United States Department of the Interior

OFFICE OF NATURAL RESOURCES REVENUE

P.O. Box 25165
Denver, Colorado 80225-0165

OCT 0 6 2010

RE: GUIDANCE ON VALUING GAS FOR ROYALTY PURPOSES - TRANSPORTATION SYSTEMS AND PROCESSING PLANTS - ONSHORE FEDERAL LEASES

Dear Reporter:

The Office of Natural Resources Revenue (ONRR) is providing guidance for federal royalty payors in situations where they are assessed a combined contract rate for a variety of services (bundled rate) under their arm's-length contracts with third-party service providers. The ONRR is publishing "Annual Factors" that represent the percentage of the arm's-length rate that may be deductible as a cost of transportation and/or processing at certain facilities. The ONRR will publish Annual Factors on our website at www.onrr.gov/unbundling/. Currently, the website provides Annual Factors for the following transportation systems and/or processing plants:

- Williams Manzanares Transportation System
- Williams Torre Alta Transportation System – Kutz Plant
- Williams Torre Alta Transportation System – Lybrook Plant
- Williams San Juan Conventional Transportation System – Ignacio Plant
- ConocoPhillips San Juan (Blanco) Plant

Service providers typically perform a range of services that include allowable transportation and/or processing costs and non-allowable costs related to functions necessary to place production in marketable condition such as gathering, dehydration, compression, and sweetening. Contracts may specify various rates or fees that combine both allowable and non-allowable costs. This guidance provides a method to determine the percentage of these fees that ONRR considers deductible as transportation or processing costs. This letter only applies to you if your company is currently using bundled transportation or processing contracts.

The regulations at 30 CFR § 1206.151 (2010) (formerly 30 CRF § 206.151) define "marketable condition" as "lease products which are sufficiently free from impurities and otherwise in a

condition that they will be accepted by a purchaser under a sales contract typical for the field or area." A "transportation allowance" is "an allowance for the reasonable, actual costs of moving unprocessed gas, residue gas, or gas plant products to a point of sale or delivery off the lease, unit area, or communitized area, or away from a processing plant. The transportation allowance does not include gathering costs." Processing is "any process designed to remove elements or compounds (hydrocarbon and nonhydrocarbon) from gas, including absorption, adsorption, or refrigeration. Field processes which normally take place on or near the lease, such as natural pressure reduction, mechanical separation, heating, cooling, dehydration, and compression, are not considered processing." The regulations at 30 CFR § 1206.158(d)(1) (formerly 30 CFR § 206.158(d)(1)) further clarify that "except as provided in paragraph (d)(2) of this section, no processing cost deduction shall be allowed for the costs of placing lease products in marketable condition, including dehydration, separation, compression, or storage, even if those functions are performed off the lease or at a processing plant. Where gas is processed for the removal of acid gases, commonly referred to as 'sweetening', no processing cost deduction shall be allowed for such costs unless the acid gases removed are further processed into a gas plant product. In such event, the lessee shall be eligible for a processing allowance as determined in accordance with this subpart. However, MMS [*sic*] will not grant any processing allowance for processing lease production which is not royalty bearing."

Non-deductible marketable conditioning costs would include the costs of compression and dehydration necessary to meet the requirements of the pipeline serving the market into which the gas is typically sold. These costs may be incurred downstream of the Bureau of Land Management-approved royalty measurement point. Non-deductible marketable condition costs may also include removal of non-royalty-bearing carbon dioxide from coal bed methane gas or boosting of residue gas at a processing facility (See 30 CFR § 1202.151(b)) (formerly 30 CFR § 202.151(b)). Once gas reaches marketable condition, costs of further compression, dehydration, or functions required during processing would generally be deductible.

The ONRR allocates costs that are deductible as either a transportation or processing allowance and non-deductible costs associated with placing production into marketable condition, using the same methodology as that affirmed by the decision in *Devon Energy Corp. v. Kempthorne*, 551 F.3d 1030 (D.C. Cir. 2008). ONRR obtains the best available cost information, including actual or replacement costs where practicable, from the service providers and determines the proportion of allowable costs. This information may include capital costs or operating and maintenance costs, overhead, depreciation, and return on investment for the various components comprising the transmission and/or processing facilities.

The ONRR allocates costs between system and facility components associated with deductible transportation or processing functions, and components associated with non-deductible marketable condition functions to derive the Annual Factors. For royalty computation purposes, you would multiply the Annual Factor by the bundled arm's-length contract rate levied by the service provider. The resulting value of the transportation and processing deductions remain subject to the allowance limitations at 30 CFR §§ 1206.156 (c) and 1206.158(c) (formerly 30 CFR §§ 206.156 (c) and 206.158(c)).

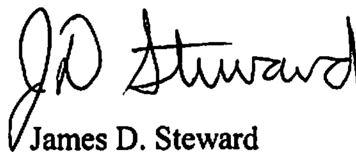
The ONRR website includes more detailed information and examples of how Annual Factors are applied. The ONRR periodically may revise the Annual Factors based upon available or updated information obtained from service providers and will update the website accordingly.

This letter does not require you to perform any form of restructured accounting or to recalculate and pay royalties. This letter serves as guidance for determining appropriate transportation and processing allowances in computing Federal royalties and is not an appealable decision or order under 30 CFR Part 1290, Subpart B (formerly 30 CFR Part 290, Subpart B). If ONRR issues you an order or assesses civil penalties under 20 CFR Part 1241 (formerly 30 CFR Part 241) at a later date based on this guidance, your appeal rights will be provided at that time. While this letter is not appealable, ONRR may use the factors provided under this guidance in conducting audits and as a basis for demanding additional royalties.

Please note that the citations to regulations are for the current versions. If these change, please use the most recent applicable version. If you have questions regarding a specific situation involving movement of your gas production through a bundled system, you may submit a request for a valuation determination under 30 CFR §§ 1206.152(g) or 1206.153(g) (formerly 30 CFR §§ 206.152(g) or 206.153(g)) to:

Asset Management
Attn: Lawrence Cobb
Office of Natural Resources Revenue
Royalty Valuation
P.O. Box 25165
MS 61112B
Denver, CO 80225-0165

Sincerely,



James D. Steward
Program Director, Asset Management
Office of Natural Resources Revenue