

Barton, Jayne

From: Conway, Karen
Sent: Tuesday, January 06, 2004 7:16 AM
To: Burhop, Shirley
Subject: RE: Intro2.doc

Attachments: Intro2.doc



Intro2.doc (42 KB)

I changed the bullets to look alike and added a coma, took out a 91) and changed some spacing. See what you think.

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

From: Burhop, Shirley [mailto:Shirley.Burhop@mms.gov]
Sent: Monday, January 05, 2004 5:20 PM
To: Conway, Karen
Subject: Intro2.doc

<<Intro2.doc>> It keeps getting longer and longer...

INTRODUCTION – IMPACT OF FINA DECISION

Finna and the Benchmarks

Background:

The Finna decision came out of the U.S. Court of Appeals, District of Columbia Circuit, and was decided June 27, 2003. The decision essentially overturned the Texaco decision (MMS-92-0306-O&G, May 18, 1999), which auditors had been following.

The Texaco decision determined that Texaco Refining and Marketing, Inc., the purchaser of Texaco E & P's production, was a "marketing affiliate" of Texaco, Inc., parent company of the affiliates. The decision relied upon 30 CFR § 206.102(b)(i) which states:

For purposes of this section, oil 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.

Texaco, Inc. argued that, because Texaco Marketing bought oil from unrelated sellers and not just from Texaco E & P, it was not a "marketing affiliate" and that MMS could not therefore require Texaco to value the production at Texaco Marketing's arm's-length resale price.

The MMS Director did not agree with Texaco and held that:

"nothing in the rule or the preamble implies that MMS intended to prevent itself from looking to the subsequent arm's-length sale as establishing the lessee's gross proceeds if an affiliate is not a marketing affiliate as defined in section 206.101... The difference is that 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 arm's-length resale 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.

This finding allowed auditors to pursue the affiliate's arm's-length gross proceeds, in many cases without working through the benchmarks. The rationale for this was often that the auditee was unable to provide any comparable arm's-length contracts to determine a benchmark value. This, in many cases, simplified the auditor's work.

The Finna decision, however, said that the Texaco decision improperly applied the gross proceeds rule to affiliates who were not, per the regulations, marketing affiliates.

- "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.”

The reasoning?

- FNGC (Fina Natural Gas Company, the purchaser of Fina’s production), 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.”
- “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.”
- “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.”
- “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 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”.

Federal and Indian oil and gas benchmarks

In light of the Fina decision there has been some discussion concerning the application of the Federal and Indian oil and gas benchmarks.

1. Does the Fina decision impact the application of the oil and gas benchmarks?
 - Because the Fina audit was assessed under the marketing affiliate resales Sec. 206.151, and the related company was a non-marketing affiliate, i.e. purchased from other companies, the benchmarks must apply.

- The result is that when the related company purchases one Mcf of gas or a barrel of oil from an unrelated company the benchmarks must be used for valuation.
2. Does this limit the valuation(s) to less than the “gross proceeds accruing to the lessee?” The benchmarks specifically state in Sec. 206.152 (h) Notwithstanding any other provision of this section, under no circumstances shall the value of production for royalty purposes be less than the gross proceeds accruing to the lessee for lease production....
 - After consideration of the benchmarks under a non-arm’s-length sale, if the value is less than the gross proceeds then royalties must be paid on the gross proceeds.
 3. Does the Fina decision impact the application of the oil benchmarks prior to July 2000? (New Federal oil valuation regulations were published on March 15, 2000 and took effect July 1, 2000.)
 - The oil benchmarks are applicable when the lessee sells to a related company and the purchaser is a non-marketing affiliate, a related company that purchases from others.
 4. Does the Fina decision impact the application of the Indian gas benchmarks prior to January 2000?. (New Indian gas valuation regulations were published on August 10, 1999 and took effect January 1, 2000.)
 - Yes, since the Indian gas valuation regulations prior to January 2000 were similar to the Federal gas regulations at that time, the Fina decision applies to the valuation of NAL sales of Indian gas prior to January 2000.
 5. Are there other court decisions that help us determine the use of the benchmarks?
 - Yes, Xeno, MMS-89-0189-O&G, in the Conclusions and Order stated:

Physical treatment, handling operations, measuring, gathering, dehydrating, compressing, separation, and storage are required to place the product into a marketable condition. All of these services are considered necessary to market the product and are to be performed at no cost to the lessor...In the instant case, the reasonable value of the gas is its gross value. No reduction in value is allowed for the cost of any gathering or compression which may have been necessary in order to bring the gas to the market in which it was being sold, regardless of whether that compression or gathering was performed by the lessees, the purchaser of the gas, or some third party.
 6. The Marathon Oil case, MMS-94-0404-O&G required that in the case of a NAL sale of the residue gas the company must perform accounting for comparison where the value of the unprocessed gas using the NAL unprocessed gas benchmarks must be compared to the value of all products at the tailgate of the plant and royalty paid on the higher of the two.

7. In another Marathon Oil case, MMS-92-0077-O&G where Marathon Oil sold to Marathon Production Company (MPC) and then that company sold to Exxon, and Exxon reimbursed MPC for gathering the companies appeal was denied. Quoting a long history of cases the case noted that,

Although, MMS acknowledges that MPC is not the Appellant's marketing affiliate as defined in the new product valuation regulations, that does not relieve Marathon from its obligation to pay royalties on gathering reimbursements received by MPC.... In light of the corporate relationship between Marathon and MPC, Marathon the parent and MPC its wholly-owned subsidiary, Marathon and MPC must be treated as one and the same entity.

In conclusion, there are a multitude of court cases and regulations that support the benchmarks and accounting for comparison and these can and should be used when determining royalty liabilities for NAL transactions.

Federal Coal Benchmarks

Subject: Fina Oil and Chemical Company and the Federal Coal Benchmarks

The Fina Oil and Chemical Company (Fina) decision was directed at natural gas that is sold to a gas marketing firm that it controls and then the controlled marketing firm sells the gas again to end users. Since the federal coal regulations are modeled after the oil and gas regulations, it has been determined that the Fina case applies to federal coal. This memorandum will discuss the application of the Federal coal benchmarks.

8. Does the Fina decision impact the application of the coal benchmarks?
 - The coal regulations do not define or mention a marketing affiliate. The coal regulations are modeled after the oil and gas regulations.
 - Because the Fina audit was assessed under the marketing affiliate resales Sec. 206.151, and the related company was a non-marketing affiliate, i.e. purchased from other companies, the benchmarks must apply.
 - The result is that when one ton of coal is purchased from an unrelated company the benchmarks must be used.
9. Does this limit the valuations to less than the "gross proceeds accruing to the lessee"? The benchmarks specifically state in Sec. 206.257:

(g) Notwithstanding any other provision of this section, under no circumstances shall the value for royalty purposes be less than the gross proceeds accruing to the lessee for the disposition of coal produced....
10. After consideration of the benchmarks under a non-arm's-length sale, if the value is less than the gross proceeds then royalties must be paid on the gross proceeds.

Barton, Jayne

From: Conway, Karen
Sent: Wednesday, January 07, 2004 7:35 AM
To: Burhop, Shirley; MRM/Bldg. 85 Mile High Room, Room F201B; Johnson, Brian C; Summers, Dana; Soderlind, Ellwood; Loomis, F David; Staigle, George; Kepler, Glenn; Conway, Karen; Kirumakki, Nagaraja; Rodriguez, Nancy; Perry Shirley; Davidoff, Robert; Teel, Sara; Fisher, Terence
Subject: RE: Guidance and training on applying the benchmarks

Attachments: Federal coal.doc; Federal gas.doc; Federal Oil.doc; Indian Gas.doc; Indian Oil.doc; Intro2.doc



Federal coal.doc
(46 KB)



Federal gas.doc (92 KB)



Federal Oil.doc (49 KB)



Indian Gas.doc (83 KB)



Indian Oil.doc (50 KB)



Intro2.doc (42 KB)

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

From: Burhop, Shirley [mailto:Shirley.Burhop@rums.gov]
Sent: Friday, December 19, 2003 2:14 PM
To: MRM/Bldg. 85 Mile High Room, Room F201B; Brian Johnson; Dana Summers; Ellwood Soderlind; F David Loomis; George Staigle; Glenn Kepler; Karen Conway; Nagaraja Kirumakki; Nancy Rodriguez; Perry Shirley; Robert Davidoff; Sara Teel; Terence Fisher
Subject: Guidance and training on applying the benchmarks

When: Wednesday, January 07, 2004 9:00 AM-10:00 AM (GMT-07:00) Mountain Time (US & Canada).

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FEDERAL COAL
NON-ARM'S-LENGTH VALUATION

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VALUATION – FEDERAL COAL

Regulation: 30 CFR § 206.256 (2003)

Section 206.256 Valuation standards for cents-per-ton leases.

(b) The royalty from coal from leases subject to this section shall be based on the dollar rate per ton prescribed in the lease.

Section 206.257 Valuation standards for ad valorem leases.

(b)(1) The value of coal that is sold pursuant to an arm's-length contract shall be the gross proceeds accruing to the lessee....

(b)(2) Value may not be based on less than the gross proceeds accruing to the lessee for the coal production, including the additional consideration.

(c)(1) The value of coal from leases subject to this section which is not sold pursuant to an arm's-length contract shall be determined in accordance with this section.

(c)(2) If the value of coal cannot be determined pursuant to paragraph (b) of this section, then the value shall be determined through application of other valuation criteria. The criteria shall be considered in the following order, and the value shall be based upon the first applicable criterion:

Gross proceeds: In the General valuation guidance for auditing affiliate sales of coal dated 11/26/1996 page 1 states:

Regardless of the benchmark value chosen, under no circumstances shall the value of production, for royalty purposes, be less than the gross proceeds accruing to the lessee.

