United States Department of the Interior
MINERALS MANAGEMENT SERVICE
ROYALTY MANAGEMENT PROGRAM
P.O. BOX 25165
DENVER, COLORADO 80225

IN REPLY REFER TO:

MMS-AD
Mail Stop 3150

OCT 22 1996

Memorandum

To: Deputy Associate Director for Compliance
Deputy Associate Director for Valuation and Operations

From: Associate Director for Royalty Management James W. Shaw

Subject: Valuation Guidance for Auditing Affiliate Sales of Natural Gas

Attached is a guidance paper for you to follow when auditing royalties affiliate sales of natural gas produced from Federal and Indian leases under the current regulations. Address any questions about the policy to the Chief, Valuation and Standards Division.

Attachment

September 19, 1996

GENERAL VALUATION GUIDANCE FOR AUDITING AFFILIATE SALES OF NATURAL GAS

GUIDANCE:

Arm's-length Contracts

The value of natural gas sold under an arm's-length contract is generally the gross proceeds accruing to the lessee. If the arm's-length contract does not reflect the total consideration for the value of production received by the lessee, then value may be determined under the valuation benchmarks (30 CFR 206.152 (c) and 206.153 (c)). The lessee's gross proceeds may not be reduced by the costs of placing production in marketable condition.

Non-arm's-length Contracts or No Sale Situations

The value of natural gas sold under a non-arm's-length contract or not sold at all is determined by the criteria set forth in the benchmarks as described in Attachment 1 - Applicable Regulations, Policies, and Case History.

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

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.

The affiliate's records may be examined in order to determine if the affiliate performed services that are the responsibility of the lessee to perform at no cost to the lessor or whether the affiliate received additional consideration for the value of production that should be part of the lessee's gross proceeds. Specific guidance on determining the lessee's gross proceeds after examining the affiliate's records cannot be detailed here. Such determinations must be made on a case-by-case basis taking into account services necessary to place the production in marketable condition or to market the production, the location of the resale, and other relevant matters.

RATIONALE FOR GUIDANCE:

The concept that royalty value cannot be less than the gross proceeds accruing to the lessee is an underlying principle of the natural gas valuation rules. The recent Shell Interior Board of Land Appeals decision (132 IBLA 354) underscores MMS' right to determine what the lessee's gross proceeds are, even after an interim transfer of production to an affiliate. In its brief before the IBLA in the Shell case (132 IBLA 354, decided May 11, 1995, on reconsideration), MMS argued that nowhere in the 1988 rules or rulemaking history is there any restriction against MMS looking to an affiliate's arm's-length sales of production. The MMS has authority under its regulations, and as confirmed by IBLA in the circumstances present in the Shell case, to compare the value properly determined under the first applicable benchmark to the lessee's gross proceeds and select the higher of the two. Sales by affiliates may provide information concerning gross proceeds to the lessee and the appropriate benchmark value in some situations and thus may be considered in determining royalty value.

PROCEDURES:

Arm's-Length Contracts

As a general practice, gross proceeds under an arms-length contract are determined by the sales contract and revenue accounts representing consideration actually received. Any differences between contract values and amounts actually received may represent additional consideration paid for the value of natural gas production. Royalty value is determined by the total consideration received or accruing under the contract or otherwise, less allowable costs of transportation under MMS regulations. Reviews or audits of natural gas gross proceeds should include a verification of all relevant documents such as revenue account bookings and/or purchaser statements.

Non-arm's-length Contracts

As a general practice, royalty value for a non-arm's-length sale or transfer is determined by application of the benchmarks. The first applicable valuation benchmark is used to determine the royalty value. However, under no circumstances can value be less than gross proceeds accruing to the lessee. Royalty value is determined by the higher of consideration received by the lessee less allowable costs of transportation under MMS regulations, or the applicable benchmark value. Reviews or audits of natural gas gross proceeds may include a verification of all relevant documents of the lessee or its affiliate, as well as records of arm's-length purchasers not affiliated with the lessee. Relevant documents may include revenue account bookings and/or purchaser statements.

The guidance provided above applies even if the lessee's affiliate is not a "marketing affiliate". If the lessee's affiliate is a "marketing affiliate", MMS must look directly to the sales by the affiliate to determine gross proceeds.

SPECIFIC GUIDANCE REGARDING GAS COMPARABILITY CRITERIA

Comparability can ultimately only be determined from the unique circumstances uncovered in each audit. Auditor's judgment will prevail. However, it may be useful in certain circumstances to utilize some screening criteria to help evaluate which contracts might be more appropriate than others.

