wholly-owned subsidiary and then first transferring the production to the affiliate, for a price the lessee determines unilaterally, before selling the production at arm's length at a higher price. Texaco's theory would confine gross proceeds to the intra-corporate transfer price, even if the lessee's convenient device ultimately realizes more money from the sale of the production."

Texaco Decision, cont'd.

- "Texaco's theory would create an exception to the gross proceeds rule that in practice would swallow it, and completely nullify its underlying intent."

Texaco Decision, cont'd.

- "I believe MMS was correct in interpreting the term "gross proceeds accruing to the lessee" to mean that the true measure of the gross proceeds derived from the disposition of the production is the proceeds which that enterprise receives in selling oil at arm's length on the open market. I believe that to do otherwise would, in practical application, essentially vitiate the gross proceeds rule."

Texaco Decision, cont'd.

- Issue 2 – Marketing Affiliate
- Texaco claims that Texaco Marketing is not a "marketing affiliate" because it buys oil from unrelated sellers and not just from Texaco E&P.
- "…if an affiliate is not a 'marketing affiliate' as defined in the rules, then MMS is not obligated to exclude consideration of the benchmarks and conclusively accept the affiliate's proceeds as royalty value. If the benchmark value under 30 CFR 206.102(c) is higher than the arm's-length resale proceeds, then the benchmark value is higher than the gross proceeds minimum and is a proper royalty value."

Texaco Decision, cont'd.

- Texaco argues that the term "lessee" in the phrase "gross proceeds accruing to the lessee" is limited to the particular corporate entity that holds an ownership interest in the lease or has been assigned royalty payment responsibility.
- This decision held otherwise.
- "…the plain intent of the gross proceeds rule is to encompass the total consideration the production and marketing enterprise received from selling the oil on the open market…"

Texaco Decision, cont'd.

- Issue 3 – Federal lessees have an implied duty to market production at no cost to the lessor
- Therefore: "…marketing costs are not deductible, regardless of whether the lessee bears them directly or transfers the marketing function or costs to a contractor, affiliate, or any other entity. If marketing costs are borne by a purchaser, affiliate, or contractor, they may be added back to gross proceeds (or other measure of value, if appropriate) to arrive at the value of the production."

IPAA v. De Witt

- Decision by the U.S. Court of Appeals, District of Columbia Circuit
- February 8, 2003

- IPAA = Independent Petroleum Association of America

IPAA

- Two issues:
- Lessee's duty to market at no cost to the lessor
- Deductibility of payments for unused firm pipeline capacity as a transportation cost

IPAA

- First issue:
- The duty of natural gas producers under Federal and Indian oil and gas leases to market production at no cost to the Federal lessor, regardless of whether the lessee sells the gas at the lease or "downstream"

IPAA

- This decision upheld the lessee's duty to market at no cost to the lessor regardless of where the lessee chooses to sell the gas
- This requirement is stated at:
  - 30 CFR 206.152 (i) Federal gas, unprocessed
  - 30 CFR 206.153 (i) Federal gas, processed

IPAA

- Issue 2:
- Background:
- Traditionally, MMS has allowed only two deductions from gross proceeds when calculating value for royalty purposes:
  - Transportation costs
  - Processing costs

IPAA

- Marketing costs are not deductible
- In response to changes by FERC (Federal Energy Regulatory Commission), which required pipelines to separate sales from transportation services, and price the services separately, MMS amended it's gas royalty regulations to clarify its existing policy and to prevent lessees from taking improper deductions from royalties.

IPAA

- API (American Petroleum Institute) and IPAA (trade associations representing oil and gas producers) fought these changes, claiming they were “arbitrary and capricious”.

IPAA

- Specifically, they wanted to be able to deduct:
- (1) fees incurred in aggregating and marketing gas for downstream sale
- (2) “intra-hub transfer fees” charged by pipelines
- (3) unused pipeline demand charges (fees paid to secure firm service for quantities in excess of actual shipments)

IPAA

- API and IPAA won their case in District Court
- However, the District Court provided that they must limit any deductions for firm demand charges to the applicable rate multiplied by the actual volumes transported

IPAA

- Interior appealed to the U.S. Court of Appeals which ruled that:
- There were no legal errors with Interior's rule regarding deductibility of marketing costs, so the District Court's ruling on this was overturned
- But the unused demand charge issue as ruled by the District Court was affirmed

Fina Decision

- United States Court of Appeals
- June 27, 2003
- Overturns Texaco
- Note that this is not yet either MMS or DOI policy – the Department has yet to decide what to do. The options are to ask the Court to reconsider or to appeal to the Supreme Court.

Fina Decision, cont'd.

- "Gas sold to owned or controlled affiliated entities, that, because they purchase at least some gas from sources other than their owning or controlling producer, are not "marketing affiliates", is valued on the basis of the first applicable of three benchmarks."
- Benchmarks are at 30 CFR 206.152(c)

Fina Decision, cont'd.

- The reasoning?
- FNGC (Fina Natural Gas Company), though controlled by Fina, is not a "marketing affiliate" because it purchases gas from both Fina and other gas producers.
- "If the affiliate of the lessee also purchases gas from other sources, then that affiliate presumably will have comparable arm's-length contracts with other parties which should demonstrate the acceptability of the gross proceeds accruing to the lessee from its affiliate."

Fina Decision, cont'd.

- "Gas sold directly to unaffiliated entities is valued at the contract price, since that price reliably indicates objective value."
- "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, cont'd.

- "Accordingly gas sold to non-marketing affiliates – where 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."

Fina Decision, cont'd

- "Even Fina's position would not allow it to set prices "unilaterally" for the benchmarks require Fina to base value on the prices that its affiliate, FNGC, pays *other* producers. In other words, Fina must pay royalties based on the actual market value of the gas at the time Fina transfers the gas to its affiliate."

Fina Decision, cont'd

- Fina also clarifies the definition of "lessee" and makes it clear that a lessee and its affiliate are not the same entity.
- "If affiliates *are* lessees then it makes no sense to talk about an 'affiliate of the lessee' nor of affiliates acquiring lessees' production".

Does the Fina Decision Apply to Federal Oil?

- No
- Not since the “new” oil rule became effective in June 2000
- The new oil rule expressly states how oil sold to an affiliate is to be valued

Does the Fina Decision Apply to Federal Oil?

- 30 CFR 206.102
- Oil sold under an arm's-length contract
- (a) "The value of oil under this section is the gross proceeds accruing to the seller under the arm's-length contract, less applicable allowances…"
- This value does not apply if you exercise an option to use a different value

Federal Oil

- The different values are:
- 30 CFR 206.102 (d) (1):
- Clarifies how to value oil sold under an exchange agreement
- 30 CFR 206.102 (d) (2):
- Clarifies how to value oil sold or transferred to your affiliate and then sold by the affiliate under an arm's-length contract

Federal Oil

- 30 CFR 206.103
- Oil that is not sold under an arm's-length contract
- Valued at index prices

Barton, Jayne

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Sent: Thursday, January 08, 2004 6:44 AM
To: Burhop, Shirley; Kirumakki, Nagaraja
Cc: Conway, Karen
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I have a book entitled "Preparing Instructional Objectives", I will share that with you on Tuesday.

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Look forward to getting this training off the ground.

Karen hope this answers your question.
Raj

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If it's O.K. with you all, let's wait till Tuesday to discuss the objectives further.

You may want to be aware that are "Beartooth Oil & Gas Co." court decision dated Sept. 1993 and the IPAA v. DeWitt US Court of Appeals 2003, decision.
Raj

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