On page 3 the document states :

Because coal production from Federal and Indian leases is not subject to FOGRMA, lease terms may be invoked as a basis for accessing records of an affiliate.

There is further valuable information in this document and it may be located on the MMS website in the library section.

First benchmark:

(i) The gross proceeds accruing to the lessee pursuant to a sale under its non-arm's-length contract (or other disposition of produced coal by other than by an arm's-length contract), provided that those gross proceeds are within the range of gross proceeds derived from, or paid under, comparable arm's-length contracts between buyers and sellers neither of whom is

affiliated with the lessee for sales, purchases, or other dispositions of like-quality coal produced in the area. 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 coal, quantity, and such other factors as may be appropriate to reflect the value of the coal;

Second Benchmark:

(ii) Prices reported for that coal to a public utility commission;

Third benchmark:

(iii) Prices reported for that coal to the Energy Information Administration of the Department of Energy;

Fourth Benchmark:

(iv) Other relevant matters including, but not limited to, published or publicly available spot market prices, or information submitted by the lessee concerning circumstances unique to a particular lease operation or the saleability of certain types of coal;

Fifth Benchmark:

(v) If a reasonable value cannot be determined using paragraphs (c)(2) (i), (ii), (iii), or (iv) of this section, then a net-back method or any other reasonable method shall be used to determine value.

Observation:

Some companies are using the Fina decision to refuse to provide contracts. According to Section 206.257 (d) (2), they must provide the arms-length contracts;

Any Federal lessee will make available upon request to the authorized MMS or State representatives, to the Office of the Inspector General of the Department of the Interior or other persons authorized to receive such information, arm's-length sales value and sales quantity data for like-quality coal sold, purchased, or otherwise obtained by the lessee from the area.

Section 206.257 (f) states:

The lessee may request a value determination from MMS. In that event, the lessee shall propose to MMS a value determination method, and may use that method in determining value for royalty purposes until MMS issues its decision.

Section 206.264 In-situ and surface gasification and liquefaction operations.

If an ad valorem Federal coal lease is developed by in-situ or surface gasification or liquefaction technology, the lessee shall propose the value of coal for royalty purposes to MMS.

Section 206.265 Value enhancement of marketable coal.

If, prior to use, sale, or other disposition, the lessee enhances the value of coal after the coal has been placed in marketable condition in accordance with 206.257 (h) of this subpart, the lessee shall notify MMS that such processing is occurring or will occur. The value of that production shall be determined as follows:

- (a) A value established for the feedstock coal in marketable condition by application of the provisions of 206.257 (c)(2)(i-iv) of this subpart; or,
- (b) 206.257(c)(2)(v)

FEDERAL GAS
NON-ARM'S-LENGTH VALUATION

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GAS VALUATION – FEDERAL UNPROCESSED GAS

Regulation: 30 CFR § 206.152 (2002)

Sec. 206.152 Valuation standards--unprocessed gas.

(c) The value of gas 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 methods:

First benchmark:

(1) The gross proceeds accruing to the lessee pursuant to a sale under its non-arm's-length contract (or other disposition other than by an 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). 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 gas, volume, and such other factors as may be appropriate to reflect the value of the gas;

The Oil and Gas Payor Handbook, Volume III, Product Valuation, 08/01/2000, discusses valuation of unprocessed gas not sold under an arm's-length contract in section 4.1.2, beginning on page 4-20. The first benchmark is discussed in section 4.1.2.1.

Equivalency: The lessee's non-arm's-length gross proceeds are considered equivalent if they are not less than the gross proceeds derived from or paid under the most comparable arm's-length contract in the same field (or area) for like-quality gas.

Comparability: Use the following factors to evaluate comparability of arm's-length contracts:

- Price
- Duration of contract
- Market(s) served
- Terms
- Quality of gas
- Volume
- Other appropriate factors

Lessees must use the most comparable arm's-length contract to determine value.

Analysis:

For example:

- Compare the company's non-arm's-length (NAL) price to the arm's-length (AL) price(s) in the field or area. This can be a related company's AL contract. If the NAL price is greater than or equal to the price(s) of a comparable AL contract and the price, duration of contract, market, terms, quality and volume

of gas are equivalent, then the price may be acceptable. If not then go to the second benchmark.

Gross proceeds: The lessee's gross proceeds for unprocessed gas sold under a non-arm's-length contract include all consideration paid directly or indirectly under the contract. However, the gross proceeds under a non-arm's-length contract cannot be reduced by a transportation factor

Second Benchmark:

(2) 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; or

The Oil and Gas Payor Handbook, Volume III, Product Valuation, 08/01/2000, discusses valuation of unprocessed gas not sold under an arm's-length contract in section 4.1.2, beginning on page 4-20. The second benchmark is discussed in section 4.1.2.2.

Used when:

- Lessee's gross proceeds are not equivalent to the gross proceeds paid under comparable arm's-length contracts, or if
- No comparable arm's-length contracts exist in the field or area, or if
- The lessee receives no consideration for its gas

Under this benchmark, the lessee must consider other information that is relevant or would be used in valuing like-quality gas in the field or area including:

- Gross proceeds under arm's-length contracts in the field or area
- Published prices for unprocessed gas
- Arm's-length spot prices for unprocessed gas
- Other reliable public sources of price or market information; or
- Information relevant to the particular lease or salability of the lessee's gas

The lessee must select the method that best determines the value of the lessee's unprocessed gas. The selected criterion should either:

- Reflect most closely the circumstances surrounding the disposition of the lessee's unprocessed gas, or
- Be the most relevant factor in valuing the lessee's unprocessed gas.

Analysis:

For example:

- A valuation determined by like-quality gas in the same field or nearby fields, including gross proceeds under AL contracts, posted prices for gas, prices received in AL spot sales of gas, other reliable public sources of price or

market information, and other information as to the particular lease operation or the salability of the gas.

- There is no long-term contract for the field or area and the company contract is long-term, then gross proceeds under short-term AL contracts in the field or area might be used.
- If a company is NAL to the lessee and they purchase in the same field or area from arm's-length companies, these agreements may be used to value production under the second benchmark because these prices are AL prices in the field or area. This may not be a valid pricing method if this is a captive market.

Third benchmark:

(3) A net-back method or any other reasonable valuation method.

The Oil and Gas Payor Handbook, Volume III, Product Valuation, 08/01/2000 discusses valuation of unprocessed gas not sold under an arm's-length contract in section 4.1.2, beginning on page 4-20. The third benchmark is discussed in section 4.1.2.3.

- Because the circumstances regarding the use of a net-back or other method cannot be foreseen, no instructions are provided in this handbook.
- Determined on a case-by-case basis

Further guidance was provided in the preamble to the 1988 Federal Gas Rule, found in the Federal Register / Vol. 53, No 10 / Friday, January 15, 1988, Page 1243, states:

The MMS's intent is that a net-back method be used for valuation primarily where the form of the lease product has changed, and it is necessary to start with the sales prices of the changed product and deduct transportation and processing costs. An example would be where gas production from a Federal lease is used on lease to generate electricity which is then sold. If the value of the gas cannot be determined through application of the first three benchmarks in the regulations (see §206.152(c)), then a net-back method would involve beginning with the sale price of the electricity and deducting the costs of generation and transportation, thus working back to a value at the lease.

Analysis:

For example:

- This may be an AL price in a different field or area adjusted for quality and transportation as long as it is reasonable.

Further valuation regulations for unprocessed gas:

(e)(1) Where the value is determined pursuant to paragraph (c) of this section, the lessee shall retain all data relevant to the determination of royalty value. Such data shall be subject to review and audit, and MMS will direct a lessee to use a different value if it determines that the reported value is inconsistent with the requirements of these regulations.

(2) Any Federal lessee will make available upon request to the authorized MMS or State 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.

(3) A lessee shall notify MMS if it has determined value pursuant to paragraph (c)(2) or (c)(3) of this section. The notification shall be by letter to the MMS Associate Director for Minerals Royalty Management or his/her designee. The letter shall identify the valuation method to be used and contain a brief description of the procedure to be followed. The notification required by this paragraph is a one-time notification due no later than the end of the month following the month the lessee first reports royalties on a Form MMS-2014 using a valuation method authorized by paragraph (c)(2) or (c)(3) of this section, and each time there is a change in a method under paragraph (c)(2) or (c)(3) of this section.

(f) If MMS determines that a lessee has not properly determined value, the lessee shall pay the difference, if any, between royalty payments made based upon the value it has used and the royalty payments that are due based upon the value established by MMS. The lessee shall also pay interest on that difference computed pursuant to 30 CFR 218.54. If the lessee is entitled to a credit, MMS will provide instructions for the taking of that credit.

(g) The lessee may request a value determination from MMS. In that event, the lessee shall propose to MMS a value determination method, and may use that method in determining value for royalty purposes until MMS issues its decision. The lessee shall submit all available data relevant to its proposal. The MMS shall expeditiously determine the value based upon the lessee's proposal and any additional information MMS deems necessary. In making a value determination MMS may use any of the valuation criteria authorized by this subpart. That determination shall remain effective for the period stated therein. After MMS issues its determination, the lessee shall make the adjustments in accordance with paragraph (f) of this section.

(h) **Notwithstanding any other provision of this section, 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.**
(bold added for emphasis)

Gross Proceeds:

(h) Notwithstanding any other provision of this section, 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.

