Barton, Jayne

From:	Loomis, F David
Sent:	Friday, November 21, 2003 2:45 PM
To:	Burhop, Shirley; MRM/Bldg. 85 Mile High Room, Room F201B; Johnson, Brian C; Soderlind, Ellwood; Loomis, F David; Staigle, George; Kepler, Glenn; Kirumakki, Nagaraja; Rodriguez, Nancy; Shirley, Perry; Teel, Sara; tfisher@washakie.net; Summers, Dana; Conway, Karen
Subject:	RE: Development of training and guidance
Attachments:	FINA and Gas Benchmark analysis Nov 21 2003.doc

FINA and Gas Benchmark analysi..

Attached is a file with Karen Conway's analysis on the Fina case and benchmark discussion for gas.
Please let me know what you think.
Karen has my thanks and appreciation for putting this together for us.

Also, for those who want to open the scanned files from MMS, the web site to download the program is:
www.scansoft.com/paperport/viewers
My thanks to Ken Vogel, Brenda Petersen, and Dana Summers for this information.

Dave

-----Original Message-----
From: Shirley.Burhop@mms.gov [mailto:Shirley.Burhop@mms.gov]
Sent: Friday, November 21, 2003 12:45 PM
To: MileHighRoom@mms.gov; Brian.C.Johnson@mms.gov; esoderlind@wyaudit.state.wy.us; dloomis@spike.dor.state.co.us; georgestaigle.mms@midconetwork.com; Glenn.Kepler@mms.gov; Nagaraja.Kirumakki@mms.gov; nrodriguez@state.nm.us; pshirley@frontiernet.net; sara.teel@mms.gov; tfisher@washakie.net
Subject: Development of training and guidance

When: Monday, December 01, 2003 1:00 PM-2:30 PM (GMT-07:00) Mountain Time (US & Canada).
Where: Mile High Room

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Hopefully, we will have had a chance to review Karen Conway's paper by then.

November 21, 2003

From: Karen Conway, State of Colorado
To: MMS and STRAC
Subject: Fina and the Benchmarks

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

1. Does the Fina decision impact the application of the gas benchmarks?
    - Because the Fina audit was assessed under the marketing affiliate resales Sec. 206.151, and the related company was a non-marketing affiliate, i.e. purchased from other companies, the benchmarks must apply.
    - The result is that when one Mcf of gas is purchased from an unrelated company the benchmarks must be used.
2. Does this limit the valuations 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.

Benchmark Analysis

(November 21, 2003)

Unprocessed gas

Regulation:

[Code of Federal Regulations]
[Title 30, Volume 2]
[Revised as of July 1, 2001]
Subpart D--Federal Gas

Sec. 206.**152** Valuation standards--unprocessed gas.

(c) The value of gas subject to this section which is not sold pursuant to an arm's-length contract shall be the reasonable value determined in accordance with the first applicable of the following methods:

First benchmark:

(1) The gross proceeds accruing to the lessee pursuant to a sale under its non-arm's-length contract (or other disposition other than by an arm's-length contract), provided that those gross proceeds are equivalent to the gross proceeds derived from, or paid under, comparable arm's-length contracts for purchases, sales, or other dispositions of like-quality gas in the same field (or, if necessary to obtain a reasonable sample, from the same area). In evaluating the comparability of arm's-length contracts for the purposes of these regulations, the following factors shall be considered: price, time of execution, duration, market or markets served, terms, quality of gas, volume, and such other factors as may be appropriate to reflect the value of the gas;

First Valuation Benchmark from the Oil and Gas Payor Handbook, January 1994, unprocessed gas.

Comparability:

- First, use contracts where sellers and purchasers are not affiliated with lessee
- Second, use contracts where sellers are not affiliated with the lessee but purchasers are
- Price
- Time of execution
- Duration of contract
- Market or markets served
- Terms
- Quality of the gas
- Volume
- Other appropriate factors

Equivalency is based on the lowest-priced comparable arm's-length contract.

Analysis

For example:

- Compare company non-arm's-length (NAL) price to Arm's-length (AL) prices in the field or area. If the NAL price is greater than or equal to the lowest price of a comparable AL contract and the price, time of execution, duration of contract, market, terms, quality and volume of gas are equivalent, then the price is acceptable.

