Barton, Jayne

From: Conway, Karen
Sent: Thursday, January 08, 2004 6:57 AM
To: Burhop, Shirley
Subject: RE: 3Intro.doc

Shirley, I was looking for the first quote in the Fina decision, is this an exact quote and where is it located?

* "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."

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Sent: Wednesday, January 07, 2004 4:30 PM
To: Brian Johnson; Cynthia Stuckey; Dana Summers; Ellwood Soderlind; F David Loomis; George Staigle; Karen Conway; Nagaraja Kirumakki; Nancy Rodriguez; Perry Shirley; Robert Davidoff; Sara Teel; Terence Fisher
Subject: 3Intro.doc

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Barton, Jayne

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Sent: Thursday, January 08, 2004 10:34 AM
To: Burhop, Shirley
Subject: RE: 3Intro.doc

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"The measure of gross proceeds used in the comparison with other valuation criteria is the marketing entity's arm's-length sales price."

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From: Conway, Karen
Sent: Thursday, January 08, 2004 10:39 AM
To: Burhop, Shirley
Subject: RE: 3Intro.doc

Attachments: 3Intro.doc

3Intro.doc (43 KB)

Shirley, other than the quotes I could not find here are just a few corrections. Please check them and if you agree you can accept them.

Thanks

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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 Fina decision said that the Texaco decision improperly applied the gross proceeds rule to affiliates who were not 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.

- Marketing affiliate is defined in the regulations [at 30 CFR § 206. 51 and 206.151, (2003)] as:
  "*Marketing affiliate* means an affiliate of the lessee whose function is to acquire only the lessee's production and to market that production."

- "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."

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- "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."

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Previously, 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)91)(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 Acting Assistant Secretary for Land and Minerals did not agree with Texaco and held that:

> "Texaco Marketing's arm's-length sales proceeds are the correct measure of the gross proceeds accruing to the lessee", and
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> "The measure of gross proceeds used in the comparison with other valuation criteria is the marketing entity's arm's-length sales price."

This finding allowed auditors to pursue the affiliate's arm's-length gross proceeds, in many cases without working through the benchmarks, by claiming 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.

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?

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- 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.

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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.

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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.

Deleted: 1/7/2004

Barton, Jayne

From: Burhop, Shirley
Sent: Thursday, January 08, 2004 12:16 PM
To: Conway, Karen
Subject: RE: 3Intro.doc

The top of page 4. The paragraph begins "Pursuant to FOGRMA..." and it's in about the middle of that paragraph.

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<<3Intro.doc>> Is this better? Sorry, I have not yet gotten to the other 3 things I said I would do today.

Barton, Jayne

From: Conway, Karen
Sent: Thursday, January 08, 2004 12:24 PM
To: Burhop, Shirley
Subject: RE: 3Intro.doc

Yes, thanks.

-----Original Message-----
From: Burhop, Shirley [mailto:Shirley.Burhop@mms.gov]
Sent: Thursday, January 08, 2004 11:14 AM
To: Conway, Karen
Subject: RE: 3Intro.doc

The quotes were headings within the document. Is it valid to quote them? They seem to summarize the results quite well.

-----Original Message-----
From: Conway, Karen
Sent: Thursday, January 08, 2004 10:34 AM
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Subject: RE: 3Intro.doc

Shirley, I was trying to verify the quotes and looked at the case; I could not find these.
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Barton, Jayne

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To: Burhop, Shirley
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I think a quote within a quote is 'marketing affiliates'. Do you agree?

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From: Burhop, Shirley
Sent: Thursday, January 08, 2004 12:59 PM
To: Conway, Karen
Subject: RE: 3Intro.doc

yep

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Barton, Jayne

From: Conway, Karen
Sent: Friday, January 09, 2004 8:27 AM
To: Burhop, Shirley
Subject: RE: 3Intro.doc

Attachments: 3Intro.doc

3Intro.doc (53 KB)

Just some corrections.

-----Original Message-----
From: Burhop, Shirley [mailto:Shirley.Burhop@mms.gov]
Sent: Thursday, January 08, 2004 5:21 PM
To: Brian Johnson; Cynthia Stuckey; Dana Summers; Ellwood Soderlind; F David Loomis; George Staigle; Karen Conway; Nagaraja Kirumakki; Nancy Rodriguez; Perry Shirley; Robert Davidoff; Sara Teel; Terence Fisher
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<<3Intro.doc>> Use this version rather than the last. Once again, only the last page is new.

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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.

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Statute of Limitations

MMS's statute of limitations policy, applicable to Federal oil and gas and solid minerals production, affects the time periods to which benchmark analysis may apply. The policy arose from provisions in the Federal Oil and Gas Royalty Simplification and Fairness Act of 1996 (RSFA), but has been augmented to apply to prior periods.

Relevant policy guidance is reproduced in the "Policy Documents" section of this training manual and includes the following:

- October 8, 2002 memo from the Associate Director for Minerals Revenue Management, subject: Guidelines Regarding Statute of Limitations for Demands and Orders and Appeals Decisions for Federal Leases

- January 28, 2003 letter to Valdean Severson, Oil and Gas Bureau Chief, New Mexico Taxation and Revenue Department, from the Associate Director for Minerals Revenue Management and attached "Procedures for Implementing October 8, 2002 'Guidelines Regarding Statute of Limitations for Demands and Orders and Appeals Decisions for Federal Leases'"

The effect of this policy is that orders to pay cannot be issued for production periods prior to 7 years prior to the date of the order. Thus an order sent in January 2004 could not cover periods prior to the December 1996 sales month, for which royalty reporting would have been due by the end of January 1997. (An exception occurs if the payor has an estimate on file, allowing the reporting one month later. Thus December 1996 production would not be reported until the end of February 1997 and an order covering that production month could be issued in February 2004.) The policy papers also discuss "compelling circumstances" under which exceptions may be granted and procedures for tolling the statute.

Thus, the applicability of the "old" Federal oil rule and the applicability of the benchmarks to Federal oil is declining as time goes on. The new Federal oil rule took effect in July 2000, so the benchmarks will apply to Federal oil production only through the June 2000 production month and any orders to pay for that month will need to be sent no later than July 2007. After that time, we will be precluded from issuing orders to pay on Federal oil based on the benchmarks.

The statute of limitations policy does not apply to Indian production, but does apply to Federal oil and gas and solid minerals.

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Deleted: 1/8/2004

Barton, Jayne

From: Burhop, Shirley
Sent: Wednesday, January 14, 2004 1:06 PM
To: Gibbs Tschudy, Deborah
Subject: RE: 4Intro.doc

The final product will be a power point presentation, accompanied by case studies and examples. The papers were, first of all, an attempt to get all our thoughts and references together as a basis for the power point slides. We thought we'd include them, along with the policy papers you mention and relevant legal decisions, in a training manual. If you think this is all overkill, let us know. We all have the perception that there are a lot of resources available, but auditors aren't necessarily aware of them or where to find them, so putting everything together in one place would be a big help.

-----Original Message-----
From: Gibbs Tschudy, Deborah
Sent: Wednesday, January 14, 2004 12:26 PM
To: Williams, Mary; Burhop, Shirley; Kirumakki, Nagaraja; Conway, Karen
Subject: RE: 4Intro.doc

A couple of other thoughts:

What final product(s) are you working towards? Guidance papers with cover memos signed by the AD similar to what was done in 1995 and 1996? Or, guidance papers AND Powerpoint slides that will be used to deliver the training?