Marketable Condition:

(i) The lessee must place gas in marketable condition and market the gas for the mutual benefit of the lessee and the lessor at no cost to the Federal Government. Where the value established under this section is determined by a lessee's gross proceeds, that value will 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 gas in marketable condition or to market the gas.

Observation:

Many companies are using the Fina decision to refuse to provide contracts. According to Sec. 206.152 (e) (2), they must provide the AL contracts.

Any Federal lessee will make available upon request to the authorized MMS or State 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.

Ultimately these AL contracts may be used to determine gross proceeds.

GAS VALUATION – FEDERAL PROCESSED GAS

Regulation: 30 CFR § 206.153 (2002)

Sec. 206.153 Valuation standards--processed gas.

(c) The value of residue gas or any gas plant product 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 methods:

Used when:

- Sales contract is non-arm's-length
- Residue gas or gas plant products are transferred without a contract
- Transaction does not meet the arm's-length criteria

Benchmarks focus on:

- Comparable arm's-length gross proceeds, published prices, or spot market prices

First benchmark:

(1) The gross proceeds accruing to the lessee pursuant to a sale under its non-arm's-length contract (or other disposition other than by an 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). 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;

First benchmark from the Oil and Gas Payor Handbook, Volume III, Product Valuation, 08/01/2000 discusses valuation of processed gas not sold under an arm's-length contract in section 4.2.2.1, beginning on page 4-47.

Equivalency: The lessee's non-arm's-length gross proceeds are considered equivalent if they are not less than the gross proceeds derived from or paid under the most comparable arm's-length contract.

Comparability:

- Price
- Duration of contract
- Market(s) served
- Terms
- Quality of the gas
- Volume
- Other appropriate factors

Analysis:

For example:

- Compare the company's NAL price to AL prices, including a related company's price, at the plant. If there are no AL prices at the plant then nearby plants may be used. If the NAL price is greater than or equal to the price of a comparable AL contract and the price, time of execution, duration of contract, market, terms, quality and volume of gas are equivalent, then the price may be acceptable. If not then go to the second benchmark.

Gross Proceeds: The lessee's gross proceeds for residue gas or gas plant products sold under a non-arm's-length contract include all consideration paid directly or indirectly under the contract. However the gross proceeds under a non-arm's-length contract cannot be reduced by a transportation factor.

Analysis:

For example:

- Gross proceeds would not be reduced for NAL processing cost as well, because the deduction for both transportation and processing is only allowed for the actual cost for transportation and processing for NAL contracts and transfers.

Second benchmark:

(2) 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; or

Second Valuation Benchmark from the Oil and Gas Payor Handbook, Volume III, Product Valuation, 08/01/2000 discusses valuation of processed gas not sold under an arm's-length contract in section 4.2.2.2, beginning on page 4-49.

Other relevant information

Used when:

- Lessee's gross proceeds are not equivalent to gross proceeds under comparable arm's-length contracts
- No comparable arm's-length contracts exist at plant or nearby plant
- Lessee receives no consideration for its gas and gas plant products

Criteria can include:

- Gross proceeds under arm's-length contracts at the plant or nearby plants
- Published prices for residue gas or gas plant products
- Prices under arm's-length spot sales of residue gas or gas plant products

- Other reliable public sources of price or market information; and
- Information relevant to that particular lease or salability of lessee's gas and plant products

Selected criteria should:

- Reflect most closely the circumstances surrounding the disposition of the lessee's residue gas or gas plant products, or
- Be the most relevant factor in valuing the lessee's residue gas and gas plant products.

Analysis:

For example:

- A value determined by consideration of other information relevant in valuing like-quality residue gas and plant products, including gross proceeds under AL contracts for like-quality gas in the same field or nearby fields or areas at the plant or a near by plant. This includes a related company's AL sales or purchases.
- Residue gas or gas plant products published prices; spot prices and other reliable public sources of price; or market information; or other relevant information may be used.

Third benchmark:

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

Third Valuation Benchmark from the Oil and Gas Payor Handbook, Volume III, Product Valuation, 08/01/2000 discusses valuation of processed gas not sold under an arm's-length contract in section 4.2.2.3, beginning on page 4-50.

The third benchmark for valuing processed gas is the net-back method or any other reasonable method for valuing residue gas or gas plant products.

Analysis:

For example:

- Determined on a case-by-case basis
- Valuation may be based on an AL price in a different field or area adjusted for quality and transportation as long as it is reasonable, or other method.

Further valuation regulations for processed gas:

(e)(1) Where the value is determined pursuant to paragraph (c) of this section, the lessee shall retain all data relevant to the determination of royalty value. Such data shall be subject to review and audit, and MMS will direct a lessee to use a different value if it determines upon review or audit that the reported value is inconsistent with the requirements of these regulations.

(2) Any Federal lessee will make available upon request to the authorized MMS or State representatives, to the Office of the Inspector General of the Department of the Interior, or other persons authorized to receive such information, arm's-length sales and volume data for like-quality residue gas and gas plant products sold, purchased or otherwise obtained by the lessee from the same processing plant or from nearby processing plants.

(3) A lessee shall notify MMS if it has determined any value pursuant to paragraph (c)(2) or (c)(3) of this section. The notification shall be by letter to the MMS Associate Director for Royalty Management or his/her designee. The letter shall identify the valuation method to be used and contain a brief description of the procedure to be followed. The notification required by this paragraph is a one-time notification due no later than the end of the month following the month the lessee first reports royalties on a Form MMS-2014 using a valuation method authorized by paragraph (c)(2) or (c)(3) of this section, and each time there is a change in a method under paragraph (c)(2) or (c)(3) of this section.

(f) If MMS determines that a lessee has not properly determined value, the lessee shall pay the difference, if any, between royalty payments made based upon the value it has used and the royalty payments that are due based upon the value established by MMS. The lessee shall also pay interest computed on that difference pursuant to 30 CFR 218.54. If the lessee is entitled to a credit, MMS will provide instructions for the taking of that credit.

(g) The lessee may request a value determination from MMS. In that event, the lessee shall propose to MMS a value determination method, and may use that method in determining value for royalty purposes until MMS issues its decision. The lessee shall submit all available data relevant to its proposal. The MMS shall expeditiously determine the value based upon the lessee's proposal and any additional information MMS deems necessary. In making a value determination, MMS may use any of the valuation criteria authorized by this subpart. That determination shall remain effective for the period stated therein. After MMS issues its determination, the lessee shall make the adjustments in accordance with paragraph (f) of this section.

(h) Notwithstanding any other provision of this section, under no circumstances shall the value of production for royalty purposes be less than the gross proceeds accruing to the lessee for residue gas and/or any gas plant products, less applicable transportation allowances and processing allowances determined pursuant to this subpart.
(Bold added for emphasis)

Access to information:

Royalty must be paid on the gross proceeds accruing to the lessee. Many companies are using the Fina decision to refuse to provide contracts. According to Sec. 206.153 (e) (2), they must provide the arm's-length contracts.

Any Federal lessee will make available upon request to the authorized MMS or State representatives, to the Office of the Inspector General of the Department of the Interior, or other persons authorized to receive such information, arm's-length sales and volume data for like-quality residue gas and gas plant products sold, purchased or otherwise obtained by the lessee from the same processing plant or from nearby processing plants.

Ultimately these AL contracts may be used to determine gross proceeds.

(i) The lessee must place residue gas and gas plant products in marketable condition and market the residue gas and gas plant products for the mutual benefit of the lessee and the lessor at no cost to the Federal Government. Where the value established under this section is determined by a lessee's gross proceeds, that value will 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 residue gas or gas plant products in marketable condition or to market the residue gas and gas plant products.

Marketable Condition:

According to Sec. 206.153 (i) if gross proceeds have been reduced because of the cost to place the product in marketable condition or the cost to market, the value will be increased. This is applicable to Sec. 206.152 (i) as well. Ultimately if NAL contracts or AL contracts reduce the value because of these costs then the value will be increased. (See MMS-89-0189-O&G, Xeno, Inc)

ACCOUNTING FOR COMPARISON (Also known as Dual Accounting)

Regulation: 30 CFR § 206.155 (2002)

This regulation directly impacts the non-arm's-length contracts and transfers to plants when the residue gas is not sold pursuant to an arm's-length contract:

Sec. 206.155 Accounting for comparison.

(a) Except as provided in paragraph (b) of this section, where the lessee (or a person to whom the lessee has transferred gas pursuant to a non-arm's-length contract or without a contract) processes the lessee's gas and after processing the gas the residue gas is not sold pursuant to an arm's-length contract, the value, for royalty purposes, shall be the greater of (1) the combined value, for royalty purposes, of the residue gas and gas plant products resulting from processing the gas determined pursuant to Sec. 206.153 of this subpart, plus the value, for royalty purposes, of any condensate recovered downstream of the point of royalty settlement without resorting to processing determined pursuant to Sec. 206.102 of this subpart; or (2) the value, for royalty purposes, of the gas prior to processing determined in accordance with Sec. 206.152 of this subpart.

Analysis:

For example:

- If after the transfer or sale of gas to a related company the residue gas is sold NAL then the value will be calculated on the greater of the value of all the products after processing or the value of the gas prior to processing (measured at the BLM approved measurement point), and the value will be calculated under the benchmarks for unprocessed gas in Sec. 206.152.
- In the Marathon Oil case, MMS-94-0404-O&G the company was required to calculate the accounting for comparison and was not relieved of this duty even though it owned less than 50 percent of the plant and argued that the purchaser, although a related party, should be considered arm's-length.