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

Second Benchmark:

(2) A value determined by consideration of other information relevant in valuing like-quality gas, including gross proceeds under arm's-length contracts for like-quality gas in the same field or nearby fields or areas, posted prices for gas, prices received in arm's-length spot sales of gas, other reliable public sources of price or market information, and other information as to the particular lease operation or the saleability of the gas; or

Second Valuation Benchmark from the Oil and Gas Payor Handbook, January 1994, unprocessed gas.

Used when:

- Lessee's gross proceeds are not equivalent
- Lessee receives no consideration for its gas

Criteria can include:

- Gross proceeds under arm's-length contracts in the field or area
- Published prices
- Spot prices
- Other reliable public sources of price or market information
- Information relevant to that particular lease or saleability of the lessee's gas

Selected criteria should:

- Closely reflect the lessee's circumstances
- Be the most relevant factor

Lessee must notify MMS

Analysis

For example:

- 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.

- For instance, there is no long-term contract for the field or area and the company contract is long-term, then gross proceeds under short term arm's-length contracts in the field or area may be used. Published prices; spot prices to other reliable public sources of price; or market information; or other relevant information may be used.

- If there is a company that is non-arm's-length 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 arm's-length prices in the field or area. This may not be a valid pricing method if this is a captive market.

Third benchmark:

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

Third Valuation Benchmark from the Oil and Gas Payor Handbook, January 1994, unprocessed gas.

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

Analysis

For example:

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

Maximum price regulation, not applicable at the moment:

d)(1) Notwithstanding any other provisions of this section, except paragraph (h) of this section, if the maximum price permitted by Federal law at which gas may be sold is less than the value determined pursuant to this section, then MMS shall accept such maximum price as the value. For purposes of this section, price limitations set by any State or local government shall not be considered as a maximum price permitted by Federal law.

Warranty contract only, warranty contract regulation:

2) The limitation prescribed in paragraph (d)(1) of this section shall not apply to gas sold pursuant to a warranty contract and valued pursuant to paragraph (b)(2) of this section.

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)

Observation:

Many companies are using the Fina decision to refuse to provide contracts. According to Sec. 206.152 (e) (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 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.

Processed gas

Regulation:

[Code of Federal Regulations]
[Title 30, Volume 2]
[Revised as of July 1, 2001]
Subpart D--Federal Gas

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:

First benchmark:

(1) The gross proceeds accruing to the lessee pursuant to a sale under its non-arm's-length contract (or other disposition other than by an arm's-length contract), provided that those gross proceeds are equivalent to the gross proceeds derived from, or paid under, comparable arm's-length contracts for purchases, sales, or other dispositions of like quality residue gas or gas plant products from the same processing plant (or, if necessary to obtain a reasonable sample, from nearby plants). In evaluating the comparability of arm's-length contracts for the purposes of these regulations, the following factors shall be considered: price, time of execution, duration, market or markets served, terms, quality of residue gas or gas plant products, volume, and such other factors as may be appropriate to reflect the value of the residue gas or gas plant products;

First Valuation Benchmark from the Oil and Gas Payor Handbook, January 1994, processed gas.

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

Comparability:

- First, use contracts where sellers and purchasers are not affiliated with the lessee
- Second, use contracts where sellers are not affiliated with the lessee but purchasers are
- Price
- Time of execution
- Duration of contract
- Market or markets served
- Terms
- Quality of the gas and products
- Volume

- Other appropriate factors

Equivalency is based on the lowest-priced comparable arm's-length contract.

Analysis

For example:

- Compare company non-arm's-length (NAL) price to Arm's-length (AL) prices at the plant. If there are no AL prices at the plant then nearby plants may be used. If the NAL price is greater than or equal to the lowest price of a **comparable** AL contract and the price, time of execution, duration of contract, market, terms, quality and volume of gas are equivalent, then the price is acceptable.

