United States Department of the Interior

MINERALS MANAGEMENT SERVICE
Royalty Management Program
P.O. Box 25165
Denver, Colorado 80225-0165

IN REPLY REFER TO

APR 22 1996

Dear Operator/Payor:

The Minerals Management Service (MMS) has received many questions, primarily from producers in the vicinity of New Mexico's San Juan Basin, on how to report and pay royalties on coalbed methane. The following guidelines answer those questions.

These guidelines apply to coalbed methane produced from Federal and Indian leases. You must follow these guidelines to ensure proper payment of royalties and correct reporting of production. They apply specifically to circumstances where carbon dioxide (CO_2) is removed from produced coalbed methane and is vented without sale.

Valuing Production

<u>Sales at the wellhead or CDP</u>

If you sell your coalbed methane at the wellhead or a central delivery point (CDP) in the field or unit, you must value the coalbed methane as unprocessed gas under 30 CFR § 206.152 (1995).

For arm's-length sales, value for royalty purposes will be the gross proceeds you receive under your arm's-length contract. However, that value cannot be reduced, either directly or indirectly, for the costs of placing coalbed methane in marketable condition. Placing production in marketable condition includes, but is not limited to, CO_2 removal (commonly called sweetening). Under 30 CFR § 206.152(I), if your sales price is reduced by fees for services to place production in marketable condition, either directly or indirectly, you must add that portion of the fees attributable to those services, including CO_2 removal, to your gross proceeds received from the sale of the coalbed methane to determine value for royalty purposes. If you pay a bundled fee for both CO_2 removal and transportation, we recognize that you may be unable to obtain the information necessary to segregate the CO_2-removal costs. If you are in this situation, contact the MMS' Valuation and Standards Division at 303-275-7240 for assistance in determining the portion of your service fees attributable to CO_2 removal.

For non-arm’s-length sales, you must determine the value of the coalbed methane under the methods (benchmarks) described at 30 CFR § 206.152(c). Again, you cannot deduct costs of placing the coalbed methane in marketable condition. You must ensure that any value determined under the methods is not improperly adjusted for nonallowable costs.

For Indian leases, you must also meet the dual accounting and majority price requirement established by regulation and lease terms. However, for both Federal and Indian leases, under no circumstances can the value of the production for royalty purposes be less than the gross proceeds accruing to the lessee, less applicable allowances.

Sales at the CO_2-removal facility

If you sell your coalbed methane at the tailgate of a CO_2-removal or other treating facility, you must value it as unprocessed gas under 30 CFR § 206.152. For arm’s-length sales, value will be your gross proceeds under the arm’s-length contract. For non-arm's-length sales, you must determine the value of the coalbed methane under the benchmarks at 30 CFR § 206.152(c). You cannot deduct costs of removing the CO_2 or otherwise placing the coalbed methane in marketable condition. However, you can deduct costs of transportation as discussed below.

Determining Allowable Deductions From value

Transportation allowances

You can take a transportation allowance for your reasonable, actual, and necessary costs of transporting the coalbed methane from the royalty measurement point (either the wellhead or the CDP) to the point of sale remote from the lease. You must use the regulation in 30 CFR § 206.156 and 206.157 (1995) and the instructions in Chapter 6 of the *Oil and Gas Payor Handbook, Volume III,* to calculate your transportation allowance.

In general, the regulations state that (1) you must allocate your transportation charges to all products produced and transported, and (2) you can only deduct the allocated costs from the value of products that are royalty bearing. For coalbed methane production, you can increase the transportation costs allocated to the methane component for the amount of CO_2 permitted in the main (inter- or intrastate) transmission line. For example, if your gas stream consists of 90 percent methane and 10 percent CO_2 and the main transmission line allows 2 percent CO_2 in the makeup of its gas stream, you can include the costs of transporting the 2 percent CO_2 volume (or 92 percent of the total transportation cost) when calculating your allowance for methane.

You can include costs of dehydration occurring after metering at the royalty measurement point in your transportation allowance but you cannot deduct costs of dehydration occurring at the wellhead. You can include costs for compression occurring downstream of the royalty measurement point, to the extent the compression is necessary for transportation. This includes compression at the CDP and in the transportation system to the CO_2-removal facility. You cannot include those compression costs associated with production operations.

You must convert any payment for transportation that is made in-kind for dehydration and allowable compression to a dollar equivalent and include this amount in the transportation allowance deduction. You must allocate transportation costs for any allowable dehydration and compression (either in-value or in-kind) between the methane and CO_2 in the came manner as the in-value transportation cost.

You cannot include the costs of removing CO_2 as part of your transportation allowance. If you pay a bundled fee for both transportation and CO_2 removal and are unable to segregate the fee between these two cervices, the MMS’ Valuation and Standards Division will help you determine the proper portion attributable to transportation.

<u>Processing allowances</u>

You cannot take a proceeding allowance for your costs of removing CO_2.

<u>Other deductions</u>

You cannot include any costs associated with moving the production from the wellhead to the CDP (gathering) when the Bureau of Land Management (BLM) has approved the CDP as the royalty measurement point.

You cannot include any costs associated with wellhead separation.

Reporting Production

For each lease or agreement producing coalbed methane, you must report the total volume of gas measured at the BLM-approvsd royalty measurement point on the Monthly Report of Operations (Form MMS-3160) as a Gas Transfer. Report the four-digit gas plant number and name of the plant receiving the largest volume of gas from the property (if gas is being transferred to more than one plant) in the Plant Number/Name field. If you are using additional plants for CO_2 removal, identify the other plant(s) in the Comments section.

Report the Btu content of the gas, as determined at the royalty measurement point, on the API Gravity/Btu Content line. Report the percentage of CO_2 in the gas stream, as measured at the royalty measurement point, in the Comments section.

If you report gas as Used on or for Benefit of Lease, you must be consistent with the approvals of BLM. Do not include any gas used off-lease for compression, dehydration, or CO_2 removal unless specifically approved by BLM.

Reporting Royalty

For each lease/revenue source combination, you must report the allocated share of the total volume of gas determined at the BLM-approved royalty measurement point in the Sales Quantity field on the Report of Sales and Royalty Remittance (Form MMS-2014). Report the gas as unprocessed gas (Product Code 04) using Transaction Code 01, Royalty Due. Report the Btu content of the gas, as determined at the royalty measurement point, in the Quality Measurement field.

Base the value reported in the Sales Value field on the criteria described in the Valuing Production section of this letter.

Report transportation allowances against Product Code 04 using Transaction Code 11.

If you have any questions about production or royalty reporting, contact the MMS Reports Branch at 800-525-0309 or 303-231-3288.

Sincerely,

Robert E. Brown
Acting **Associate Director for Royalty Management**