Court cases:

- Pioneer Kettleman, MMS-89-0232-O&G and MMS-90-0405-O&G
- Marathon Oil, MMS-94-0404-O&G

GAS DISPOSED OF UNDER SPECIAL CONTRACTS OR SITUATIONS

The Payor Handbook, Volume III, Product Valuation, 08/01/2000, on page 4-55, begins discussion of gas disposed of under special contracts or situations.

Topics discussed there include:

1. POP contracts (Percentage of Proceeds Contracts)
2. Warranty Contracts
3. Exchange agreements
4. Arrangements for the transportation and processing of the gas under a tariff structure
5. Processing agreements that provide for compensation for the PVR (plant volume reduction), also known as "keep-whole" agreements
6. Contacts providing for residue gas to be returned to the lease
7. Production imbalances
8. Weighted-average (or pool) pricing.

The Payor Handbook is a good reference if the auditor encounters any of these situations. POP contracts are so common that they are discussed in more detail in this paper.

POP CONTRACTS

Percentage of Proceeds (POP) Contract Analysis

Under regulations effective November 1, 1991, gas sold under POP contracts is valued differently than other processed gas depending on the type of contract.

Arm's-Length:

Gas sold under an arm's-length POP contract is valued as unprocessed gas for royalty purposes. Value is based on the greater of the lessee's gross proceeds received under its arm's-length POP contract or a minimum value that is 100% of the value of the residue gas at the tailgate of the plant.

Non-Arm's-Length:

Gas sold under non-arm's-length POP contracts continues to be valued as processed gas. However, values of the residue gas and gas plant products are based on the benchmark system and the lessee's processing costs are based on the actual costs to process the gas.

The value is based on the full value of residue gas, gas plant products, and drip condensate recovered less actual processing and transportation allowances. The Sec. 206.155 accounting for comparison, must be considered if residue gas is not sold pursuant to an arm's-length contract.

Other Guidance:

- Federal Register, Vol. 56, No. 178, pages 46527 – 46531, "Revision of Valuation Regulations Governing Gas Sold Under Percentage-of-Proceeds Contracts"
- Memo, date uncertain, "Interpretation – Dual Accounting for Gas Sold Under Percentage-of-Proceeds (POP) Contracts [Issue 1995-1]"
- Dear Payor letter, April 16, 1992
- Dear Payor letter, June 25, 1992
- Policy Paper, August 19, 1994, "Policy Paper – Retroactive Application of the Percentage-of-Proceeds (POP) Rule"
- Payor Handbook, Volume III, 8/01/2000, Section 4.3.1, page 4-56

FEDERAL OIL
NON-ARM'S-LENGTH VALUATION

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FEDERAL OIL

Regulation: 30 CFR § 206.102 (1999)

Sec. 206.102 Valuation standards--oil.

(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:

First benchmark:

- (1) 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); 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). In evaluating the comparability of posted prices or oil sales contract prices, the following factors shall 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. 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;

First benchmark from the Oil and Gas Payor Handbook, Volume III, Product Valuation, 08/01/2000 discusses valuation of oil not sold under an arm's-length contract in section 3.2.1, beginning on page 3-13.

Lessee's contemporaneous posted prices or oil sales contract prices used in arm's-length transactions.

Lessee's price must be:

- Comparable to other contemporaneous arm's-length prices
- Used to purchase significant quantities of like-quality oil
- Used to purchase production in the same field or area

Comparability is based on:

- Price
- Duration of contract
- Market or markets served
- Terms
- Quality
- Volume
- Other appropriate factors

Note: However, if the lessee makes arm's-length purchases or sales at different posted or contract prices during the production month, value is determined by the volume-weighted-average price for the purchases or sales during that month.

Analysis:

For example:

- If a company sells to a related company, a NAL transaction, and the related company purchases from other companies in the field then the NAL price must be compared to other AL purchase prices.
- If a company sells under a NAL contract and also sells production arm's-length then the NAL price would be compared to the AL price.
- If the NAL price is less than the AL price and there are two or more sales of significant quantities then a volume-weighted average AL price is used to compare the value.
- If the company has a posting for the field or area the posting is compared to other postings for the field or area. The posting must be comparable to postings used in AL contracts so if there are premiums in the field or area then the premiums would be included in the comparison.
- If the NAL prices meet the comparison used then the NAL contract may be used to value the oil.

Second benchmark:

- (2) 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);

Second Valuation Benchmark from the Oil and Gas Payor Handbook, Volume III, Product Valuation, 08/01/2000 discusses valuation of oil not sold under an arm's-length contract in section.3.2.2, beginning on page 3-14.

Arithmetic average of contemporaneous posted prices used in arm's-length transactions by persons other than the lessee.

Must be used to purchase:

- Significant quantities of like-quality oil
- Production in the same field or area
- Arm's-length purchases other than the lessee.

Analysis:

For example:

- Significant quantities would be determined by the relevant facts in each case using the auditor's judgment.

- If there are posted prices used in arm's-length transactions and these also contained premiums then the premium would be added to the calculation.

Third benchmark:

- (3) The arithmetic average of other contemporaneous arm's-length contract prices for purchases or sales of significant quantities of like-quality oil in the same area or nearby areas;

Third Valuation Benchmark from the Oil and Gas Payor Handbook, Volume III, Product Valuation, 08/01/2000 discusses valuation of oil not sold under an arm's-length contract in section 3.2.3, beginning on page 3-14.

Arithmetic average of other contemporaneous arm's-length contract prices in the area.

Must be used to purchase:

- Significant quantities of like-quality oil
- Production in the same area or nearby areas

Analysis:

For example:

- Significant quantities would be determined by the relevant facts in each case using the auditor's judgment.
- Production located in the same area and nearby areas would be acceptable if the quality was adjusted to be comparable and contemporaneous AL contract prices were available. Confidentiality would have to be protected.
- Premiums would be included.

Fourth benchmark:

- (4) 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;

Fourth Valuation Benchmark from the Oil and Gas Payor Handbook, Volume III, Product Valuation, 08/01/2000 discusses valuation of oil not sold under an arm's-length contract in section 3.2.4, beginning on page 3-15.

Arm's-length spot sales prices and other relevant matters.

- Used when no arm's-length posted prices or sales contracts exist in the same field, area, or nearby areas.

Analysis:

For example:

- If there are AL spot prices for this field or area and, after reviewing the relevant facts, the spot price, is greater than the NAL price, the spot price may be used to value the oil.
- If there are no spot prices for the field, but the oil is transported to a nearby field or area and there are spot prices in this location, these may be used in the valuation of the oil.

Fifth benchmark:

- (5) A net-back method or any other reasonable method to determine value;

Fifth Valuation Benchmark from the Oil and Gas Payor Handbook, Volume III, Product Valuation, 08/01/2000 discusses valuation of oil not sold under an arm's-length contract in section 3.2.5, beginning on page 3-15.

Netback or other reasonable valuation method

- Determined on a case-by-case basis

Analysis:

For example:

- If none of the other benchmarks apply then alternative methods, such as netting back the price using a transportation differential from a refinery that purchases from others, and adjusting for quality in order to value the production, or another logical method could be used for valuation.

Further regulations:

- (6) For purposes of this paragraph, 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. (d) Any Federal lessee will make available, upon request to the authorized MMS or State representatives, to the Office of the Inspector General of the Department of the Interior, or other persons 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.

Observation:

According to Sec. 206.102 (c) (6) **it is noted that the term lessee includes the lessee's designated purchasing agent, and that could be a related company. This section also requires the lessee (and designated purchasing agent) to provide the relevant contract information on the AL sales for the field or area or from nearby fields or areas.**

Further regulations:

(e)(1) Where the value is determined pursuant to paragraph (c) of this section, the lessee shall retain all data relevant to the determination of royalty value. Such data shall be subject to review and audit, and MMS will direct a lessee to use a different value if it determines that the reported value is inconsistent with the requirements of these regulations. (2) A lessee shall notify MMS if it has determined value pursuant to paragraph (c)(4) or (c)(5) of this section. The notification shall be by letter to the MMS Associate Director for Royalty Management or his/her designee. The letter shall identify the valuation method to be used and contain a brief description of the procedure to be followed. The notification required by this paragraph is a one-time notification due no later than the end of the month following the month the lessee first reports royalties on a Form MMS-2014 using a valuation method authorized by paragraph (c)(4) or (c)(5) of this section and each time there is a change from one to the other of these two methods.

Observation:

This section **requires** that the lessee provide and retain all information relevant to the valuation determination in order for the information to be reviewed.

(f) If MMS determines that a lessee has not properly determined value, the lessee shall pay the difference, if any, between royalty payments made based upon the value it has used and the royalty payments that are due based upon the value established by MMS. The lessee shall also pay interest on the difference computed pursuant to 30 CFR 218.54. If the lessee is entitled to a credit, MMS will provide instructions for the taking of that credit.

(g) The lessee may request a value determination from MMS. In that event, the lessee shall propose to MMS a value determination method and may use that value for royalty payment purposes until MMS issues a value determination. The lessee shall submit all available data relevant to its proposal. MMS shall expeditiously determine the value based upon the lessee's proposal and any additional information MMS deems necessary. In making a value determination, MMS may use any of the valuation criteria authorized by this subpart. That determination shall remain effective for the period stated therein. After MMS issues its determination, the lessee shall make the adjustments in accordance with paragraph (f) of this section.

(h) **Notwithstanding any other provision of this section, 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 determined pursuant to this subpart.** (Bold added for emphasis)

Observation:

Royalty must be paid on the gross proceeds accruing to the lessee.

(i) 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. 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.