Eight factors are listed under the first benchmark in the gas valuation regulations at 30 CFR §206.152 and 30 CFR § 206.153. Attachment 2 provides definitions of each of the factors. Several of these factors naturally operate together and, when grouped, can be used as a series of "filters" to determine which contracts are comparable for establishing value. The factors may be grouped as follows:

- Volume and quality
- Markets served
- Duration and time of contract
- Price, terms, and other appropriate factors

The first "filter" used is volume and quality. Evaluate each contract and eliminate those not involving sales of equivalent volumes or like-quality production. Next, "filter" the remaining contracts for market(s) served and eliminate any contracts not serving similar market(s). Third, "filter" the contracts for duration and time of sale and eliminate dissimilar contracts. Last, "filter" on price, terms, and other appropriate factors. The remaining contracts become the comparable contracts used to determine value. For example, in the event of a fixed-price contract, the time of sale may be the most important factor.

TIME PERIODS:

Decisions about how far back MMS would assess royalties for natural gas undervaluation under the current regulations would be subject to the Director's July 14, 1995, guidelines regarding audit timing and resource allocation. Section 4 of the Federal Oil and Gas Royalty Simplification and Fairness Act of 1996, paragraph (b)(1) provides that actions to assess additional royalties shall be commenced within 7 years from the date on which the obligation becomes due.

APPLICABLE REGULATIONS, POLICIES, AND CASE HISTORY:

REGULATIONS:

The regulations at 30 CFR 206.152 (h) and 206.153 (h) state, in part,

> 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.

The regulations are 30 CFR 206.152 (c) and 206.153 (c) state,

> 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:
>
> (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 . . . .
>
> (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 salability of the gas.
>
> (3) A net-back method or any other reasonable method to determine value.

POLICIES AND DIRECTIVES:

An October 14, 1988, memorandum from the Assistant Secretary - Land and Minerals Management states

> . . . the gross proceeds accruing to a lessee under its non-arm'-length contract shall be viewed as meeting the requirement of 30 CFR 206.152(c)(1) and 206.153 (c)(1) if they are within the range of the

> gross proceeds derived from or paid under comparable arm's-length contracts between parties not affiliated with the lessee for similarly situated production.

A December 12, 1988, memorandum from the Assistant Secretary - Land and Minerals Management supplemented the October 14, 1988 guidance as follows:

> . . . the policy is hereby supplemented to cover situations where there are no comparable arm's-length contracts in the field or area between parties not affiliated with the lessee. In those situations, the lessee's gross proceeds [under its non-arm's-length contract] will determine the value of the production if they are within the range of the gross proceeds derived from comparable arm's-length contracts between sellers who are not affiliated with the lessee and purchasers who are affiliated with the lessee for sales or other dispositions of like-quality production in the same field or, if necessary to obtain a reasonable sample, from the same area.

The October 14, 1993, policy paper *Valuation of Sales to Affiliates* states that

> When applying the benchmarks, it is necessary to consider the gross proceeds requirement discussed previously. Gross proceeds may not be reduced by costs to place the product in marketable condition or marketing costs . . . .
>
> If the resale from the affiliate to a third party occurs in the same field as the first sale from the lessee to the affiliate and if the affiliate is performing services other than transportation or processing (i.e., marketing services), the resale price would represent the minimum value for royalty purposes under the gross proceeds requirement.

ADMINISTRATIVE AND COURT DECISIONS:

In Santa Fe Energy Products Co., 127 IBLA 265, 268 (1993), the Board affirmed MMS'

> . . . authority [under the Federal Oil and Gas Royalty Management Act (FOGRMA)] to obtain records from any affected person involved in purchasing or selling oil, and that MMS is not limited to dealing exclusively with the signatory lessee concerned. . . . [Therefore,] . . . the obligation to report 'gross proceeds accruing to the lessee' cannot be avoided by an inter-affiliate transfer made in contemplation of later sale to third parties.

In Santa Fe Energy Products Company, No. 95-1221, Tenth Circuit, April 10, 1996, the Court of Appeals stated:

> Under the gross proceeds rule, the MMS could reasonably require information relating to Products' sales in order to ascertain the oil's fair market value and to determine the gross proceeds accruing to Energy . . . . The MMS' determination that the first arm's-length sale of oil produced under a federal lease was covered by the "other relevant matters" language of its regulations was not arbitrary, capricious, or contrary to law . . . . Products is a wholly owned affiliate of Energy. Accordingly, Products sales were relevant to determining gross proceeds accruing to Energy.

In Shell Oil Co. (on reconsideration) 132 IBLA 354, the IBLA ruled that

> Consequently, no matter what regulatory benchmark is used to determine royalty, MMS must compare the result obtained thereby against a gross proceeds analysis in any case . . . .
>
> Upon reconsideration of the question whether MMS had authority to require disclosure of information regarding the transfer of production to Shell in this case, therefore, we find that the marketing affiliate distinction, upon which the Shell decision turned, had no relevance to the question whether the gross proceeds rule must first be applied . . . .
>
> Contrary to the argument advanced by Shell, therefore, the policy paper also indicated that there is an obligation and an expectation that MMS will look beyond the inter-affiliate transfer to determine whether other factors affect product value. As suggested in Santa Fe [127 IBLA 265, 1993], affiliates participating in a transfer of Federal lease production in contemplation of sales to a third party should expect MMS to scrutinize an inter-affiliate transfer and all subsequent affiliate sales.