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

Second benchmark:

> (2) A value determined by consideration of other information relevant in valuing like-quality residue gas or gas plant products, including gross proceeds under arm's-length contracts for like-quality residue gas or gas plant products from the same gas plant or other nearby processing plants, posted prices for residue gas or gas plant products, prices received in spot sales of residue gas or gas plant products, other reliable public sources of price or market information, and other information as to the particular lease operation or the saleability of such residue gas or gas plant products; or

Second Valuation Benchmark from the Oil and Gas Payor Handbook, January 1994, processed gas.

Other relevant information

Used when:

- Lessee's gross proceeds are not equivalent
- 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 in the field or area
- Published prices
- Spot prices
- Other reliable public sources of price or market information
- Information relevant to that particular lease or salability of lessee's gas and plant products

Selected criteria should:

- Closely reflect the lessee's circumstances
- Be the most relevant factor

Lessee must notify MMS

Analysis

For example:

- A value determined by consideration of other information relevant in valuing like-quality residue gas and plant products, including gross proceeds under arm's-length contracts for like-quality gas in the same field or nearby fields or areas at the plant or a near by plant. This includes a related company's arm's-length sales.

- Residue gas or gas plant products published prices; spot prices to other reliable public sources of price; or market information; or other relevant information may be used.

Third benchmark:

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

Third Valuation Benchmark from the Oil and Gas Payor Handbook, January 1994, processed gas.

Determined on a case-by-case basis

Lessee must notify MMS

Analysis

For example:

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

Maximum price regulation, not applicable at the moment:

(d)(1) Notwithstanding any other provisions of this section, except paragraph (h) of this section, if the maximum price permitted by Federal law at which any residue gas or gas plant products may be sold is less than the value determined pursuant to this section, then MMS shall accept such maximum price as the value. For the purposes of this section, price limitations set by any State or local government shall not be considered as a maximum price permitted by Federal law.

Warranty contract only, warranty contract regulation:

(2) The limitation prescribed by paragraph (d)(1) of this section shall not apply to residue gas sold pursuant to a warranty contract and valued pursuant to paragraph (b)(2) of this section.

Further valuation regulations for processed gas:

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

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

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

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

If the lessee is entitled to a credit, MMS will provide instructions for the taking of that credit.

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

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

(Bold added for emphasis)

Observation:

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 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 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.

Observation:

According to Sec. 206.153 (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. 206.152 (i)(2) as well. Ultimately if non-arm's-length contracts or arm's-length contracts reduce the value because of these costs then the value will be increased. (See MMS-89-0189-O&G, Xeno, Inc)

Benchmarks and Pop Contract Analysis

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

Arm's-Length:

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

Non-Arm's-Length

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

Source: MMS Memorandum dated August 19, 1994 with attached Policy Paper outlining the application of the valuation regulations for gas sold under a POP contract.

History:

Federal Gas Valuation Negotiated Rulemaking Committee:

The rule did not become effective.

MMS & States proposed rulemaking

a. The weighted average of gross proceeds paid under comparable arm's-length contracts (without any deductions for marketing or placing production in marketable condition) in the field or area between third parties and the lessee or its affiliate; i.e. arm's-length contracts to which the lessee or its affiliate have access. In order to assure that the arm's-length contracts are arrived at in a free and open market, at least 50 percent of the lessee's or affiliate's purchases in the field or area must be under arm's length contracts in order for this benchmark to be used. In evaluating the comparability of arm's-length contracts the following factors will be considered:
   - Place of sales
   - Time of sale
   - Duration of contract
   - Volume

   A comparable arm's-length contract by volume will be one whose volume is within plus or minus 20 percent of the volume sold pursuant to the non-arm's-length sales being evaluated.

b. The first bona fide arm's-length sale of the production by the affiliate.

c. Other relevant matters including, in the following order:

i. Gross proceeds paid under comparable arm's-length contracts in the same field or nearby fields,
ii. Prices reported to FERC or the relevant public utility commission,
iii. Netback method, or
iv. Any other reasonable method to determine value.

MMS and States modified original proposal by the following benchmarking:

a. Other arm's-length sales by the lessee in the field/area.
b. Other arm's-length purchases by the lessee's affiliate in the field/area.
c. Affiliate's arm's-length resale values (excluding direct sales to residential customers).
d. Other relevant matters.