Observation:

According to Sec. 206.102 (i), if gross proceeds have been reduced because of the cost to place the product in marketable condition or the cost to market, the value will be increased. Ultimately if NAL contracts or AL contracts reduce the value because of these costs then the value will be increased. (See MMS-89-0189-O&G, Xeno, Inc.)

Further regulations:

(j) Value shall be based on the highest price a prudent lessee can receive through legally enforceable claims under its contract. Absent contract revision or amendment, if the lessee fails to take proper or timely action to receive prices or benefits to which it is entitled, it must pay royalty

at a value based upon that obtainable price or benefit. Contract revisions or amendments shall be in writing and signed by all parties to an arm's-length contract. If the lessee makes timely application for a price increase or benefit allowed under its contract but the purchaser refuses, and the lessee takes reasonable measures, which are documented, to force purchaser compliance, the lessee will owe no additional royalties unless or until monies or consideration resulting from the price increase or additional benefits are received. This paragraph shall not be construed to permit a lessee to avoid its royalty payment obligation in situations where a purchaser fails to pay, in whole or in part or timely, for a quantity of oil.

(k) Notwithstanding any provision in these regulations to the contrary, no review, reconciliation, monitoring, or other like process that results in a redetermination by MMS of value under this section shall be considered final or binding as against the Federal Government or its beneficiaries until the audit period is formally closed.

(l) Certain information submitted to MMS to support valuation proposals, including transportation allowances or extraordinary cost allowances, is exempted from disclosure by the Freedom of Information Act, 5 U.S.C. 552, or other Federal law. Any data specified by law to be privileged, confidential, or otherwise exempt, will be maintained in a confidential manner in accordance with applicable laws and regulations. All requests for information about determinations made under this part are to be submitted in accordance with the Freedom of Information Act regulation of the *Department of the Interior*, 43 CFR part 2.

NAL oil sales from July 1, 2000 changed the method of valuation and no longer fall under the benchmarks.

**GAS VALUATION – INDIAN
NON-ARM’S-LENGTH VALUATION**

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GAS VALUATION – INDIAN UNPROCESSED GAS

Regulation: 30 CFR § 206.172 (1999)

Note that these rules apply only until the effective date of the new Indian gas rule, January 1, 2000.

Sec. 206.172 Valuation standards--unprocessed gas.

(c) The value of gas 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 methods:

First benchmark:

(1) The gross proceeds accruing to the lessee pursuant to a sale under its non-arm's-length contract (or other disposition other than by an 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). 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 gas, volume, and such other factors as may be appropriate to reflect the value of the gas;

The Oil and Gas Payor Handbook, Volume III, Product Valuation, 08/01/00, Sec. 4.1.2, discusses "Valuation of unprocessed gas not sold under an arm's-length contract": Sec. 4.1.2.1 discusses "First valuation benchmark: Lessee's gross proceeds if equivalent to gross proceeds under comparable arm's-length contracts."

Equivalency: The lessee's non-arm's-length gross proceeds are considered equivalent if they are not less than the gross proceeds derived from or paid under the most comparable arm's-length contract in the same field (or area) for like-quality gas.

Comparability: Use the following factors to evaluate comparability of AL contacts:

- Price
- Duration of the contract
- Market(s) served
- Terms
- Quality of gas
- Volume
- Other appropriate factors

An example provided in the Handbook (page 4-21, 08/01/00) is:

For example, a 5-year sales contract for a large volume of unprocessed gas delivered to a distant utility company is not comparable to a monthly interruptible sales contract covering a small volume of unprocessed gas sold in the field.

Gross proceeds must:

...include all consideration paid directly or indirectly under the contract...However, the gross proceeds under a non-arm's-length contract cannot be reduced by a transportation factor...If the lessee's proceeds under its non-arm's-length contract are reduced by the costs of transportation, the transportation reduction must be added to those proceeds to determine value for royalty purposes. The lessee may, however, receive an allowance for its actual transportation costs.

Analysis:

For example:

- Compare company non-arm's-length (NAL) price to Arm's-length (AL) prices in the field or area. If the NAL price is greater than or equal to the lowest price of a comparable AL contract and the price, time of execution, duration of contract, market, terms, quality and volume of gas are equivalent, then the price is acceptable.
- Compare company (NAL) price to a related company's (AL) price for purchases in the field or area. If the NAL price is greater than or equal to the lowest price of a comparable AL contract and the price, time of execution, duration of contract, market, terms, quality and volume of gas are equivalent, then the price is acceptable. If not then go to the second benchmark.

Second Benchmark:

(2) 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; or

The Oil and Gas Payor Handbook, Volume III, Product Valuation, 08/01/00, Sec. 4.1.2.2, discusses "Second valuation benchmark: Other relevant information":

Used when:

- The lessee's gross proceeds are not equivalent to the gross proceeds paid under comparable arm's-length contracts, or
- No comparable arm's-length contracts exist in the field or area, or

- The lessee receives no consideration for its gas, as in cases of waste or avoidable loss

The lessee must consider other information that is relevant or would be used in valuing like-quality gas in the field or area, including:

- Gross proceeds under arm's-length contracts in the field or area
- Published prices for unprocessed gas
- Prices for arm's length spot sales of unprocessed gas
- Other reliable public sources of price or market information, or
- Other information relevant to that particular lease operation or the saleability of the lessee's gas

The lessee must select the method that best determines the value of the lessee's gas, based on the following criteria:

- Which method most closely reflects the circumstances surrounding the disposition of the lessee's unprocessed gas, or
- Which method reflects the most relevant factor

Analysis:

For example:

- A value determined by consideration of other information relevant in valuing like-quality gas, including gross proceeds under AL 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 salability of the gas.
- For instance, there is no long-term contract for the field or area and the company contract is long-term, then gross proceeds under short-term AL contracts in the field or area may be used. Published prices; spot prices or other reliable public sources of price; or market information; or other relevant information may be used.
- If there is a company that is NAL to the lessee and they purchase in the same field or area from AL companies, these agreements may be used to value production under the second benchmark because these prices are AL prices in the field or area. This may not be a valid pricing method if this is a captive market.

Third benchmark:

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

The Oil and Gas Payor Handbook, Volume III, Product Valuation, Section 4.1.2.3, 08/01/00, discusses "Third valuation benchmark: Net-back or other reasonable valuation method":

- If there are no other factors relevant in valuing like-quality gas in the field or area
- Determined on a case-by-case basis

Analysis:

For example:

- This may be an arm's-length price in a different field or area adjusted for quality and transportation as long as it is reasonable, or other method.

Further valuation regulations for unprocessed gas:

(e)(1) Where the value is determined pursuant to paragraph (c) of this section, the lessee shall retain all data relevant to the determination of royalty value. Such data shall be subject to review and audit, and MMS will direct a lessee to use a different value if it determines that the reported value is inconsistent with the requirements of these regulations.

(2) Any Indian lessee will make available upon request to the authorized MMS 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.

(3) A lessee shall notify MMS if it has determined value pursuant to paragraph (c)(2) or (c)(3) of this section. The notification shall be by letter to the MMS Associate Director for Royalty Management or his/her designee. The letter shall identify the valuation method to be used and contain a brief description of the procedure to be followed. The notification required by this paragraph is a one-time notification due no later than the end of the month following the month the lessee first reports royalties on a Form MMS-2014 using a valuation method authorized by paragraph (c)(2) or (c)(3) of this section, and each time there is a change in a method under paragraph (c)(2) or (c)(3) of this section.

(f) If MMS determines that a lessee has not properly determined value, the lessee shall pay the difference, if any, between royalty payments made based upon the value it has used and the royalty payments that are due based upon the value established by MMS. The lessee shall also pay interest on that difference computed pursuant to 30 CFR 218.54. If the lessee is entitled to a credit, MMS will provide instructions for the taking of that credit.

(g) The lessee may request a value determination from MMS. In that event, the lessee shall propose to MMS a value determination method, and may use that method in determining value for royalty purposes until MMS issues its decision. The lessee shall submit all available data relevant to its proposal. The MMS shall expeditiously determine the value based upon the lessee's proposal and any additional information MMS deems necessary. In making a value determination MMS may use any of the valuation criteria authorized by this subpart. That determination shall remain effective for the period stated therein. After MMS issues its determination, the lessee shall make the adjustments in accordance with paragraph (f) of this section.

(h) Notwithstanding any other provision of this section, 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...

(bold added for emphasis)

Observation:

Many companies are using the Fina decision to refuse to provide contracts. According to Sec. 206.172 (e) (2), they must provide the arms-length contracts.

Any Indian lessee will make available upon request to the authorized MMS 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.

Ultimately these arm's-length contracts may be used to determine gross proceeds.

GAS VALUATION – INDIAN PROCESSED GAS

Regulation: 30 CFR § 206.173 (1999)

Note that these rules apply only until the effective date of the new Indian gas rule, January 1, 2000.

Sec. 206.173 Valuation standards--processed gas.

(c) The value of residue gas or any gas plant product 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 methods:

First benchmark:

(1) The gross proceeds accruing to the lessee pursuant to a sale under its non-arm's-length contract (or other disposition other than by an 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). 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;

The Oil and Gas Payor Handbook, Volume III, Product Valuation, 08/01/00, Sec. 4.2.2 discusses "Valuation of processed gas not sold under an arm's-length contract": Sec. 4.2.2.1 discusses "First valuation benchmark: Lessee's gross proceeds if equivalent to gross proceeds under comparable arm's-length contracts for gas processed at the same plant":

Used when:

- Gross proceeds accruing to the lessee are equivalent to the gross proceeds derived from, or paid under, comparable arm's-length contracts for sales, purchases, or other dispositions of like-quality residue gas or gas plant products from the same plant
- If transactions for production from the same plant do not provide a reasonable sample of arm's-length values, nearby plants should be used

Equivalency: Gross proceeds are considered equivalent if they are not less than the gross proceeds derived from, or paid under, the most comparable arm's-length contract.