The IBLA goes on to say at 132 IBLA 357

> The term lessee, however, is specific and cannot be expanded to include an affiliate of the lessee. 30 CFR 206.101 (lessee).

In Xeno, Inc. 134 IBLA 172 (November 14, 1995), the IBLA ruled that

> The sale price received by an affiliate of the lessee in the first arm's-length transaction is properly considered in determining the value of produced gas under the gross proceeds rule.

DEFINITION OF FACTORS

PRICE: All components of the contract price (transportation factors, marketing fees, etc.).

TIME OF EXECUTION: Effective date of the contract (not the signed date).

DURATION OF CONTRACT: The stated period of time the contract is in effect.

MARKET OR MARKETS SERVED: Based on the point of sale established in the contract, including sales at the wellhead, gas processing plant inlet, mainline interconnect, or LDC or industrial user.

TERMS: Contract factors not related to price, volume, quality, duration, etc. (Example: Percentage-of-Proceeds v. Conventional Contract)

QUALITY (Gas stream components): Includes, but is not limited to:

- Methane content (mole percent)
- NGL content (GPM - gallons per Mcf)
- Non-hydrocarbon gas content
  - -- hydrogen sulfide
  - -- helium
  - -- nitrogen
  - -- CO_2

VOLUME: The delivered volume measured in Mcf.

OTHER FACTORS: Any factors that are unique to a particular audit situation, auditor judgement, or a cost/benefit analysis.

Affiliate Sales of Natural Gas

Benchmarks and Pooling

Affiliate Sales of Natural Gas

- Regardless of the benchmark value determined, under no circumstances shall the production value, for royalty purposes, be less than the gross proceeds accruing to the lessee. 30 CFR §§ 206.152 (h) and 206.153(h).

- Benchmarks at 30 CFR §§ 206.152(c) and 206.153(c).

Affiliate Sales of Natural Gas

- Unique circumstances in each case; case-by-case.
- Comparable arm's-length sales or purchases in the field or area or gas plant.
- Lessee has to have access to the data - affiliate's sales or purchases.
- First benchmark - filter.

Affiliate Sales of Natural Gas

- Volume and quality.
- Markets served.
- Duration and time of contract.
- Price, terms, and other appropriate factors.

Affiliate Sales of Natural Gas

- October 14, 1988 - Range of prices.
- December 12, 1988 - Expanded to purchases.
- October 14, 1993 - Look to resales at the same delivery point.
- October 22, 1996 - Best criteria available.

Affiliate Sales of Natural Gas

Celsius sold 1,927,014 MMBtus in a pool to QEC for $1.7852 per MMBtu.

CELSIUS/QEC PRICING ARRANGEMENTS

December 1992 Sales

QPC				MMB/Day	Days	MMB/Month	Price	Value
QP0569C	*	E00413		5,000	31	155,000	$1.30000	$201,500.00
QP0370U	*	E00419		1,400	31	43,400	$1.50000	$65,100.00
		E00403	AIG	10,000	31	310,000	$1.61000	$499,100.00
QP0370G	*	E00402		8,000	31	248,000	$1.76000	$436,480.00
GPA224	*	E00411	GVG	4,431	31	137,367	$1.85000	$254,128.95
QP0370M	*	E00409		3,226	31	100,000	$1.86000	$186,000.00
QP0370D	*	E00936		4,962	31	153,825	$1.88000	$289,191.00
GPA224	*	E00406	GVG	405	31	12,544	$1.90000	$23,833.60
QP0370P	*	E00414		8,000	31	248,000	$1.90000	$471,200.00
QP0370I	*	E00186		3,000	31	93,000	$1.91000	$177,630.00
QP0370V	*	E00401		2,979	31	92,338	$1.93000	$178,212.34
QP0370	*	E00404		5,000	31	155,000	$1.95000	$302,250.00
		E00405	MFS	4,259	31	132,040	$1.98375	$261,934.35
M00928	*	E00412		1,500	31	46,500	$2.01159	$93,538.94
		Total		62,162		1,927,014	$1.78520	$3,440,099.18

Affiliate Sales of Natural Gas

URC, Celsius' affiliate, resold the 1,927,104 MMBtus for $1.86657 per MMBtu.