On all of the products that you are working on, please add DRAFT at the top of every page and also add a statement as follows: For Internal Government Use Only
Do Not Release

-----Original Message-----
From: Williams, Mary
Sent: Wednesday, January 14, 2004 12:17 PM
To: Burhop, Shirley; Kirumakki, Nagaraja; Conway, Karen
Cc: Gibbs Tschudy, Deborah
Subject: FW: 4Intro.doc

I made some additional suggestions along with Debbie's.
Mary Williams
Manager, Federal Onshore Oil and Gas
Compliance and Asset Management
(303) 231-3403
(303) 231-3744 (fax)

-----Original Message-----
From: Gibbs Tschudy, Deborah
Sent: Wednesday, January 14, 2004 10:42 AM
To: Burhop, Shirley; Williams, Mary
Cc: Conway, Karen; Kirumakki, Nagaraja
Subject: RE: 4Intro.doc

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Sent: Monday, January 12, 2004 4:06 PM
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Cc: Conway, Karen; Kirumakki, Nagaraja
Subject: 4Intro.doc

<< File: 4Intro.doc >> Revised intro piece of training, including some discussion on marketable condition and duty to market.

Barton, Jayne

From: Burhop, Shirley
Sent: Wednesday, January 14, 2004 2:38 PM
To: Gibbs Tschudy, Deborah; Williams, Mary; Kirumakki, Nagaraja; Conway, Karen
Subject: RE: 4Intro.doc

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Cc: Conway, Karen; Kirumakki, Nagaraja
Subject: 4Intro.doc

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Barton, Jayne

From: Burhop, Shirley
Sent: Wednesday, January 14, 2004 3:43 PM
To: Gibbs Tschudy, Deborah
Subject: RE: 4Intro.doc

Yes. No.

-----Original Message-----
From: Gibbs Tschudy, Deborah
Sent: Wednesday, January 14, 2004 3:16 PM
To: Burhop, Shirley
Subject: Re: 4Intro.doc

So are you thinking just a Powerpoint presentation with an attached resource list? If so, do you still want me to look at the papers you sent me?

Sent from my BlackBerry Wireless Handheld

-----Original Message-----
From: Burhop, Shirley <Shirley.Burhop@mms.gov>
To: Gibbs Tschudy, Deborah <Deborah.Gibbs.Tschudy@mms.gov>; Williams, Mary <Mary.Williams@mms.gov>; Kirumakki, Nagaraja <Nagaraja.Kirumakki@mms.gov>; Conway, Karen <kconway@spike.dor.state.co.us>
Sent: Wed Jan 14 14:38:18 2004
Subject: RE: 4Intro.doc

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Cc: Conway, Karen; Kirumakki, Nagaraja
Subject: 4Intro.doc

<< File: 4Intro.doc >> Revised intro piece of training, including some discussion on marketable condition and duty to market.

Barton, Jayne

From: Burhop, Shirley
Sent: Wednesday, January 14, 2004 4:01 PM
To: Kirumakki, Nagaraja
Subject: RE: 4Intro.doc

Good. Thanks.

-----Original Message-----
From: Kirumakki, Nagaraja
Sent: Wednesday, January 14, 2004 3:58 PM
To: Burhop, Shirley
Subject: RE: 4Intro.doc

I agree. Raj

-----Original Message-----
From: Burhop, Shirley
Sent: Wednesday, January 14, 2004 2:38 PM
To: Gibbs Tschudy, Deborah; Williams, Mary; Kirumakki, Nagaraja; Conway, Karen
Subject: RE: 4Intro.doc

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Barton, Jayne

From: Burhop, Shirley
Sent: Wednesday, January 14, 2004 4:02 PM
To: Stuckey, Cynthia
Subject: FW: 4Intro.doc

What you have prepared so far will work as a basis for the slides, so don't work on it any more. If we have questions, we'll ask. Thanks.

-----Original Message-----
From: Kirumakki, Nagaraja
Sent: Wednesday, January 14, 2004 4:00 PM
To: Burhop, Shirley; Gibbs Tschudy, Deborah; Williams, Mary; Conway, Karen
Cc: Fields, Gary
Subject: RE: 4Intro.doc

I whole heartedly agree with this idea. No need to reinvent the wheel.
Raj

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From: Burhop, Shirley
Sent: Wednesday, January 14, 2004 2:38 PM
To: Gibbs Tschudy, Deborah; Williams, Mary; Kirumakki, Nagaraja; Conway, Karen
Subject: RE: 4Intro.doc

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Kirumakki, Nagaraja

From: Fields, Gary
Sent: Wednesday, January 14, 2004 4:05 PM
To: Kirumakki, Nagaraja
Subject: RE: 4Intro.doc

Raj. I agree. Let's keep it as simple and understandable as possible. Folks can do their own referencing.

-----Original Message-----
From: Kirumakki, Nagaraja
Sent: Wednesday, January 14, 2004 4:00 PM
To: Burhop, Shirley; Gibbs Tschudy, Deborah; Williams, Mary; Conway, Karen
Cc: Fields, Gary
Subject: RE: 4Intro.doc

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INTRODUCTION – IMPACT OF FINA DECISION

Fina and the Benchmarks

Background:

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

The Fina decision said that the Texaco decision improperly applied the gross proceeds rule to affiliates who were not 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 Court's 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.
- Marketing affiliate is defined in the regulations [at 30 CFR § 206. 51 and 206.151, (2003)] as:
  "an affiliate of the lessee whose function is to acquire only the lessee's production and to market that production."
- "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." (From MMS 1988 regulation preamble)
- "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 discusses the definition of "lessee", based on FOGRMA section 3(7) (30 U.S.C. § 1702(7) and MMS' own definition included in 30 CFR § 206.151, making 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".

Previously, the Texaco decision

held that:

> "Texaco Marketing's arm's-length sales proceeds are the correct measure of the gross proceeds accruing to the lessee", and
>
> "The measure of gross proceeds used in the comparison with other valuation criteria is the marketing entity's arm's-length sales price."

The Texaco decision allowed auditors to pursue the affiliate's arm's-length gross proceeds in determining the gross proceeds accruing to the lessee under 206.152(h). The auditor was then to compare the affiliate's arm's-length gross proceeds to the value determined under the benchmarks at 206.152(c), and assess value on the higher of the two. However, in many cases, auditors simply assessed value on the affiliate's arm's-length resale price and did not calculate a value under the benchmarks generally because of the effort required to obtain comparable arm's-length contracts from the auditee or from other sources.

Federal and Indian oil and gas gross proceeds

In light of the Fina decision , determining gross proceeds on oil and gas not sold under an arm's-length contract.

Does the Fina decision impact the application of the oil and gas benchmarks? (Is this really the question you want to ask because Fina doesn't impact the application of the benchmarks. It's impact is on gross proceeds. Maybe the question you want to ask is, "How does Fina impact how oil and gas not sold under an arm's-length contract is valued?)

- No. Even under the Texaco decision the benchmarks still applied. What changed after the Fina decision is that when comparing the value determined under the benchmarks with the gross proceeds accruing to the lessee, the gross proceeds are those that accrue to the producer, not to the affiliate. That is, the auditor must compare the value under the benchmarks with the non-arm's-length gross proceeds paid by the affiliate to the producer, NOT the proceeds received by the affiliates in its arm's-length resale of the production to a third party.