Comparability is determined by the following factors:

- Price
- Duration of contract
- Market(s) served
- Terms
- Quality of the gas
- Volume

- Other appropriate factors

Analysis:

For example:

- Compare company non-arm's-length (NAL) price to arm's-length (AL) prices at the plant. If there are no AL prices at the plant then nearby plants may be used. If the NAL price is greater than or equal to the lowest price of a **comparable** AL contract and the price, time of execution, duration of contract, market, terms, quality and volume of gas are equivalent, then the price is acceptable.
- Compare company non-arm's-length (NAL) price to a **related company's** arm's-length (AL) price for purchases in the field or area at the plant. If there are no AL prices at the plant then nearby plants may be used. If the NAL price is greater than or equal to the lowest price of a **comparable** related company AL contract and the price, time of execution, duration of contract, market, terms, quality and volume of gas are equivalent, then the price is acceptable. If not then go to the second benchmark.

Second benchmark:

(2) 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; or

The Oil and Gas Payor Handbook, Volume III, Product Valuation, 08/01/00, Sec. 4.2.2.2, discusses "Second valuation benchmark: Other relevant information":

Used when:

- Lessee's gross proceeds are not equivalent to the gross proceeds paid under comparable arm's-length contracts for the plant or nearby plants, or
- No comparable arm's-length contracts exist for the plant or nearby plants, or
- The lessee receives no consideration for its gas as in cases of waste or avoidable loss

The lessee must consider other information that would be relevant, such as

- Gross proceeds under arm's-length contracts at the plant or nearby plants
- Published prices for residue gas or gas plant products
- Prices for arm's-length spot prices of residue gas or gas plant products
- Other reliable public sources of price or market information
- Information relevant to that particular lease operation or saleability of the lessee's residue gas and plant products
-

Selected criteria should:

- Closely reflect the circumstances surrounding the lessee's disposition of residue gas or gas plant products, or
- Be the most relevant factor

Analysis:

For example:

- A value determined by consideration of other information relevant in valuing like-quality residue gas and plant products, including gross proceeds under arm's-length contracts for like-quality gas in the same field or nearby fields or areas at the plant or a near by plant. This includes a related company's arm's-length sales.
- Residue gas or gas plant products published prices; spot prices to other reliable public sources of price; or market information; or other relevant information may be used.

Third benchmark:

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

The Oil and Gas Payor Handbook, Volume III, Product Valuation, Section 4.2.2.3, 08/01/00, discusses "Third valuation benchmark: Net-back or other reasonable valuation method":

- If there are no other factors relevant in valuing like-quality gas in the field or area
- Determined on a case-by-case basis

Analysis:

For example:

- This may be an arm's-length price in a different field or area adjusted for quality and transportation as long as it is reasonable, or other method.

Further valuation regulations for processed gas:

(e)(1) Where the value is determined pursuant to paragraph (c) of this section, the lessee shall retain all data relevant to the determination of royalty value. Such data shall be subject to review and audit, and MMS will direct a lessee to use a different value if it determines upon review or audit that the reported value is inconsistent with the requirements of these regulations.

(2) The Indian lessee will make available upon request to the authorized MMS or Indian representatives, to the Office of the Inspector General of the Department of the Interior, or other persons authorized to receive such information, arm's-length sales and volume data for like-quality residue gas and gas plant products sold, purchased or otherwise obtained by the lessee from the same processing plant or from nearby processing plants.

(3) A lessee shall notify MMS if it has determined any value pursuant to paragraph (c)(2) or (c)(3) of this section. The notification shall be by letter to the MMS Associate Director for Royalty

Management or his/her designee. The letter shall identify the valuation method to be used and contain a brief description of the procedure to be followed. The notification required by this paragraph is a one-time notification due no later than the end of the month following the month the lessee first reports royalties on a Form MMS-2014 using a valuation method authorized by paragraph (c)(2) or (c)(3) of this section, and each time there is a change in a method under paragraph (c)(2) or (c)(3) of this section.

(f) If MMS determines that a lessee has not properly determined value, the lessee shall pay the difference, if any, between royalty payments made based upon the value it has used and the royalty payments that are due based upon the value established by MMS. The lessee shall also pay interest computed on that difference pursuant to 30 CFR 218.54. If the lessee is entitled to a credit, MMS will provide instructions for the taking of that credit.

(g) The lessee may request a value determination from MMS. In that event, the lessee shall propose to MMS a value determination method, and may use that method in determining value for royalty purposes until MMS issues its decision. The lessee shall submit all available data relevant to its proposal. The MMS shall expeditiously determine the value based upon the lessee's proposal and any additional information MMS deems necessary. In making a value determination, MMS may use any of the valuation criteria authorized by this subpart. That determination shall remain effective for the period stated therein. After MMS issues its determination, the lessee shall make the adjustments in accordance with paragraph (f) of this section.

(h) **Notwithstanding any other provision of this section, under no circumstances shall the value of production for royalty purposes be less than the gross proceeds accruing to the lessee for residue gas and/or any gas plant products, less applicable transportation allowances and processing allowances determined pursuant to this subpart.**
(Bold added for emphasis)

Observation:

Many companies are using the Fina decision to refuse to provide contracts. According to Sec. 206.173 (e) (2), they must provide the arm's-length contracts.

The Indian lessee will make available upon request to the authorized MMS or State representatives, to the Office of the Inspector General of the Department of the Interior, or other persons authorized to receive such information, arm's-length sales and volume data for like-quality residue gas and gas plant products sold, purchased or otherwise obtained by the lessee from the same processing plant or from nearby processing plants.

Ultimately these arm's-length contracts may be used to determine gross proceeds.

(i) The lessee must place residue gas and gas plant products in marketable condition and market the residue gas and gas plant products for the mutual benefit of the lessee and the lessor at no cost to the Indian lessor. Where the value established under this section is determined by a lessee's gross proceeds, that value will 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 residue gas or gas plant products in marketable condition or to market the residue gas and gas plant products.

Observation:

According to Sec. 206.173 (i) (2), if gross proceeds have been reduced because of the cost to place the product in marketable condition or the cost to market, the value will be increased. This is applicable to Sec. 206.172 (i)(2) as well. Ultimately if non-arm's-length contracts or arm's-length contracts reduce the value because of these costs then the value will be increased. (See MMS-89-0189-O&G, Xeno, Inc)

BENCHMARKS AND POP CONTRACT ANALYSIS

Under regulations effective November 1, 1991, Percentage of Proceeds contracts are valued differently than other processed gas depending on the type of contract.

Arm's-Length:

Gas sold under an arm's-length POP contract is valued as unprocessed gas for royalty purposes. Value is based on the greater of the lessee's gross proceeds received under its arm's-length POP contract or a minimum value that is 100% of the value of the residue gas at the tailgate of the plant.

Non-Arm's-Length

Gas sold under non-arm's-length POP contracts continues to be valued as processed gas. However, values of the residue gas and gas plant products are based on the benchmark system and the lessee's processing costs are based on the actual costs to process the gas.

Source: MMS Memorandum dated August 19, 1994 with attached Policy Paper outlining the application of the valuation regulations for gas sold under a POP contract. See also pages 4-56 through 4-67 of the Oil and Gas Payor Handbook, Volume III, Product Valuation, 8/01/00 for guidance and examples, and Dear Payor letters of April 16, 1992 and June 25, 1992.

ACCOUNTING FOR COMPARISON (Also known as Dual Accounting)

30 CFR 206.175 (1999)

(a) Except as provided in paragraph (b) of this section, where the lessee (or a person to whom the lessee has transferred gas pursuant to a non-arm's-length contract or without a contract) processes the lessee's gas and after processing the gas the residue gas is not sold pursuant to an arm's-length contract, the value, for royalty purposes, shall be the greater of (1) the combined value, for royalty purposes, of the residue gas and gas plant products resulting from processing the gas determined pursuant to § 206.173 of this subpart, plus the value, for royalty purposes of any condensate recovered downstream of the point of royalty settlement without resorting to processing determined pursuant to §206.52 of this subpart; or (2) the value, for royalty purposes, of the gas prior to processing determined in accordance with §206.172 of this subpart.

(b) The requirement for accounting for comparison contained in the terms of leases, particularly Indian leases, will govern as provided in §206.170(b) of this subpart. When accounting for comparison is required by the lease terms, such accounting for comparison shall be determined in accordance with paragraph (a) of this section.

The Oil and Gas Payor Handbook, Volume III, Product Valuation, pages 4-90 through 4-102, 08/01/00, discusses Accounting for Comparison and provides examples. This section states:

Accounting for comparison, or "dual accounting," is required under certain circumstances to determine the value of gas that has been processed. When dual accounting is required, royalty is based on the greater of the value for the gas before processing (unprocessed gas) or the value of the gas after processing (processed gas).

Dual accounting is mandatory in the following situations:

Situation 1. The lessee or the lessee's affiliate to whom the lessee has transferred the gas under a non-arm's length contract processes the lessee's gas, **and** the residue gas after processing is not sold under an arm's-length contract...

Situation 2. On or after November 1, 1991, the lessee sells gas under a POP contract, **and** the residue gas after processing is not sold under an arm's-length contract...

Situation 3. On or after November 1, 1991, the lessee sells gas under a non-arm's-length POP contract, **and** the residue gas after processing is not sold under an arm's-length contract...