Celsius December 1992 Actual Gas Volume Contract Allocations				
Sales Contract	Purchaser	Actual MMBTU	Contract Price	Sales Value
E00403	Trading & Transportation Mgmt., Inc. (AIG)	310,000	$1.88000	$582,800.00
E00411	Grand Valley Gas Company	137,367	$1.85000	$254,128.95
E00406	Grand Valley Gas / Kanda	12,544	$1.90000	$23,833.60
E00405	Mountain Fuel Supply, Deferred	132,040	$1.98375	$261,934.35
E00412	Universal Resources Corp./ Muddy Creek	46,500	$2.26000	$105,090.00
E00414	Universal Resources Corp./ BC Gas Inc.(20%)	0	$2.00000	$0.00
E00414	Universal Resources Corp./ BC Gas Inc.(80%)	248,000	$2.00000	$496,000.00
E00401	Universal Resources Corp./ City of Colorado Springs	92,338	$1.97400	$182,275.21
E00419	Universal Resources Corp./ Crysen Refining Inc.	43,400	$1.55000	$67,270.00
E00409	Universal Resources Corp./ Dreyfus	100,000	$1.88000	$188,000.00
E00404	Universal Resources Corp./ NARCO*	155,000	$2.00000	$310,000.00
E00402	Universal Resources Corp./ Premier Enterprises, Inc	248,000	$1.80000	$446,400.00
E00936	Universal Resources Corp./ Swing	153,825	$1.88000	$289,191.00
E00413	Universal Resources Corp./ Term	155,000	$1.37000	$212,350.00
E00186	Universal Resources Corp./ WGR**	93,000	$1.91000	$177,630.00
	Total	1,927,014	$1.86657	$3,596,903.11

*North American Resources Company
**Western Gas Resources, Inc.

Universal Resources Corporation
Arm's-length Sales with URC as Purchaser
December-92

Receipt	Description	MMBtu	Amount	Price/MMBtu	Seller
03341R	Opal Plant Outlet	114,000	210,900.00	$ 1.8500	Marathon
BCGASR	BC Gas Receipt Point	45,999	85,558.14	1.8600	Mobil
03782R	Celsius Fed 20-1	7,188	13,513.44	1.8800	Washington Energy
03674R	East Hiawatha MM	248,000	480,227.20	1.9364	Texaco
GRDVLYR	Grand Valley Receipt	4,800	9,360.00	1.9500	Credo
03341R	Opal Plant Outlet	5,100	10,149.00	1.9900	Williams
GRDVLYR	*Grand Valley Receipt*	13,423	*26,711.77*	1.9900	*Williams*
1-4001R	Opal Plant Rec	63,000	126,000.00	2.0000	Enron
03341R	Opal Plant Outlet	10,500	21,000.00	2.0000	Marathon
GRDVLYR	Grand Valley Receipt	31,000	62,000.00	2.0000	Marathon
03687R	Henry Unit Tap	13,531	27,332.62	2.0200	Washington Energy
03687R	Henry Unit Tap	30,000	72,000.00	2.4000	Washington Energy

The MMS selected the contracts with receipt points similar to the Areas in the QPC Equity Pool or the wells under the pool.

Affiliate Sales of Natural Gas

Hess Energy Marketing billed Amerada Hess Corporation at $1.63 per MMBtu for 107,328 MMBtus from South Marsh Island 130.

HESS

TO:
HESSCO
PO BOX 2040
HOUSTON TEXAS 77252-2040

INVOICE NO [illegible]4-TES-9809
MAILED Nov 06, 1998

PROD. MTH: September 1998

FOR RESIDUE DELIVERED FROM THE TERREBONNE GAS PLANT

PROPERTY	DELIVERED VOLUME	BYPASS GAS	PROCESSED VOLUME	PVR	NET RES./BYPASS VOLUME	MMBT PRICE	NET DUE [illegible]
SOUTH MARSH IS 107 RESIDUE	19,518	0	19,518	2004	17,514	$ 1.63	28,547.82
SOUTH MARSH IS 107 BYPASS		0			0	$ 1.63	-
INTERCO. TRANSP.	19,518					(0.092[illegible])	(1,799.58)
INTERCO. TRANSP. FUEL	19,518					(0.008[illegible])	(184.54)
SOUTH MARSH IS 130 RESIDUE	107,328	0	107,328	17170	90,158	$ 1.63	146,957.54
SOUTH MARSH IS 130 BYPASS		0			0	$ 1.63	-
INTERCO. TRANSP.	107,328					(0.2022)	(21,701.72)
INTERCO. TRANSP. FUEL	107,328					(0.0084)	(904.76)
					TOTAL DUE :		150,934.77