2. Does Fina limit the value to less than the "gross proceeds accruing to the lessee?" *(I don't understand this question)* The regulations 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...."
    - No. Production sold under a non-arm's-length contract is valued based on the higher of the first applicable benchmark or the gross proceeds accruing to the lessee. Under Fina the gross proceeds accruing to the lessee is the non-arm's-length gross proceeds – that is, the value that the affiliate pays the lessee because the affiliate has comparable arm's-length sales.

3. Does the Fina decision impact the application of the oil benchmarks prior to July 2000? (Again – you may want to ask this question differently) (New Federal oil valuation regulations were published on March 15, 2000 and took effect July 1, 2000.)
    - No. Even under the Texaco decision the benchmarks still apply to crude oil produced from Federal and Indian leases prior to June 1, 2000. (see response to question 1.) However, the Fina decision is not applicable to crude oil produced from Federal leases after June 1, 2000. The Fina decision still applies to crude oil produced from Indian leases.
    - 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.)

No, the application of the benchmarks is still the same. What has changed under the Fina decision is that gas produced from Indian leases prior to January 1, 2000, and not sold under an arm's-length contract, must be value based on the higher of the benchmarks or the gross proceeds accruing to the lessee. Under Fina the gross proceeds accruing to the lessee is the non-arm's-length gross proceeds – that is, the value that the affiliate pays the lessee because the affiliate has comparable arm's-length sales.

5. Are there other court decisions that assist with the application 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. (How does this decision help us determine the use of the benchmarks??? The use of the benchmarks is determined by whether the production is sold non-arm's-length or not. This portion of the Xeno decision relates to marketable condition, not to the use of the benchmarks.)

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 MPC sold to Exxon, and Exxon reimbursed MPC for gathering, Marathon's appeal was denied. Quoting a long history of cases the decison 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. (I don't see how any of these cases support the use of the benchmarks. Why are we addressing dual accounting – that is not an issue in Fina?

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, the Fina case applies to federal coal. This section 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.

Statute of Limitations - I am not sure why this is included? Maybe a separate handout on statute of limitations? Why not just include the periods of time and products that this guidance applies to?

MMS's statute of limitations policy, applicable to Federal oil and gas and solid minerals production, affects the time periods to which the benchmark analysis may apply. The policy arose from provisions in the Federal Oil and Gas Royalty Simplification and Fairness Act of 1996 (RSFA), but has been augmented to apply to prior periods.

Relevant policy guidance is reproduced in the "Policy Documents" section of this training manual and includes the following:

- October 8, 2002 memo from the Associate Director for Minerals Revenue Management, subject: Guidelines Regarding Statute of Limitations for Demands and Orders and Appeals Decisions for Federal Leases
- January 28, 2003 letter to Valdean Severson, Oil and Gas Bureau Chief, New Mexico Taxation and Revenue Department, from the Associate Director for Minerals Revenue Management and attached "Procedures for Implementing October 8, 2002 'Guidelines Regarding Statute of Limitations for Demands and Orders and Appeals Decisions for Federal Leases'"

The effect of this policy is that orders to pay cannot be issued for production periods prior to 7 years prior to the date of the order. Thus an order sent in January 2004 could not cover periods prior to the December 1996 sales month, for which royalty reporting would have been due by the end of January 1997. (An exception occurs if the payor has an estimate on file, allowing the reporting one month later. Thus December 1996 production would not be reported until the end of February 1997 and an order covering that production month could be issued in February 2004.) The policy papers also discuss "compelling circumstances" under which exceptions may be granted and procedures for tolling the statute.

Thus, the applicability of the "old" Federal oil rule and the applicability of the benchmarks to Federal oil is declining as time goes on. The new Federal oil rule took effect in July 2000, so the benchmarks will apply to Federal oil production only through the June 2000 production month and any orders to pay for that month will need to be sent no later than July 2007. After that time, we will be precluded from issuing orders to pay on Federal oil based on the benchmarks.

, but does apply to Federal oil and gas and solid minerals.

Marketable Condition and Duty to Market

The regulations, for valuation of the products listed below, require that the lessee place production in marketable condition at no cost to the lessor and that the lessee market the production for the mutual benefit of the lessee and the lessor at no cost to the lessor.

The applicable cites are:
Indian oil, 30 CFR §206.52 (i)
Federal oil, 30 CFR §206.102 (i) [prior to July 2001]
Federal oil, 30 CFR §206.106 [effective July 2001]
Federal gas, unprocessed, 30 CFR §206.152 (i)
Federal gas, processed, 30 CFR §206.153(i)
Indian gas, unprocessed, 30 CFR §206.172 (i) [prior to January 2000]
Indian gas, processed, 30 CFR §206.173 (i) [prior to January 2000]
Indian gas, not in an index zone, 30 CFR §206.174 (h) [effective January 2000]
Federal coal, ad valorem leases, 30 CFR §206.257 (h)
Indian coal, ad valorem leases, 30 CFR §206.456 (h)

These regulations state that, when gross proceeds establish the value, that value must be increased to the extent that the gross proceeds have been reduced because the purchaser, or any other person, is providing certain services to place the production in marketable condition or the market the production, the cost of which ordinarily is the lessee's responsibility.

<u>Case history:</u>

- October 9, 2003, Valuation Determination for Coalbed Methane Production from the Kitty, Spotted Horse, and Rough Draw Fields, Powder River Basin. Addressed to Devon Energy Corp., signed by the Assistant Secretary for Land and Minerals Management.
  This decision discusses the allowability of compression costs as part of the allowed costs of transportation. Certain compression costs were determined to be costs of putting production in marketable condition and were thus not allowed.

- *Walter Oil and Gas Corp.,* 111 IBLA 260 (1989)

- *Arco Oil and Gas Co.,* 112, IBLA 8 (1989)

- *California Co. v. Udall,* 296 F.2d 384, 387 (D.C. Cir. 1961)

- *Taylor Energy Co.,* 143 IBLA 80 (1998)

- *Yates Petroleum Corp.,* 148 IBLA 33 (March 9, 1999)

- *Amerac Energy Corp.,* 148 IBLA 82 (March 24, 1999)

- *Amoco Production Co.*, 143 IBLA 189 (1998)
  This decision held in favor of Amoco on the grounds that MMS had not provided adequate evidence to prove that the difference between a non-arm's-length price and the arm's-length resale price constituted a marketing fee.

- *Mesa Operating Limited Partnership v. Department of the Interior,* 931 F2d 318 (5th Cir. 1991), *cert. denied,* 502 U.S. 1059 (1992)

- *Amerada Hess v. Department of the Interior,* 170 F.3d 1032 (10th Cir. 1999)

FEDERAL AND INDIAN GAS
NON-ARM'S-LENGTH VALUATION
RESOURCES

Regulations:

- **Federal:**
  30 CFR § 206.152, unprocessed gas
  30 CFR § 206.153, processed gas
- **Indian:**
  30 CFR § 206.172 (1999), unprocessed gas
  30 CFR § 206.173 (1999), processed gas
  The Indian gas valuation regulations changed effective January 1, 2000.

Payor Handbook:

- The *Oil and Gas Payor Handbook, Volume III, Product Valuation*, 08/01/00, discusses valuation of unprocessed gas not sold under an arm's-length contract in Section 4.1.2. Section 4.2.2 discusses valuation of processed gas not sold under an arm's-length contract.

Policy Guidance:

- Guidance paper from the Associate Director for Royalty Management, MMS, *Valuation Guidance for Auditing Affiliate Sales of Natural Gas,* December 5, 1996

Case History:

- The valuation guidance mentioned above contains a list of relevant administrative and court decisions issued through 1996.