Situation 4. The terms of the leases, particularly Indian leases, require dual accounting, **and** the gas is actually processed...

NOTE: Remember that dual accounting is normally required for Indian gas that is eventually processed, even if the gas is sold at the wellhead under an arm's-length contract containing no provisions tied to the processing of the gas.

MAJOR PORTION ANALYSIS

Applies to both processed and unprocessed gas

30 CFR 206.172 (1999), unprocessed gas and 30 CFR 206.173 (1999), processed gas, both state:

(3) (i) For any Indian leases which provide that the Secretary may consider the highest price paid or offered for a major portion of production (major portion) in determining value for royalty purposes, if data are available to compute a major portion MMS will, where practicable, compare the values determined in accordance with this section for any lease product with the major portion determined for that lease product. The value to be used in determining the value of production for royalty purposes shall be the higher of those two values.

30 CFR 206.172 (1999) unprocessed:

(ii) For purposes of this paragraph, major portion means the highest prices paid or offered at the time of production for the major portion of gas production from the same field. The major portion will be calculated using like-quality gas sold pursuant to arm's-length contracts from the same field (or, if necessary to obtain a reasonable sample, from the same area) for each month. All such sales will be arrayed from highest price to lowest prices (at the bottom). The major portion is that price at which 50 percent (by volume) plus 1 mcf of the gas (starting from the bottom) is sold.

30 CFR 206.173 (1999) processed:

(ii) For purposes of this paragraph, major portion means the highest prices paid or offered at the time of production for the major portion of gas production from the same field, or for residue gas or gas plant products from the same processing plant, as applicable. The major portion will be calculated using like-quality lease products sold pursuant to arm's-length contracts from the same field or processing plant (or, if necessary to obtain a reasonable sample, from the same area or nearby processing plants) for each month. All such sales will be arrayed from highest price to lowest prices (at the bottom). The major portion is that price at which 50 percent (by volume) plus 1 mcf of the gas starting from the bottom) is sold, or for gas plant products, 50 percent (by volume) plus 1 unit.

The Oil and Gas Payor Handbook, Volume III, Product Valuation, discusses major portion pricing on pages 4-103 through 4-105. This section states:

...in addition to the accounting-for-comparison requirement, most Indian lease terms provide for, at the discretion of the Secretary of the Interior, a major portion analysis in addition to the accounting-for-comparison requirement to determine value for royalty purposes.

For those Indian leases requiring a major portion analysis, the value of the unprocessed gas, residue gas, or gas plant products in each case is the greater of the value determined by major portion analysis (known as the majority price) or the value determined based on the actual disposition of the products (arm's-length or non-arm's-length sales)...

INDIAN OIL
NON-ARM'S-LENGTH VALUATION

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VALUATION – INDIAN OIL

Regulation: 30 CFR § 206.52 (2001)

Sec. 206.52 Valuation standards-- Indian Oil.

(c) The value of oil production from leases subject to this section which is not sold under an arm's-length contract shall be the reasonable value determined in accordance with the first applicable of the following paragraphs:

First benchmark:

(1) 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); 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). In evaluating the comparability of posted prices or oil sales contract prices, the following factors shall 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. 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;

First Valuation Benchmark from the Oil and Gas Payor Handbook Volume III, Product Valuation, 08/01/2000, discusses valuation of oil in section 3:2.1 beginning on page 3-13.

Lessee's contemporaneous posted prices or oil sales contract prices used in arm's-length transactions.

Lessee's price must be:

- Comparable to other contemporaneous arm's-length (AL) prices
- Used to purchase (or sell) significant quantities of like-quality oil (Note! The MMS has never defined the word "significant", but the quantity or percentage of sales volume needed to be significant in a field (or area) would arguably, but reasonably be less than the percentages used by MMS to meet "major portion" criteria.
- Used to purchase production in the same field or area

Comparability is based on:

- Price
- Duration of contract
- Market or markets served
- Terms
- Quality
- Volume
- Other appropriate factors

The comparability of such posted prices or oil sales contract prices would be determined by the relevant facts in each case using the auditor's judgment, recognizing that such prices and other criterion do not need to be identical to be comparable.

Analysis:

For example:

- If a company sells oil under a non-arm's-length contract (NAL) to a related company and the related company purchases from other companies in the field, the NAL price must be compared to other AL purchase prices.
- If a company sells under a NAL contract and also sells production arm's-length, the NAL price could be compared to the company's AL price, provided such AL price is comparable other AL prices used in sales/purchases of significant quantities of like-quality oil in the same field or area.
- If the NAL price is less than the AL price, and the company makes AL sales at different prices during the production month, a volume-weighted average AL price is used to compare the value.
- If the company has a posting for the field or area, the posting is compared to other postings for the field or area. The posting must be comparable to postings used in AL contracts. Therefore, if there are premiums or deductions in the field or area, such premiums/deductions would be included in the comparison.
- If the NAL prices meet the appropriate comparison, the NAL contract may be used to value the oil.

Second benchmark:

- (2) 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);

Second Valuation Benchmark from the Oil and Gas Payor Handbook, Volume III, Product Valuation, 08/01/2000 discusses valuation of oil not sold under an arm's-length contract in section 3.2.2, beginning on page 3-14.

Arithmetic average of contemporaneous posted prices used in arm's-length transactions by persons other than the lessee.

Must be used to purchase (or sell):

- Significant quantities of like-quality oil
- Production in the same field or area

Analysis:

For example:

- “Significant” quantities would be determined by the relevant facts in each case using the auditor’s judgment.
- If the posted prices used in arm’s-length transactions contained premiums or deductions, such premiums/deductions would be included in the calculation.

Third benchmark:

(3) The arithmetic average of other contemporaneous arm's-length contract prices for purchases or sales of significant quantities of like-quality oil in the same area or nearby areas;

Third Valuation Benchmark from the Oil and Gas Payor Handbook, Volume III, Product Valuation, 08/01/2000 discusses valuation of oil not sold under an arm’s-length contract in section 3.2.3, beginning on page 3-14.

Arithmetic average of other contemporaneous arm’s-length contract prices in the area.

Must be used to purchase (or sell):

- Significant quantities of like-quality oil
- Production in the same area or nearby areas

Analysis:

For example:

- Significant quantities would be determined by the relevant facts in each case using the auditor’s judgment.
- Production located in the same area and nearby areas would be acceptable if adjustments are made for any quality differences and if comparable and contemporaneous AL contract prices were available. Confidentiality would have to be protected.
- Premiums/deductions would be included.

Fourth benchmark:

(4) 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 salability of certain types of oil;

Fourth Valuation Benchmark from the Oil and Gas Payor Handbook, Volume III, Product Valuation, 08/01/2000 discusses valuation of oil not sold under an arm’s-length contract in section 3.2.4, beginning on page 3-15.

Arm's-length spot sales prices and other relevant matters.

- Significant quantities of like-quality oil must be purchased (or sold) at spot market prices
- Used when no arm's-length posted prices or sales contracts exist in the same field, area, or nearby areas.
- Lessee must notify MMS

Analysis:

For example:

- If there are significant AL spot price purchases (or sales) for this field or area, after reviewing the relevant facts, using the auditor's judgment, the spot prices may be used to value the oil.
- If there are no spot price purchases (or sales) for the field, but the oil is transported to a nearby field or area and there are spot price purchases (or sales) in this location, using the auditor's judgment, these spot prices may be used to value the oil.

Fifth benchmark:

- (5) A net-back method or any other reasonable method to determine value;

Fifth Valuation Benchmark from the Oil and Gas Payor Handbook, Volume III, Product Valuation, 08/01/2000 discusses valuation of oil not sold under an arm's-length contract in section 3.2.5, beginning on page 3-15.

Netback or other reasonable valuation method

- Determined on a case-by-case basis
- Lessee must notify MMS

Analysis:

For example:

- If none of the other benchmarks apply, alternative methods, such as netting back the price using a transportation differential from a refinery that purchases from others, and adjusting for quality in order to value the production, or another logical method could be used for valuation.

Further regulations:

(6) For purposes of this paragraph (30 CFR Section 206.52(c)(6)), 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. Also, per 30 CFR Section 206.52(d), Any Indian lessee will make available, upon request to the authorized MMS or Indian representatives, to the Office of the Inspector General of the Department of the Interior, or other persons 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.

Observation:

According to Sec. 206.52 (c) (6), **the term lessee includes the lessee's designated purchasing agent, which could be a related company. As noted above, subparagraph (d) of this section of the regulations also requires the lessee (and designated purchasing agent) to provide the relevant sales and volume data, which may be construed to mean "contract information" on the AL sales for the field or area or from nearby fields or areas.**

Further regulations:

(e)(1) Where the value is determined under paragraph (c) of this section, the lessee shall retain all data relevant to the determination of royalty value. Such data shall be subject to review and audit, and MMS will direct a lessee to use a different value if it determines that the reported value is inconsistent with the requirements of these regulations. (2) A lessee shall notify MMS if it has determined value under paragraph (c)(4) or (c)(5) of this section. The notification shall be by letter to MMS Associate Director for Royalty Management or his/her designee. The letter shall identify the valuation method to be used and contain a *brief description of the procedure to be followed*. The notification required by this paragraph is a one-time notification due no later than the end of the month following the month the lessee first reports royalties on a Form MMS-2014 using a valuation method authorized by paragraph (c)(4) or (c)(5) of this section and each time there is a change from one to the other of these two methods.

Observation:

This section **requires** that the lessee provide and retain all information relevant to the valuation determination in order for the information to be reviewed.