Change

Amerada Hess
Lease No. 054-002280-0

Market	Monthly Volume Mmbtu	Invoiced Amount	Reservation Fee	Total	Average Price
Amoco	4,800	$ 8,040.00		$ 8,040.00	$ 1.67500
Aquila	402,754	$ 692,208.21		$ 692,208.21	$ 1.71869
Atlanta	258,485	$ 461,234.66		$ 461,234.66	$ 1.78438
Brooklyn	547,274	$ 892,056.62	$ 60,954.72	$ 953,011.34	$ 1.74138
Con Ed	580,458	$ 946,146.54	$ 61,505.84	$ 1,007,652.38	$ 1.73596
Con Ed Energy	12,212	$ 24,694.88		$ 24,694.88	$ 2.02218
Cook Inlet	147,569	$ 241,644.24		$ 241,644.24	$ 1.63750
Duke/Dreyfus	4,000	$ 5,760.00		$ 5,760.00	$ 1.44000
ERI Services	119,322	$ 197,716.55		$ 197,716.55	$ 1.65700
KIAC	311,398	$ 549,014.65		$ 549,014.65	$ 1.76306
Murphy	5,000	$ 10,975.00		$ 10,975.00	$ 2.19500
North Carolina	144,990	$ 236,333.70	$ 11,544.91	$ 247,878.61	$ 1.70963
North Carolina	148,064	$ 281,321.60		$ 281,321.60	$ 1.90000
NUI Energy	149,396	$ 354,442.01		$ 354,442.01	$ 2.37250
PG&E Energy	20,000	$ 44,350.00		$ 44,350.00	$ 2.21750
Philadelphia Gas	132,976	$ 216,750.88	$ 9,165.84	$ 225,916.72	$ 1.69893
Piedmont	346,081	$ 564,620.09	$ 31,739.28	$ 596,359.37	$ 1.72318
Piedmont	145,189	$ 248,534.53		$ 248,534.53	$ 1.71180
Public Service	75,049	$ 122,329.87	$ 3,535.22	$ 125,865.09	$ 1.67711
Public Service	229,693	$ 374,383.29	$ 25,605.77	$ 399,989.06	$ 1.74141
Seagull	3,500	$ 7,682.50		$ 7,682.50	$ 2.19500
Sempra	141,613	$ 230,829.19		$ 230,829.19	$ 1.63000
Southern Energy	375,213	$ 733,168.50		$ 733,168.50	$ 1.95401
Streamline	51,600	$ 95,583.00		$ 95,583.00	$ 1.85238
Unocal	20,000	$ 33,700.00		$ 33,700.00	$ 1.68500
Williams	130,294	$ 260,014.23		$ 260,014.23	$ 1.98599
Western Gas	4,403	$ 9,334.36		$ 9,334.36	$ 2.12000
	4,511,333	$ 7,842,869.10	$ 204,051.59	$ 8,046,920.69	$ 1.78371

Author: Gary L Johnson at ~MMS-Dallas-Audit
Date: 2/8/96 10:16 AM
Priority: Normal
TO: Pamela Rieger at ~MMS-OkCity-Audit
TO: William Boyer
TO: John Kirkpatrick
TO: Roy Williams at ~MMS-Tulsa-Audit
BCC: Gary L Johnson
Subject: Re: Comparability Team

------------------------------------ Message Contents ------------------------------------

Please provide any comments to Ken.

Thanks.

Forward Header

Subject: Re: Comparability Team
Author: Gary L Johnson at ~MMS-Dallas-Audit
Date: 2/8/96 10:13 AM

Ken, this is nice, but it really doesn't say much except auditor judgement. I also find it interesting that arms-length and non-arms-length are always so important, and that information is not a required reporting element. I will ask my folks for better comments.

Thanks.

Reply Separator

Subject: Comparability Team
Author: Kenneth Moyers at ~MMS-DENVER-85-1
Date: 1/26/96 4:29 PM

As you know, a team was formed to look at the comparability factors that are currently listed in the benchmarks. The comparability team has drafted a short document that we intend to present to MMS and STRAC auditors for comment. (Please let us know if you agree/disagree that this is the next appropriate step.) It is in the form of guidance to auditors on how to apply the benchmark factors. The document is called "flipchrt".

We had some serious discussion on "prioritizing" and we decided that a strict prioritization inhibits the auditors' flexibility to evaluate each case based on its individual merits. Instead of a strict priority system, we grouped the benchmarks by the factors that naturally operate together. These factors can then be used to "filter" information and eventually lead the auditor to the comparable contracts they need to establish value.

We would like you to review the document. If we need to, we can expand the document, but we just wanted to get a process down first, and then present it to users to get their input. After your comments, we'll revise as needed then present the document to MMS and STRAC auditors for comment. We see our final product as a chapter/insert or something that will be placed in the audit procedures manual.

I have also attached the minutes for both meetings (compmin.01 and compmin.02) because they have a lot of the reasons for our decisions. This information will probably be incorporated into the team's final report, but again, the product will be an audit procedures manual item based on the flipchart.

Please provide comments to Bob Kronebusch (275-7113) or Susan Lupinski (275-7246) at your earliest convenience.

Thank you.

Comparability Team
Meeting Minutes
November 28-29, 1995

Attending
Mike Casias, Bob Kronebusch, Kevin Lanham, Jack Lougee, Susan Lupinski

Minutes November 28, 1995
General
We went over the minutes from last meeting.

We discussed again the integrity problems with the selling arrangement (SA) screen in BIS and using these screens to determine AL/NAL contracts. We looked at the PIF and there is no AL indicator on the form. We have to imply that information by looking at the name of the payor vs. the buyer/purchaser in the BIS system. Most people fill out the PIF once just to get on the system and then don't update on a regular basis each time the SA changes. Verification is probably best done by going to the company annual report to identify affiliates.