Other related topics to consider:

- POP (Percentage-of-proceeds) contracts
  - Regulations for valuation under POP contracts were published in the *Federal Register,* Vol. 56, No, 178, pages 46527 – 46531. The preamble to this rule provides good information about why POP contract situations are treated differently than other contract situations.
  - The *Oil and Gas Payor Handbook,* pages 4-56 – 4-67
  - Dear Payor letters of April 16, 1992 and June 25, 1992
  - Indian gas sold under arm's-length POP contracts after the effective date of the new Indian gas rule, January 1, 2000, is now valued and reported as processed gas. The new rule had no effect on the reporting or valuation of non-arm's-length Indian gas sold under POP contracts.
  - Policy paper, August 19, 1994, "*Policy Paper – Retroactive Application of the Percentage-of-Proceeds (POP) Rule*"
  - Policy paper, date uncertain, *"Interpretation – Dual Accounting for Gas Sold Under Percentage-of-Proceeds Contracts [Issue 1995-1]*

- Accounting for comparison (dual accounting)
    - Federal: 30 CFR § 206.155
    - Indian: 30 CFR § 206.175 (1999)
    - The *Oil and Gas Payor Handbook, Volume III, Product Valuation,* pages 4-90 – 4-102
    - Legal decisions:
        - *Pioneer Kettleman,* MMS-89-0232-O&G
        - *Marathon Oil,* MMS-94-0404-O&G

- Major Portion Analysis (applies to Indian properties only)
    - 30 CFR §206.172 (a) (3) (i) and (ii) (1999), unprocessed gas
    - 30 CFR §206.173 (a) (3) (i) and (ii) (1999), processed gas
    - The *Oil and Gas Payor Handbook, Volume III, Product Valuation,* pages 4-103 and 4-105

FEDERAL AND INDIAN OIL
NON-ARM'S-LENGTH VALUATION
RESOURCES

Regulations:

- **Federal:**
  30 CFR § 206.102 (1999)
  The Federal gas valuation regulations changed effective July 1, 2000.
- **Indian:**
  30 CFR § 206.52

Payor Handbook:

- The *Oil and Gas Payor Handbook, Volume III, Product Valuation,* 08/01/00, discusses valuation of oil not sold under an arm's-length contract in Section 3.2.

Policy Guidance:

- Guidance paper from the Acting Associate Director for Royalty Management, MMS, *Valuation Guidance for Auditing Crude Oil Premiums*, June 24, 1996.

Case History:

- The valuation guidance mentioned above contains a list of relevant administrative and court decisions issued through 1996.

Other related topics to consider:

- Major Portion (Indian only)

FEDERAL COAL
NON-ARM'S-LENGTH VALUATION
RESOURCES

Regulations:

- 30 CFR § 206.256, cents-per-ton leases
- 30 CFR § 206.257, ad valorem leases

Payor Handbook:

- The *Solid Minerals Payor Handbook,* 10/26/92, discussed coal valuation in Chapter 10.

Policy Guidance:

- Guidance paper from the Associate Director for Royalty Management, MMS, *Valuation Guidance for Auditing Affiliate Sales of Coal*, December 5, 1996.
- Preamble to the 1989 coal regulations, *Federal Register,* January 13, 1989.

Case History:

- The valuation guidance mentioned above contains a list of relevant administrative and court decisions issued through 1996.

FEDERAL GAS

NON-ARM'S-LENGTH VALUATION

Index

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:

<u>First benchmark:</u>

> (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 arm's-length contracts:

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

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

Application:

- 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 . . 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.

<u>Second Benchmark:</u>

> (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;

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 that 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.

Application:

- If there is no long-term contract in 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

Application:
- This may be an AL price in a different field or area adjusted for quality and transportation as long as it is reasonable, or another method could be used.

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.

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 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;

The *Oil and Gas Payor Handbook, Volume III, Product Valuation*, 08/01/2000 discusses valuation under the first benchmark 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

Application:

- 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.

Application:

- 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

The *Oil and Gas Payor Handbook, Volume III, Product Valuation*, 08/01/2000 discusses valuation under the second benchmark 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.

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.

Application:

- 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) **Not withstanding 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.

Application:

- 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.

Legal Decisions:

- <u>Pioneer Kettleman</u>, MMS-89-0232-O&G and MMS-90-0405-O&G

- <u>Marathon Oil</u>, MMS-94-0404-O&G

GAS DISPOSED OF UNDER SPECIAL CONTRACTS OR SITUATIONS

The *Oil and Gas 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 *Oil and Gas Payor Handbook, Volume III, Product Valuation*, 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"
- *Oil and Gas Payor Handbook, Volume III, Product Valuation*, 8/01/2000, Section 4.3.1, page 4-56

INDIAN GAS

NON-ARM'S-LENGTH VALUATION

Index

DRAFT

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 *Oil and Gas Payor Handbook, Volume III, Product Valuation,* 08/01/00, page 4-21, 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.

Application:

- Compare the company's 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 the company's (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.

<u>Second Benchmark:</u>

> (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

Application:

- If there is no long-term contract in 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 that company purchases in the same field or area from other companies in arm's-length transactions, these transactions 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.

<u>Third benchmark:</u>

> (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

Application:

- 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.
- According to the preamble to the 1988 gas rule, as published in the *Federal Register,* Vol 53, No. 10, January 15, 1988, page 1243:

  > 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 a sales price of the changed product and deduct transportation and processing costs.

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

Application:

- Compare the company's 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 salability 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

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

Application:

- 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.
- According to the preamble to the 1988 gas rule, as published in the *Federal Register,* Vol 53, No. 10, January 15, 1988, page 1243:
  - 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 a sales price of the changed product and deduct transportation and processing costs.

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.

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, (*Federal Register*, Vol. 56, No. 178, pages 46527 – 46531) Percentage of Proceeds (POP) 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.

Indian gas sold under arm's-length POP contracts after the effective date of the new Indian gas rule (effective January 1, 2000) is now valued and reported as processed gas. The new rule had no effect on the reporting or valuation of non-arm's-length Indian gas sold under POP contracts.

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 contact, 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 of 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:

> (a) (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, 08/01/00, 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)...

IMPACT OF THE NEW INDIAN GAS RULE

The Indian gas valuation regulations at 30 CFR Parts 202 and 206 were amended by a rule published in the *Federal Register* on August, 10, 1999 (Vol. 64, No. 153, pages 43506 – 43528). The new regulations took effect on January 1, 2000.

First, determine whether the lease is in an index zone or not.

Production in an index zone:

If production is in an index zone, 30 CFR § 206.172 applies. Index zone valuation requires the use of published index zone prices. Accounting for comparison (dual accounting) may be required for leases in an index zone. Information about index zones, prices, etc. can be found on the MMS website at: **www.mrm.mms.gov/TribServ/allzones.htm.**

Production not in an index zone:

For production not in an index zone, 30 CFR §206.174 applies. For production sold under arm's-length contracts, value is generally the higher of gross proceeds value or major portion value. Dual accounting may also be required.

For non-index-zone production that is not sold at arm's length, value is generally the higher of NAL gross proceeds, a benchmark value, or major portion value. The benchmarks are found at § 206.174 (c) (1), (2), and (3). Dual accounting rules may also be required.

FEDERAL OIL

NON-ARM'S-LENGTH VALUATION

Index

SUBJECT PAGE

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.