(f) If MMS determines that a lessee has not properly determined value, the lessee shall pay the difference, if any, between royalty payments made based upon the value it has used and the royalty payments that are due based upon the value established by MMS. The lessee shall also pay interest on the difference computed pursuant to 30 CFR 218.54. If the lessee is entitled to a credit, MMS will provide instructions for the taking of that credit.

(g) The lessee may request a value determination from MMS. In that event, the lessee shall propose to MMS a value determination method and may use that value for royalty payment purposes until MMS issues a value determination. The lessee shall submit all available data relevant to its proposal. MMS shall expeditiously determine the value based upon the lessee's proposal and any additional information MMS deems necessary. In making a value determination, MMS may use any of the valuation criteria authorized by this subpart. That determination shall remain effective for the period stated therein. After MMS issues its determination, the lessee shall make the adjustments in accordance with paragraph (f) of this section.

(h) **Notwithstanding any other provision of this section, 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 determined under this subpart.**
(Bold added for emphasis)

Observation:

Royalty must be paid on the gross proceeds accruing to the lessee. Once MMS makes its valuation determination, it can direct a lessee to go back and pay additional royalties for the period where the lessee proposed its valuation method.

(i) 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. 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.

Observation:

According to Sec. 206.52 (i), if gross proceeds have been reduced because of the cost to place the product in marketable condition or the cost to market, the value will be increased. Ultimately if NAL contracts or AL contracts reduce the value because of these costs, the value will be increased. (See MMS-89-0189-O&G, Xeno, Inc.)

Further regulations:

(j) Value shall be based on the highest price a prudent lessee can receive through legally enforceable claims under its contract. Absent contract revision or amendment, if the lessee fails to take proper or timely action to receive prices or benefits to which it is entitled, it must pay royalty at a value based upon that obtainable price or benefit. Contract revisions or amendments shall be in writing and signed by all parties to an arm's-length contract. If the lessee makes timely application for a price increase or benefit allowed under its contract but the purchaser refuses, and the lessee takes reasonable measures, which are documented, to force purchaser compliance, the lessee will owe no additional royalties unless or until monies or consideration resulting from the price increase or additional benefits are received. This paragraph shall not be construed to permit a lessee to avoid its royalty payment obligation in situations where a purchaser fails to pay, in whole or in part or timely, for a quantity of oil.

(k) Notwithstanding any provision in these regulations to the contrary, no review, reconciliation, monitoring, or other like process that results in a re-determination by MMS of value under this section shall be considered final or binding as against the Indian Tribes or allottees until the audit period is formally closed.

(l) Certain information submitted to MMS to support valuation proposals, including transportation allowances or extraordinary cost allowances, is exempted from disclosure by the Freedom of Information Act, 5 U.S.C. 552, or other Federal law. Any data specified by law to be privileged, confidential, or otherwise exempt, will be maintained in a confidential manner in accordance with applicable laws and regulations. All requests for information about determinations made under this part are to be submitted in accordance with the Freedom of Information Act regulation of the Department of the Interior, 43 CFR part 2. Nothing in this section is intended to limit or diminish in any manner whatsoever the right of an Indian lessor to obtain any and all information to which the lessor may be lawfully entitled from MMS or such lessor's lessee directly under the terms of the lease, 30 U.S.C. 1733, or other applicable law.

INTRODUCTION – IMPACT OF FINA DECISION

Fina and the Benchmarks

Background:

The Fina decision came out of the U.S. Court of Appeals, District of Columbia Circuit, and was decided June 27, 2003. The decision essentially overturned the Texaco decision (MMS-92-0306-O&G, May 18, 1999), which auditors had been following.

The Texaco decision determined that Texaco Refining and Marketing, Inc., the purchaser of Texaco E & P's production, was a "marketing affiliate" of Texaco, Inc., parent company of the affiliates. The decision relied upon 30 CFR § 206.102(b)(i) which states:

For purposes of this section, oil 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.

Texaco, Inc. argued that, because Texaco Marketing bought oil from unrelated sellers and not just from Texaco E & P, it was not a "marketing affiliate" and that MMS could not therefore require Texaco to value the production at Texaco Marketing's arm's-length resale price.

The MMS Director did not agree with Texaco and held that:

"nothing in the rule or the preamble implies that MMS intended to prevent itself from looking to the subsequent arm's-length sale as establishing the lessee's gross proceeds if an affiliate is not a marketing affiliate as defined in section 206.101... The difference is that 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 arm's-length resale 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.

This finding allowed auditors to pursue the affiliate's arm's-length gross proceeds, in many cases without working through the benchmarks. The rationale for this was often that the auditee was unable to provide any comparable arm's-length contracts to determine a benchmark value. This, in many cases, simplified the auditor's work.

The Fina decision, however, said that the Texaco decision improperly applied the gross proceeds rule to affiliates who were not, per the regulations, marketing affiliates.

- "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.”

The reasoning?

- FNGC (Fina Natural Gas Company, the purchaser of Fina’s production), 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.”
- “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.”
- “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.”
- “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 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”.

Federal and Indian oil and gas benchmarks

In light of the Fina decision there has been some discussion concerning the application of the Federal and Indian oil and gas benchmarks.

1. Does the Fina decision impact the application of the oil and gas benchmarks?
 - Because the Fina audit was assessed under the marketing affiliate resales Sec. 206.151, and the related company was a non-marketing affiliate, i.e. purchased from other companies, the benchmarks must apply.

- The result is that when the related company purchases one Mcf of gas or a barrel of oil from an unrelated company the benchmarks must be used for valuation.
2. Does this limit the valuation(s) to less than the “gross proceeds accruing to the lessee?” The benchmarks specifically state in Sec. 206.152 (h) Notwithstanding any other provision of this section, under no circumstances shall the value of production for royalty purposes be less than the gross proceeds accruing to the lessee for lease production....
 - After consideration of the benchmarks under a non-arm’s-length sale, if the value is less than the gross proceeds then royalties must be paid on the gross proceeds.
 3. Does the Fina decision impact the application of the oil benchmarks prior to July 2000? (New Federal oil valuation regulations were published on March 15, 2000 and took effect July 1, 2000.)
 - The oil benchmarks are applicable when the lessee sells to a related company and the purchaser is a non-marketing affiliate, a related company that purchases from others.
 4. Does the Fina decision impact the application of the Indian gas benchmarks prior to January 2000? (New Indian gas valuation regulations were published on August 10, 1999 and took effect January 1, 2000.)
 - Yes, since the Indian gas valuation regulations prior to January 2000 were similar to the Federal gas regulations at that time, the Fina decision applies to the valuation of NAL sales of Indian gas prior to January 2000.
 5. Are there other court decisions that help us determine the use of the benchmarks?
 - Yes, Xeno, MMS-89-0189-O&G, in the Conclusions and Order stated:

Physical treatment, handling operations, measuring, gathering, dehydrating, compressing, separation, and storage are required to place the product into a marketable condition. All of these services are considered necessary to market the product and are to be performed at no cost to the lessor...In the instant case, the reasonable value of the gas is its gross value. No reduction in value is allowed for the cost of any gathering or compression which may have been necessary in order to bring the gas to the market in which it was being sold, regardless of whether that compression or gathering was performed by the lessees, the purchaser of the gas, or some third party.
 6. The Marathon Oil case, MMS-94-0404-O&G required that in the case of a NAL sale of the residue gas the company must perform accounting for comparison where the value of the unprocessed gas using the NAL unprocessed gas benchmarks must be compared to the value of all products at the tailgate of the plant and royalty paid on the higher of the two.

7. In another Marathon Oil case, MMS-92-0077-O&G where Marathon Oil sold to Marathon Production Company (MPC) and then that company sold to Exxon, and Exxon reimbursed MPC for gathering the companies appeal was denied. Quoting a long history of cases the case noted that,

Although, MMS acknowledges that MPC is not the Appellant's marketing affiliate as defined in the new product valuation regulations, that does not relieve Marathon from its obligation to pay royalties on gathering reimbursements received by MPC.... In light of the corporate relationship between Marathon and MPC, Marathon the parent and MPC its wholly-owned subsidiary, Marathon and MPC must be treated as one and the same entity.

In conclusion, there are a multitude of court cases and regulations that support the benchmarks and accounting for comparison and these can and should be used when determining royalty liabilities for NAL transactions.

Federal Coal Benchmarks

Subject: Fina Oil and Chemical Company and the Federal Coal Benchmarks

The Fina Oil and Chemical Company (Fina) decision was directed at natural gas that is sold to a gas marketing firm that it controls and then the controlled marketing firm sells the gas again to end users. Since the federal coal regulations are modeled after the oil and gas regulations, it has been determined that the Fina case applies to federal coal. This memorandum will discuss the application of the Federal coal benchmarks.

8. Does the Fina decision impact the application of the coal benchmarks?
 - The coal regulations do not define or mention a marketing affiliate. The coal regulations are modeled after the oil and gas regulations.
 - Because the Fina audit was assessed under the marketing affiliate resales Sec. 206.151, and the related company was a non-marketing affiliate, i.e. purchased from other companies, the benchmarks must apply.
 - The result is that when one ton of coal is purchased from an unrelated company the benchmarks must be used.
9. Does this limit the valuations to less than the “gross proceeds accruing to the lessee”? The benchmarks specifically state in Sec. 206.257:

(g) Notwithstanding any other provision of this section, under no circumstances shall the value for royalty purposes be less than the gross proceeds accruing to the lessee for the disposition of coal produced....
10. After consideration of the benchmarks under a non-arm’s-length sale, if the value is less than the gross proceeds then royalties must be paid on the gross proceeds.