A couple of team members tried to look at the corporate reporter function. It was used/created? with the old RATS system and is probably not being currently updated and/or reliable.

In conjunction with a discussion on getting payors to give us information we discussed the status of the payor liability rule and the FOGRMA language. Theoretically we have the right to get information but the auditors often have difficulty getting cooperation from the companies to give us 3rd party sales.

Prioritization of factors

We revisited our discussion of the difficulty in prioritizing the factors without severely limiting audit flexibility. We thought that we can't absolutely state "this is first, this is second,..." but we could help define the tools that auditors can use when applying the benchmarks.

New Mexico would like prioritization to some degree and feel that volume is an important factor. We talked about the prioritization that was discussed by the Reg Neg committee: volume, place, time, duration. But we think quality is also important.

What should be our next step--we had consensus that we should not prioritize per se, but we need to come up with more definitive guidelines for auditors.

Include in technical file:
1. Payor handbook volume III

2. Cason memos and sales to affiliates paper

Other considerations:
1. Define terms

2. State which factors would have the most weight (in other words, at a minimum, what should auditors look for)

3. If the auditors have contracts, all 8 factors could be looked at.

4. If auditors have no contracts (relying on AFS data) which of the 8 could they use? Probably volume and quality because that is on the 2014. Maybe AL/NAL indicators from th SA screen and duration by looking at the PIF start date-end date info (remembering that data may not be reliable).

There are no perfect parameters--strict prioritization will not work.

We had a discussion about contracts and getting the third party contracts in order to apply the benchmark factors. Ideally, auditors would get the contracts from the lessee, its affiliate, or other sources like previous audits, other payors, other residency audits, etc. If contracts are unavailable, then use the AFS data. The AFS data will giv a snapshot of a month and indicate how the non-arm's-length prices of the lessee being audited compare other prices (arm's-length) in the field or area.

We ran the scenario of our diagram with Texaco and TTTI. The first Cason memo says that lessees should use contracts in which they are unaffiliated with either the buyer and seller. In our diagram that would be contracts that Exxon and Amoco have with NGC. The second Cason memo states that it is probably not possible for Texaco to get those contracts so Texaco would use the contract with Conoco and TTTI to determine value under the benchmark. From an audit standpoint, if Exxon and Amoco have residencies, auditors could get those contracts from the MMS resident auditors. Or, auditors under FOGRMA could request those contracts. If they couldn't get them at all, they could at least then ask Texaco for its AL contract with NGC and probably ask TTTi for its AL contract with Conoco.

We then talked about the sales to affiliates paper in light of the Shell decision. VSD is currently looking at that decision as it relates to the sales to affiliates paper and where the "gross proceeds" accruing to the lessee really is. After much discussion, we decided that our task will be to focus on the benchmarks as they currently stand and how to apply the 8 criteria in those benchmarks. We will not address the issue brought up in the Shell case or the marketing to affiliates paper, although we will include the paper for inclusion in the technical file for the audit procedures manual.

For the rest of the day we went over the procedures we had discussed at our last meeting and began refining the benchmark procedure on the flip chart. (See attachment.)

END OF FIRST DAYMinutes November 29, 1995
We went over some of the terms again.

PRICE May include processing, admin, marketing costs
VOLUME Comparable contracts are contracts with similar volumes
PLACE OF SALE Where title transfers

As we got into a discussion we found that TIME OF SALE and DURATION OF CONTRACT are tied together. If contracts overlap in time, they may be comparable even if they didn't start/end at exactly the same time, they are in force during the same time.

We then got into a discussion about grouping the factors. It seemed to make sense that, while we can't prioritize, some factors naturally operate together and we can use these factors as a series of "filters" to get to the comparable contracts we would use to determine value. For instance, we would take a group of contracts that we were evaluating, and look at the volume/quality. We would throw some of those out if they were not for equivalent volumes or like-quality production.. Then, we would next "filter" the remaining contracts for market(s) served and throw out those that weren't for similar markets. Then we would "filter" for duration and time of sale and throw out dissimilar contracts. Then we would "filter" on price, term, and other appropriate factors. The contracts left in the pool would be the comparable contracts used to determine value. Depending on the particular circumstances in the audit, some or all of these would apply.

We had a discussion about sending our team minutes to STRAC and decided that we don't want to send the day to day stuff to them but we would get a draft of our product out to them early on so they would be included in the loop and have the opportunity to give us input.

We returned to refining our procedure (flipcharts) using the filter concept. We decided to include a caveat statement that these factors may or may not be present and that auditor judgment would be a crucial part of the process in deciding if a factor should be used (if it's available or not).

We talked about including a definitions section and decided that the regulations were enough and that we didn't want to predispose anyone toward a particular interpretation. We have the same problem though with if we don't put it in we may find consistency betwee offices becomes and issue, but if we do put it in, we limit flexibility.

Like it or not, comparability is a case-by-case situation.

We spent the rest of the day refining the flipchart procedures.
Our timeline is:

Get the draft of the flipchart procedures out to team members by Wed. Dec. 6.