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

The first benchmark applies in situations where the lessee has contemporaneous posted or 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

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.

Application:

- 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);

Application:

- 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 arm's-length transactions also contained premiums above the posted price 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;

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

Prices must be for purchases or sales under other contemporaneous arm's-length contract for

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

Application:

- 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;

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

The fourth benchmark is based on 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.

Application:

- If there are AL spot prices for this field or area and in the auditor's judgment, after reviewing the relevant facts, then the spot price, if greater than the NAL 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;

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

The fifth benchmark is the net-back method or other reasonable valuation method

- Determined on a case-by-case basis

Application:

- 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 30 CFR § 206.102 (c) (6) (1999), 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.

IMPACT OF THE NEW FEDERAL OIL RULE

The "new" Federal oil rule was published in the *Federal Register* on March 15, 2000 (Vol. 65, No. 51, pages 14022 – 14096). These new regulations took effect July 1, 2000, and amended 30 CFR § 206.

30 CFR § 206. 103 specifies how to value oil that is not sold under an arm's-length contract. The new methods do not rely on benchmarks.

The first step is to determine where the production comes from. If from leases in California or Alaska, 206.103 (a) applies. If from leases in the Rocky Mountain Region, 206.103 (b) applies. If from leases not located in California, Alaska, or the Rocky Mountain Region 206.103 (c) applies.

California or Alaska:

"Value is the average of the daily mean ANS spot prices published in any MMS-approved publication during the trading month most concurrent with the production month."

Rocky Mountain Region:

If the lessee has an MMS-approved tendering program, value oil under 206.103 (b) (2).

If the lessee does not have an MMS-approved tendering program, value is either:

- The volume-weighted average gross proceeds accruing to the seller under the lessee's or lessee's affiliates' arm's-length contracts for the purchase or sale of production from the field or area during the production month. Total volume sold or purchased under these contracts must exceed 50 percent of the lessee's and the lessee's affiliates' production from the field or area during the month. Before calculating the volume-weighted average, the oil quality must be normalized to the same gravity as that of the oil produced from the lease.
- The daily mean spot price published in any MMS-approved publication for WTI crude at Cushing, OK during the trading month concurrent with the production month.

Once one of the above two methods is chosen, the lessee may not change to the other method more often than once every 2 years, unless the method used is no longer applicable.

If the above three methods all result in unreasonable values, the MMS Director may establish an alternative valuation method.

Leases not located in California, Alaska, or the Rocky Mountain Region:

Value is the average of the daily mean spot prices published in any MMS-approved publication for the market center nearest the lease for crude oil of similar quality.

When calculating a daily mean spot price from a publication:

- The daily mean spot price is the average of the daily high and low prices for the month
- Use only the days and prices for which such prices are published
- Adjust for location and quality differentials and transportation costs, as applicable under § 206.112.

After selecting a publication, the lessee may not select a different publication more often than once every 2 years, unless MMS revokes its approval of the publication.

MMS-approved publications are listed in the *Federal Register*, Vol. 65, No. 114, page 37043, June 13, 2000. They are:

- *Platt's Oilgram Price Report, Platt's Global Alert, Platt's Crude Oil Marketwire, and Platt's U.S. Crudewire*
- *Petroleum Argus Americas Crude, Argus Crude, Argus Americas Crude Datafile, Argus Crude Datafile*
- *Bloomberg Oil Buyers Guide Petroleum Price Supplement, Bloomberg Energy Web Site, Bloomberg Professional*

INDIAN OIL

NON-ARM'S-LENGTH VALUATION

Index

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:

<u>First benchmark:</u>

> (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;

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

The first benchmark applies in situations where the lessee has contemporaneous posted or 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
- 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.

Application:

- 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);

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

The second benchmark uses the arithmetic average of contemporaneous posted prices used in arm's-length transactions by persons **other than** the lessee. The second benchmark is used when a lessee does not purchase or sell a significant quantity of like-quality oil under arm's-length contracts, or if the lessee's posted prices are not comparable to other posted prices used in arm's-length transactions in the field or area.

Comparable purchases or sales must satisfy these criteria:
- Significant quantities of like-quality oil
- Production in the same field or area
- Arm's-length purchases other than the lessee.

Application:
- "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;

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

Prices must be for purchases or sales under other contemporaneous arm's-length contract for

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

Application:

- 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;

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

The fourth benchmark is based on 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.

Application:

- 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;

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

The fifth benchmark is the net-back method or other reasonable valuation method
- Determined on a case-by-case basis

Application:
- 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 30 CFR § 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.

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.~~

(Suggest deleting this section. NAL valuation under any of the remaining (if any) cents-per ton leases still is cents-per-ton—Fina doesn't apply.)

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:

> (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 produced coal less applicable provisions of paragraph (b)(5) of this section and less applicable allowances determined pursuant to §§206.258 through 206.262 and §206.265 of this subpart.

In the general valuation guidance for auditing affiliate sales of coal dated 11/26/1996 (1996 valuation guidance paper) 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.)

The *Solid Minerals Payor* Handbook Coal Product Valuation Chapter 10, 10/26/92, Sec. 10.10.12 states:

> The value for royalty purposes cannot be less than the gross proceeds the lessee receives for the sale or disposition of Federal or Indian lease production. Under arm's-length sales conditions, gross proceeds are essentially equivalent to the contract sales price set forth in the arm's length contract under which lease production is sold. Under non-arm's-length conditions, however, this section requires that the lessee use its non-arm's-length contract value for royalty purposes if the gross proceeds under that contract exceed those found in comparable arm's-length contracts.
>
> ...Lessees should be aware that under all conditions they must account for the entire value of the coal, or all gross proceeds accruing to the lessee, even when it can be demonstrated that the cash sales price equals or exceeds the average price of coal sold in the same area.

<u>First benchmark:</u>

> (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;

Analysis:

Per the Fina decision, we cannot **<u>directly</u>** use the affiliate's arm's-length resale contract prices, as Fina defines a lessee and its affiliate as separate entities. The first benchmark requires that arm's-length contracts considered for comparability be "between buyers and sellers, neither of whom is affiliated with the lessee for sales, purchases, or other dispositions..." However, pursuing the benchmarks may lead us to use of the affiliate's resale price (described below).

Dispensing with the first benchmark can usually be successfully accomplished through use of "comparability". Lessees do not usually have access to "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." That is to say, they would have to have other lessees' contracts to make the comparison and no other lessee would be willing to provide such proprietary information.

Non-comparability can also be routinely proven through:

- quality parameters and volumes
- the time of execution of the contract
- the longevity of the contract
- that there may be no contract
- marketable condition of the product (or lack of)
- that the market served is a "broker market" or "marketing affiliate market", not the consumer market

Second Benchmark:

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

Analysis:

The lessee must look to the second benchmark if the first benchmark does not apply. Per Section 10.10.6 of the *Solid Minerals Payor Handbook*, "The second benchmark for coal valuation requires the lessee to use the coal prices reported to a PUC by the purchasing utility company. This valuation benchmark is, for the most part, applicable to integrated (affiliated) mining companies and their electric utility counterparts." Per the 1996 valuation guidance paper, page 1, "If the resale of production from the affiliate to a third party occurs in the same field or area as the sale from the lessee to its affiliate, the proceeds under the arm's-length resale contract may be used in calculating the applicable benchmark value." As the first benchmark cannot be used because of company affiliation, this statement applies to subsequent benchmarks. The resale prices reported to the PUC by the utility can be used, through the second benchmark, in establishing the proper royalty value of the original sales prices from the first sale.

