Barton, Jayne

From: Conway, Karen
Sent: Tuesday, November 25, 2003 6:50 AM
To: Burhop, Shirley
Subject: RE: Development of training and guidance

Attachments: BenchmarksAnalysis.doc

BenchmarksAnalysis.doc (75 KB)...

Sometimes it is difficult to find the arm's-length contracts and or to get them from the company. But, I have gotten them from all companies except one and that particular company had other contracts with companies under audit that I can use. I believe that we can require the company to provide us with the contracts if they have any in the field or area under 206.152
(e)(2)(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.

-----Original Message-----
From: Shirley.Burhop@mms.gov [mailto:Shirley.Burhop@mms.gov]
Sent: Monday, November 24, 2003 5:09 PM
To: dloomis@spike.dor.state.co.us; MileHighRoom@mms.gov; Brian.C.Johnson@mms.gov; esoderlind@wyaudit.state.wy.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; dsummers@spike.dor.state.co.us; kconway@spike.dor.state.co.us
Subject: RE: Development of training and guidance

This is a great start. One big question that comes to my mind is "how far must the auditor go in trying to obtain comparable arm's length contracts?"
I think we will need to discuss that as part of this project.

-----Original Message-----
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

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

~~*~*~*~*~*~*~*~*

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

Benchmark Analysis

(November 21, 2003)

[Code of Federal Regulations]
[Title 30, Volume 2]
[Revised as of July 1, 2001]
Subpart B--Indian Oil

Sec. 206.52 Valuation standards.

(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:

(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;

(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);

(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;

(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;

(5) A net-back method or any other reasonable method to determine value;

(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 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.

(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.

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

Subpart C--Federal Oil

(b) Production from leases in the Rocky Mountain Region. This paragraph provides methods and options for valuing your production under different factual situations.

(1) If you have an MMS-approved tendering program, value your oil under paragraph (b)(2) of this section. If you do not have an MMS-approved tendering program, you may value your oil under either paragraph (b)(3) or paragraph (b)(4) of this section.

(i) You must apply the same subparagraph of this section to value all of your production from the same unit, communitization agreement, or lease (if the lease is not part of a unit or communitization agreement) that you cannot value under Sec. 206.102 or that you elect under Sec. 206.102(d) to value under this section.

(ii) After you select either paragraph (b)(3) or (b)(4) of this section, you may not change to the other method more often than once every 2 years, unless the method you have been using is no longer applicable and you must apply one of the other paragraphs. If you change methods, you must begin a new 2-year period.

(2) If you have an MMS-approved tendering program, the value of production from leases in the area the tendering program covers is the highest winning bid price for tendered volumes.

(i) You must offer and sell at least 30 percent of your production from both Federal and non-Federal leases in that area under your tendering program.

(ii) You also must receive at least three bids for the tendered volumes from bidders who do not have their own tendering programs that cover some or all of the same area.

(iii) MMS will provide additional criteria for approval of a tendering program in its ``Oil and Gas Payor Handbook."

(3) Value is the volume-weighted average gross proceeds accruing to the seller under your and your affiliates' arm's-length contracts for

the purchase or sale of production from the

field or area during the production month. The total volume purchased or sold under those contracts must exceed 50 percent of your and your affiliates' production from both Federal and non-Federal leases in the same field or area during that month. Before calculating the volume-weighted average, you must normalize the quality of the oil in your or your affiliates' arms-length purchases or sales to the same gravity as that of the oil produced from the lease.

(4) Value is the average of the daily mean spot prices published in any MMS-approved publication for WTI crude at Cushing, Oklahoma, during the trading month most concurrent with the production month. (For example, if the production month is June and the trading month is May 26--June 25, compute the average of the daily mean prices using the daily Cushing spot prices published in the MMS-approved publication for all the business days between and including May 26 and June 25.)

(i) Calculate the daily mean spot price by averaging the daily high and low prices for the period in the selected publication.

(ii) Use only the days and corresponding spot prices for which such prices are published.

(iii) You must adjust the value for applicable location and quality differentials, and you may adjust it for transportation costs, under Sec. 206.112.

(iv) After you select an MMS-approved publication, you may not select a different publication more often than once every 2 years, unless the publication you use is no longer published or MMS revokes its approval of the publication. If you are required to change publications, you must begin a new 2-year period.

(5) If you demonstrate to MMS's satisfaction that paragraphs (b)(2) through (b)(4) of this section result in an unreasonable value for your production as a result of circumstances regarding that production, the MMS Director may establish an alternative valuation method.

Sec. 206.103 How do I value oil that is not sold under an arm's-length contract?

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:

(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

For example:

1. 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. If not then go to the 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:

- Lesse' 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 salability of the lessee' s gas

Selected criteria should:

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

Lessee must notify MMS

For example:

1. There is not 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; published prices; spot prices to other reliable public sources of price; or market information; or other relevant information may be used.
2. 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.

(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

(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.

(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.

(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.

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:

(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.

(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

(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

(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.

(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.

(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

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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.

(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.

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.

Processed Gas Benchmarks:

§206.153(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:

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

Therefore the first benchmark would consider the gross proceeds accruing to the lessee under its non-arms-length contract. The gross proceeds must be equivalent to the gross proceeds from a comparable arm's-length contract for purchases or sales of like-quality products from the same plant or nearby plant. The price, time market, terms, and quality shall be considered. If these factors are comparable, then arm's-length contracts can be used.

If this criteria is not met then benchmark 2 would apply and this allows for value to be determined by consideration of other information such as gross proceeds under arm's-length contracts for like quality products in the same plant or nearby plants, posted prices, spot sales prices, public sources of price or market information for the lease operation.

If these criteria are not met then benchmark 3 would apply and this allows for a net-back method or reasonable method to determine value.

Federal Gas Valuation Negotiated Rulemaking Committee:

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.

The rule did not become effective.