Team members return comments to Susan by COB Dec. 8.
FAX 303-275-7227

Revise the draft by Dec. 12 (Note to team members: I'm out on training Monday, Dec. 11 s can't revise draft until Tuesday)

Simultaneous transmit revised draft to team members and Debbie Gibbs-Tschudy/Greg Smith

Any comments from Debbie and Greg will be circulated to team members

Redraft (if necessary) and Bob will take the draft to STRAC meeting in January.

This is a tentative schedule with the goal of getting a product to STRAC for comment.

END OF SECOND DAY

SEE ATTACHED DRAFT FOR FLIPCHART PROCEDURE

NOTE: Team members, please review both minutes and procedure. Thanks!

Comparability Team
Meeting Minutes
October 24-25, 1995

Attending
Mike Casias, Jack Lougee, Kevin Lanham, Bob Kronenbusch, Susan Lupinski

Minutes October 24, 1995
General Comments

Bob started the meeting with some general statements of the problem we will try to solve:

1. There is inconsistent application of the criteria in the first gas benchmark (benchmark 1) among audit offices.

2. Because of these different interpretations, PMI has a difficult time defending the various appeals.

3. Some audit offices have requested clarification of the criteria.
4. The Fed Regneg team could not reach consensus.
5. The Royalty Policy Committee will handle any changes to regulations.

Therefore, our task will be to provide additional guidance on the current regs as they read, perhaps by prioritizing or quantifying the eight criteria.

The team talked about what we want to accomplish. We will try to define comparability, provide some kind of policy statement, and provide guidance to auditors through the audit procedures manual (APM).

Jack says from New Mexico's point of view, they try to go to the second benchmark rather than use the first benchmark. They find the first benchmark difficult to use.

Mike and Kevin both like to use the first benchmark. They feel that this benchmark has the flexibility that allows them to use any (or all) of the criteria to make determinations. They also use the BIS data as a starting point before they go to a company to begin an audit. Mike does not want to see the criteria narrowly defined because he feels that will limit the ability of the auditors to fit the benchmark to specific, individual situations.

The challenge of this team becomes how to write some guidance for auditors that want some specific guidelines without making that guidance so restrictive that auditors have no flexibility. We can't make it an on/off checklist or limit the latitude the current benchmark has for auditors.

Discussion kept cropping up about the data available and using the BIS data. Information access is the auditors' overriding concern.

Analysis of Benchmark 1
We decided to pin down what the problems were with the criteria.

1. Use AL contracts where sellers and purchasers are not affiliated with the lessee.

Lessee --No access to these contracts (anti-trust)

MMS --Access if other lessees are Federal
--Under FOGRMA can go to any purchaser in the field (Proprietary data???)
--Lessee's affiliate is only purchaser in the field

Field and area are defined differently by MMS and the lessee

2. Use AL contracts where sellers aren't affiliated with lessee, but purchaser is affiliated.

Lessee --getting contracts from affiliates
--definition of field/area

MMS --getting contracts from affiliates
--definition of field/area

3. The 8 comparability criteria

No prioritization

Since individual judgement is to be used (10-14-93 marketing affiliate paper), no consistent application between audit offices (Maybe not a problem??)

Definition of Terms

Everyone will not have the same understanding of what the terms mean. We thought a discussion of our individual perceptions of the terms would be helpful.

PRICE
Components of the contract price, any add-ons or deducts, including:
- transportation factors
- marketing fees

TIME OF EXECUTION
When the contract was effective (not signed)

DURATION OF CONTRACT
Length of contract
- spot
- short-term (are the first two the same?)
- mid-term
- long-term

MARKET OR MARKETS SERVED
Defined by purchaser
Point of sale in contract
- --at the wellhead
- --to a gas processing plant
- --to a mainline interconnect
- --to an LDC or industrial user

TERMS
related to price(?)
seems more related to "other appropriate factors"
factors not related to price, volume, quality, duration, etc.
POP vs. conventional contracts

QUALITY (Gas stream components)
methane content (mole percent)
NGL content (Btu content)
non-hydrocarbon gas content
- --sulfur dioxide (sour gas)
- --helium
- --nitrogen
- --CO2

coalbed methane

VOLUME
Mcf measurement
driven by contract quantities sales (500,000 Mcf vs. 5,000 Mcf)

OTHER FACTORS
auditor judgement ?
cost/benefit ratio ?

END OF FIRST DAYMinutes October 25, 1995

General

We started by talking about prioritizing and using AFS data in determining the value unde the benchmarks.

Bob talked to Clare about the APM. The APM has a "technical file" that is the repository of policy, dear payor letters, etc. for each subject. We discussed writing our team report and using that as part of the technical file instead of trying to get a policy paper out. The report would be circulated in draft to everyone prior to inclusion in the file. Are Cason memos and marketing affiliate paper in the technical file??