With the first benchmark inapplicable to valuation because of a non-comparability factor, the rules intend to assign a value to the coal that the consumer attributes to it. As was said in the 1989 coal regulations preamble, Federal Register, January 13, 1989, p. 1515, "Setting the coal's value for royalty purposes based on prices approved by public utility commissions is consistent with MMS's gross proceeds concept, because the amount that a utility can pay for its captive coal production is regulated and approved by the public utility commission." (While MMS was responding to a comment on captive mines, the concept applies to non-arm's-length sales in situations that are not captive.)

Third benchmark:

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

Analysis:

Section 10.10.6 of the *Solid Minerals Payor Handbook* states "This benchmark bases value on the delivered cost of coal reported to FERC. This information is collected and published by the Energy Information Administration of the Department of Energy." The affiliate resale prices reported to EIA by the utility can be used, through the third benchmark, in establishing the proper royalty value of the original sales prices from the first sale.

The analysis of the second benchmark also applies here. With the first benchmark inapplicable to valuation because of a non-comparability factor, the rules intend to assign a value to the coal that the consumer attributes to it. As was said in the 1989 coal regulations preamble, Federal Register, January 13, 1989, p. 1515, "Setting the coal's value for royalty purposes based on prices approved by public utility commissions is consistent with MMS's gross proceeds concept, because the amount that a utility can pay for its captive coal production is regulated and approved by the public utility commission."

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;

Analysis:

If, on appeal, a lessee successfully argues that MMS cannot use the second or third benchmark, we may be able to employ the affiliate's resale value through the fourth benchmark, with the same reasoning as used above. The unique factor of an affiliate acting to serve as a proxy for the lessee in marketing the coal could hold sway.

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.

Analysis:

(Same analysis as for #4)

Marketable Condition Requirement:

Section 206.257(h):

> The lessee is required to place coal in marketable condition at no cost to the Federal Government. 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 has 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 coal in marketable condition.

The preamble discussion to the January 1989 final rulemaking explained in detail the requirements of the marketable condition requirement:

> "The requirement that the lessee place the lease product in marketable condition at no expense to the lessor is a vital royalty concept. It defines the minimum level of effort and expenditure the lesee must undertake to place leasehold production in merchantable condition without any contribution or sharing of expenses by the lessor....With respect to coal, processes commonly applied by mine operators (or lessees) to prepare coal for the market include all operations which extract, sever, or otherwise separate coal from its in-place position in the geologic strata; crushing (to limit upward size); sizing, storing, blending, and loading for shipment (including oiling); and all transportation requirements in and about the mine beginning at the point of extraction and including movement to all plants and facilities in which normal mining procedures are applied...MMS will add to the gross proceeds the cost of those normal mining processes which are ordinarily the responsibility of the lessee."

Analysis:

Coal sold to an affiliate is often run-of-mine coal that does not meet marketable condition requirements. If the lessee's affiliate processes the coal into marketable condition MMS can add the affiliate's cost of improving the product to marketable standards to the non-arm's length sale price in order to compute a proper royalty 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.

Per page 1 of the 1996 valuation guidance paper, "The affiliate's records may be examined in order to determine in the affiliate performed services that are the responsibility of the lessee…"

As coal production is not subject to the Federal Oil and Gas Royalty Management Act of 1982, lease terms may be invoked as a basis for accessing records of an affiliate. Coal lease terms state at Section 6, "…Lessee shall furnish detailed statements showing the amount and quality of all products removed and sold from the lease, the proceeds therefrom, and the amount used for production purposes or unavoidably lost."

(Cite Shell decision?)

(Do we need the cites below?)

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 COAL

NON-ARM'S-LENGTH VALUATION

Index

DRAFT

Federal and Indian oil and gas gross proceeds

In light of the Fina decision , determining gross proceeds on oil and gas not sold under an arm's-length contract.

Does the Fina decision impact the application of the oil and gas benchmarks? (Is this really the question you want to ask because Fina doesn't impact the application of the benchmarks. It's impact is on gross proceeds. Maybe the question you want to ask is, "How does Fina impact how oil and gas not sold under an arm's-length contract is valued?)

No. Even under the Texaco decision the benchmarks still applied. What changed after the Fina decision is that when comparing the value determined under the benchmarks with the gross proceeds accruing to the lessee, the gross proceeds are those that accrue to the producer, not to the affiliate. That is, the auditor must compare the value under the benchmarks with the non-arm's-length gross proceeds paid by the affiliate to the producer, NOT the proceeds received by the affiliates in its arm's-length resale of the production to a third party.

Does Fina limit the value to less than the "gross proceeds accruing to the lessee*?" (I don't understand this question)* The regulations 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...."

No. Production sold under a non-arm's-length contract is valued based on the higher of the first applicable benchmark or the gross proceeds accruing to the lessee. Under Fina the gross proceeds accruing to the lessee is the non-arm's-length gross proceeds – that is, the value that the affiliate pays the lessee because the affiliate has comparable arm's-length sales. .

Does the Fina decision impact the application of the oil benchmarks prior to July 2000? (Again – you may want to ask this question differently) (New Federal oil valuation regulations were published on March 15, 2000 and took effect July 1, 2000.)

No. Even under the Texaco decision the benchmarks still apply to crude oil produced from Federal and Indian leases prior to June 1, 2000. (see response to question 1.) However, the Fina decision is not applicable to crude oil produced from Federal leases after June 1, 2000. The Fina decision still applies to crude oil produced from Indian leases.

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.

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.)

No, the application of the benchmarks is still the same. What has changed under the Fina decision is that gas produced from Indian leases prior to January 1, 2000, and not sold under an arm's-length contract, must be value based on the higher of the benchmarks or the gross proceeds accruing to the lessee. Under Fina the gross proceeds accruing to the lessee is the non-arm's-length gross proceeds – that is, the value that the affiliate pays the lessee because the affiliate has comparable arm's-length sales.

Are there other court decisions that assist with the application 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. (How does this decision help us determine the use of the benchmarks??? The use of the benchmarks is determined by whether the production is sold non-arm's-length or not. This portion of the Xeno decision relates to marketable condition, not to the use of the benchmarks.)

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.

In another Marathon Oil case, MMS-92-0077-O&G where Marathon Oil sold to Marathon Production Company (MPC) and then MPC sold to Exxon, and Exxon reimbursed MPC for gathering, Marathon's appeal was denied. Quoting a long history of cases the decison 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. (I don't see how any of these cases support the use of the benchmarks. Why are we addressing dual accounting – that is not an issue in Fina?

---Page Break---

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, the Fina case applies to federal coal. This section will discuss the application of the Federal coal benchmarks.

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.

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....

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.

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Page 3: [2] Deleted Minerals Revenue Management 1/23/2004 2:48:00 PM

Statute of Limitations - I am not sure why this is included? Maybe a separate handout on statute of limitations? Why not just include the periods of time and products that this guidance applies to?

MMS's statute of limitations policy, applicable to Federal oil and gas and solid minerals production, affects the time periods to which the benchmark analysis may apply. The policy arose from provisions in the Federal Oil and Gas Royalty Simplification and Fairness Act of 1996 (RSFA), but has been augmented to apply to prior periods.

Relevant policy guidance is reproduced in the "Policy Documents" section of this training manual and includes the following:

October 8, 2002 memo from the Associate Director for Minerals Revenue Management, subject: Guidelines Regarding Statute of Limitations for Demands and Orders and Appeals Decisions for Federal Leases

January 28, 2003 letter to Valdean Severson, Oil and Gas Bureau Chief, New Mexico Taxation and Revenue Department, from the Associate Director for Minerals Revenue Management and attached "Procedures for Implementing October 8, 2002 'Guidelines Regarding Statute of Limitations for Demands and Orders and Appeals Decisions for Federal Leases'"

The effect of this policy is that orders to pay cannot be issued for production periods prior to 7 years prior to the date of the order. Thus an order sent in January 2004 could not cover periods prior to the December 1996 sales month, for which royalty reporting would have been due by the end of January 1997. (An exception occurs if the payor has an estimate on file, allowing the reporting one month later. Thus December 1996 production would not be reported until the end of February 1997 and an order covering that production month could be issued in February 2004.) The policy papers also discuss "compelling circumstances" under which exceptions may be granted and procedures for tolling the statute.

Thus, the applicability of the "old" Federal oil rule and the applicability of the benchmarks to Federal oil is declining as time goes on. The new Federal oil rule took effect in July 2000, so the benchmarks will apply to Federal oil production only through the June 2000 production month and any orders to pay for that month will need to be sent no later than July 2007. After that time, we will be precluded from issuing orders to pay on Federal oil based on the benchmarks.

, but does apply to Federal oil and gas and solid minerals.

----------Page Break----------

Barton, Jayne

From: Burhop, Shirley
Sent: Friday, January 23, 2004 4:31 PM
To: Gibbs Tschudy, Deborah; Williams, Mary
Cc: Conway, Karen; Kirumakki, Nagaraja
Subject: Status - Fina training

Attachments: FED AND IND OIL6.doc; FED AND IND COAL6.doc; FED AND IND GAS6.doc; 6Intro.doc

FED AND IND OIL6.doc (36 KB) FED AND IND COAL6.doc (60 KB) FED AND IND GAS6.doc (38 KB) 6Intro.doc (129 KB)

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Why do we think this information is necessary? X 5

X 5

X 5 So I think that providing a "resource list" to accompany the training would be very valuable.

Debbie, you asked why we should even bother mentioning dual accounting and major portion. It think it's important that auditors understand that they don't stop when they've arrived at a benchmark value - that other things may need to be considered. Thus the references to these topics.

Status of the rest of the project: we have an 80+ page slide show developed which I think is in final form. It includes many place-holders for examples, which are still being developed. The examples, and a case study will be presented as handouts. I would prefer to pass along the whole package for review and will hope to have it available next week. I believe we're in pretty good shape with both gas and coal examples and oil should be fairly easy.

FEDERAL AND INDIAN OIL NON-ARM'S-LENGTH VALUATION RESOURCES

Regulations:

- **Federal:**
  30 CFR § 206.102 (1999)
  The Federal gas valuation regulations changed effective July 1, 2000.
- **Indian:**
  30 CFR § 206.52

Payor Handbook:

- The *Oil and Gas Payor Handbook, Volume III, Product Valuation,* 08/01/00, discusses valuation of oil not sold under an arm's-length contract in Section 3.2.

Policy Guidance:

- Guidance paper from the Acting Associate Director, *Valuation Guidance for Auditing Crude Oil Premiums*, June 24, 1996.
- Guidance paper from the Royalty Policy Board, *Royalty Valuation Guidance fro Sales to Joint Venture Affiliates*, December 14, 1998.

Case History:

- *Valuation Guidance for Auditing Crude Oil Premiums* contains a list of relevant administrative and court decisions issued through 1996.

Other related topics to consider:

- Major Portion Analysis (applies to Indian properties only)
  - 30 CFR §206.52 (a) (2) (i) and (ii) (2003)
  - The *Oil and Gas Payor Handbook, Volume III, Product Valuation,* Section 3.5, page 3-40.

FEDERAL COAL
NON-ARM'S-LENGTH VALUATION
RESOURCES

<u>Regulations:</u>

- 30 CFR § 206.257, ad valorem leases

<u>Payor Handbook:</u>

- The *Solid Minerals Payor Handbook,* 10/26/92, discusses coal valuation in Chapter 10.

<u>Policy Guidance:</u>

- Guidance paper from the Associate Director for Royalty Management, *Valuation Guidance for Auditing Affiliate Sales of Coal,* December 5, 1996.
- Preamble to the 1989 coal regulations, *Federal Register,* January 13, 1989.
- Guidance paper from the Royalty Policy Board, *Royalty Valuation Guidance fro Sales to Joint Venture Affiliates,* December 14, 1998.

<u>Case History:</u>

- *<u>Valuation Guidance for Auditing Affiliate Sales of Coal</u>* contains a list of relevant administrative and court decisions issued through 1996.

FEDERAL AND INDIAN GAS NON-ARM'S-LENGTH VALUATION RESOURCES

Regulations:

- **Federal:**
  30 CFR § 206.152, unprocessed gas
  30 CFR § 206.153, processed gas
- **Indian:**
  30 CFR § 206.172 (1999), unprocessed gas
  30 CFR § 206.173 (1999), processed gas
  The Indian gas valuation regulations changed effective January 1, 2000.

Payor Handbook:

- The *Oil and Gas Payor Handbook, Volume III, Product Valuation*, 08/01/00, discusses valuation of unprocessed gas not sold under an arm's-length contract in Section 4.1.2. Section 4.2.2 discusses valuation of processed gas not sold under an arm's-length contract.

Policy Guidance:

- Guidance paper from the Associate Director for Royalty Management, *Valuation Guidance for Auditing Affiliate Sales of Natural Gas,* December 5, 1996.
- Guidance paper from the Royalty Policy Board, *Royalty Valuation Guidance fro Sales to Joint Venture Affiliates,* December 14, 1998.

Case History:

- *Valuation Guidance for Auditing Affiliate Sales of Natural Gas* contains a list of relevant administrative and court decisions issued through 1996.

Other related topics to consider:

- POP (Percentage-of-proceeds) contracts
  - Regulations for valuation under POP contracts were published in the *Federal Register,* Vol. 56, No, 178, pages 46527 – 46531. The preamble to this rule provides good information about why POP contract situations are treated differently than other contract situations.
  - The *Oil and Gas Payor Handbook,* pages 4-56 – 4-67
  - Dear Payor letters of April 16, 1992 and June 25, 1992
  - Indian gas sold under arm's-length POP contracts after the effective date of the new Indian gas rule, January 1, 2000, is now valued and reported as processed gas. The new rule had no effect on the reporting or valuation of non-arm's-length Indian gas sold under POP contracts.
  - Policy paper, August 19, 1994, "*Policy Paper – Retroactive Application of the Percentage-of-Proceeds (POP) Rule*"

- Policy paper, date uncertain, *"Interpretation – Dual Accounting for Gas Sold Under Percentage-of-Proceeds Contracts [Issue 1995-1]*

- Accounting for comparison (dual accounting)
  - Federal: 30 CFR § 206.155
  - Indian: 30 CFR § 206.175 (1999)
  - The *Oil and Gas Payor Handbook, Volume III, Product Valuation,* pages 4-90 – 4-102
  - Legal decisions:
    - *Pioneer Kettleman,* MMS-89-0232-O&G
    - *Marathon Oil,* MMS-94-0404-O&G

- Major Portion Analysis (applies to Indian properties only)
  - 30 CFR §206.172 (a) (3) (i) and (ii) (1999), unprocessed gas
  - 30 CFR §206.173 (a) (3) (i) and (ii) (1999), processed gas
  - The *Oil and Gas Payor Handbook, Volume III, Product Valuation,* pages 4-103 and 4-105

INTRODUCTION – IMPACT OF FINA DECISION

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Background:

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

The Fina decision said that the Texaco decision improperly applied the gross proceeds rule to affiliates who were not 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 Court's 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.