We pulled some examples of lease information off the AFS to see if information already in the system could be used under the benchmark criteria. We looked particularly at the selling arrangement information and found that some of the data appeared outdated. We questioned how that information is updated and whether on the PIF there is any information that pertains to the criteria.

Discussion on Data Gathering

We talked about using AFS/PAAS data as the starting point for the benchmark criteria. What can we get off AFS?

Comparability criteria that is not considered when using AFS/PAAS data only (assume that SA info is correct)
- --pricing components
- --market(s) served (unless we consider the purchaser the market)
- --terms
- --quality (not considering Btu content)

Questionable items we need to check with DMD about
- --time of execution (on selling arrangement)
- --duration of contract

On STATSS, the Corporate Reporter (Main menu) payor code, phone number, address, is available. Is this information current/useful?

Houston Audit Procedure

Mike has a lot of input on auditing the first benchmark based on the method his office uses. He got his office to fax some of the audit procedures they use when auditing. We thought it would be a good exercise to see how he addresses benchmark problems.

Gather background data on company prior to entrance conference.
Look at 10K
- -Will help identify affiliates
- -available at library or company

Download lease information for payor
- -royalty data for audit period

Identify NAL sales
- -through prior audit information
- -From STATSS information (SA)

MMS report of affiliates
- -Is this current

Entrance conference
Ask company to support what they put on the 2014.
- -Who do they sell to
  - --If to their affiliate is the affiliate a marketing affiliate under MMS rules
  - --This will indicate they should have used benchmarks
- -How do they value production

Ask for list of leases with NAL sales/transfers

Ask about access issues
- -Company people
- -Time
- -Records

Audit work
Verify information

Ask other residency audits for non-affiliated AL contracts

Ask affiliate for other AL sales info
- -If no disparity in prices, ok
- -If there is disparity, ask for contracts

Other AFS data

Use the SRH 800, 801 to dump attributes such as: volume, value, royalty, AL/NAL, product, processed/unprocessed, allowances.

Lease characteristics such as: variable royalty rate, Fed/Ind.

Policy: FERC 94

Short discussion on oil
Should we do the same prioritizing?

What about premiums?

Jack gave out notice soliciting comments on oil postings, premiums, and significant quantities (written by EVB, Dave Hubbard)

We decided to wait and see how gas prioritizing goes, then use same system for oil

ACTION ITEMS FOR NEXT MEETING

1. Gather appeal information
2. Gather case studies on benchmarks (audit examples)
3. Interviews
4. Check with DMD on the reliability of reference data, especially selling arrangement info
5. Check on reliability of affiliate reports on STATSS
6. Find any relevant valuation decisions on benchmarks

Next meeting November 14 and 15, 1995.

END OF MEETING

Comparability Factors
NON-ARM'S-LENGTH VALUATION PROCEDURE

COMPANY BACKGROUND

Identify company affiliates

- -- Corporate reports
- -- Annual reports
- -- Company 10-K
- -- Penwell directories
- -- Past audit work

Identify non-arm's-length lease sales

- -- From prior audit
- -- By researching STATSS/BIS data using both royalty and reference data

DATA REQUIRED FROM COMPANY

Ask company to identify its affiliates

Ask company to identify its non-arm's-length lease sales

Ask company to explain its valuation procedure for its non-arm's-length contracts for unprocessed gas and processed gas

ANALYZE THE NON-ARM'S-LENGTH PROCEDURE/PROCESS/INTERNAL CONTROL

Analyze the company's valuation procedure for compliance with:

Lease terms

Regulations

Current policy papers

SELECT LEASE SAMPLE AND TEST FOR COMPLIANCE

Review the contract(s) that the company used for their non-arm's-length valuation.

Verify the company's compliance with contract terms and company procedure

Get affiliate's contract and/or other arm's-length contracts in the field or area from:

- -- affiliate
- -- other MMS audit offices
- -- 202/205 STRAC auditors
- -- State Land Commission
- -- other if payors

DECISION
Sufficient number of contracts are obtainable: Go to Benchmark Procedure

Contracts are unavailable: Go to STATSS/BIS Data Procedure
BENCHMARK PROCEDURE

In evaluating the comparability of arm's-length contracts, any of the following factors can be considered, but not all are necessarily required. Auditor judgment will prevail.

Volume and Quality

Markets served

Duration and time of contract

Price, terms, and other appropriate factors

Reference: "Policy Paper, Valuation of Sales to Affiliates"
Two Cason Memos dated October 14, 1988, and December 12, 1988STATSS/BIS DATA PROCEDURE

This procedure is an alternate approach that can be used when contract or other actual price data is unavailable from the company for the field or area. This procedure will aid the auditor in determining if the lessee's non-arm's-length value is comparable to other arm's-length transactions reported by other payors in the field or area.

Determine payors with arm's-length sales in the field or area (other payors on the same lease)

Calculate price for the identified arm's-length sales

Consider the comparability criteria outlined under BENCHMARK PROCEDURE to determine if non-arm's-length price falls within the range of reported arm's-length prices