- Marketing affiliate is defined in the regulations [at 30 CFR § 206. 51 and 206.151, (2003)] as:
  "an affiliate of the lessee whose function is to acquire only the lessee's production and to market that production."

- "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." (From MMS 1988 regulation preamble)

- "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

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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 discusses the definition of "lessee", based on FOGRMA section 3(7) (30 U.S.C. § 1702(7) and MMS' own definition included in 30 CFR § 206.151, making 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.".

Previously, the Texaco decision held that:

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¶

"Texaco Marketing's arm's-length sales proceeds are the correct measure of the gross proceeds accruing to the lessee", and

"The measure of gross proceeds used in the comparison with other valuation criteria is the marketing entity's arm's-length sales price."

The Texaco decision allowed auditors to pursue the affiliate's arm's-length gross proceeds in determining the gross proceeds accruing to the lessee under 206.152(h). The auditor was then to compare the affiliate's arm's-length gross proceeds to the value determined under the benchmarks at 206.152(c), and assess value on the higher of the two. However, in many cases, auditors simply assessed value on the affiliate's arm's-length resale price and did not calculate a value under the benchmarks generally because of the effort required to obtain comparable arm's-length contracts from the auditee or from other sources.

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Marketable Condition and Duty to Market

The regulations, for valuation of the products listed below, require that the lessee place production in marketable condition at no cost to the lessor and that the lessee market the production for the mutual benefit of the lessee and the lessor at no cost to the lessor.

The applicable cites are:
Indian oil, 30 CFR §206.52 (i)
Federal oil, 30 CFR §206.102 (i) [prior to July 2001]
Federal oil, 30 CFR §206.106 [effective July 2001]
Federal gas, unprocessed, 30 CFR §206.152 (i)
Federal gas, processed, 30 CFR §206.153(i)
Indian gas, unprocessed, 30 CFR §206.172 (i) [prior to January 2000]
Indian gas, processed, 30 CFR §206.173 (i) [prior to January 2000]
Indian gas, not in an index zone, 30 CFR §206.174 (h) [*effective* January 2000]
Federal coal, ad valorem leases, 30 CFR §206.257 (h)
Indian coal, ad valorem leases, 30 CFR §206.456 (h)

These regulations state that, when gross proceeds establish the value, that value must be increased to the extent that the gross proceeds have been reduced because the purchaser, or any other person, is providing certain services to place the production in marketable condition or the market the production, the cost of which ordinarily is the lessee's responsibility.

Case history:

- October 9, 2003, Valuation Determination for Coalbed Methane Production from the Kitty, Spotted Horse, and Rough Draw Fields, Powder River Basin. Addressed to Devon Energy Corp., signed by the Assistant Secretary for Land and Minerals Management.
  This decision discusses the allowability of compression costs as part of the allowed costs of transportation. Certain compression costs were determined to be costs of putting production in marketable condition and were thus not allowed.

- *Walter Oil and Gas Corp.*, 111 IBLA 260 (1989)
- *Arco Oil and Gas Co.*, 112, IBLA 8 (1989)
- *California Co. v. Udall*, 296 F.2d 384, 387 (D.C. Cir. 1961)
- *Taylor Energy Co.*, 143 IBLA 80 (1998)
- *Yates Petroleum Corp.*, 148 IBLA 33 (March 9, 1999)

Deleted: **Federal and Indian oil and gas gross proceeds** ¶
¶
In light of the Fina decision, determining gross proceeds on oil and gas not sold under an arm's-length contract. ¶
Does the Fina decision impact the application of the oil and gas benchmarks? (Is this really the question you want to ask because Fina doesn't impact the application of the benchmarks. It's impact is on gross proceeds. Maybe the question you want to ask is, "How does Fina impact how oil and gas not sold under an arm's-length contract is valued?)¶
<#>No. Even under the Texaco decision the benchmarks still applied. What changed after the Fina decision is that when comparing the value determined under the benchmarks with the gross proceeds accruing to the lessee, the gross proceeds are those that accrue to the producer, not to the affiliate. That is, the auditor must compare the value under the benchmarks with the non-arm's-length gross proceeds paid by the affiliate to the producer, NOT the proceeds received by the affiliates in its arm's-length resale of the production to a third party. ¶
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MMS's statute of limitations policy, applicable to Federal oil and gas and solid minerals production, affects the time periods to which the benchmark analysis may apply. The policy arose from provisions in the Federal Oil and Gas Royalty Simplification and Fairness Act of 1996 (RSFA), but has been augmented to apply to prior periods.¶
¶
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¶ ... [2]

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- *Amerac Energy Corp.*, 148 IBLA 82 (March 24, 1999)

- *Amoco Production Co.*, 143 IBLA 189 (1998)
  This decision held in favor of Amoco on the grounds that MMS had not provided adequate evidence to prove that the difference between a non-arm's-length price and the arm's-length resale price constituted a marketing fee.

- *Mesa Operating Limited Partnership v. Department of the Interior*, 931 F2d 318 (5th Cir. 1991), *cert. denied*, 502 U.S. 1059 (1992)

- *Amerada Hess v. Department of the Interior*, 170 F.3d 1032 (10th Cir. 1999)

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Barton, Jayne

From: Burhop, Shirley
Sent: Monday, January 26, 2004 10:32 AM
To: Gibbs Tschudy, Deborah
Subject: RE: Status - Fina training

Should we be taking some action to clean up the policy documents that are out on the pipeline? I would advocate effective dating them so as not to lose track of the history, but there's a lot of stuff out there that is no longer in effect.

-----Original Message-----
From: Gibbs Tschudy, Deborah
Sent: Monday, January 26, 2004 9:08 AM
To: Burhop, Shirley; Williams, Mary
Cc: Conway, Karen; Kirumakki, Nagaraja
Subject: RE: Status - Fina training

These look really good. Just one comment. The December 14, 1998, Royalty Valuation Guidance for Sales to Joint Venture Affiliate was withdrawn at STRAC and RPC's request. If you cannot find the letter withdrawing it, let me know as I think I have a copy.

-----Original Message-----
From: Burhop, Shirley
Sent: Friday, January 23, 2004 4:31 PM
To: Gibbs Tschudy, Deborah; Williams, Mary
Cc: Conway, Karen; Kirumakki, Nagaraja
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Barton, Jayne

From: Burhop, Shirley
Sent: Monday, January 26, 2004 10:54 AM
To: Johnson, Ralph
Subject: FW: Status - Fina training

Ralph, can this be done? Not sure who's the best person to identify what's no longer in effect, but the first step is to create a field in which to enter the effective dates or, at least, expiration date.

-----Original Message-----
From: Gibbs Tschudy, Deborah
Sent: Monday, January 26, 2004 10:40 AM
To: Burhop, Shirley
Subject: RE: Status - Fina training

Good idea.

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Sent: Monday, January 26, 2004 10:32 AM
To: Gibbs Tschudy, Deborah
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Sent: Monday, January 26, 2004 9:08 AM
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