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David S. Guzy
Chief, Rules and Procedures Staff
Royalty Management Program
Minerals Management Service
P.O. Box 25165
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Dear Mr. Guzy:

Enclosed please find Natural Gas Supply Association's (NGSA) comments pursuant to Federal Register Notices of November 6, 1995, May 21, 1996, and July 22, 1996. The enclosed comments represent an extraordinary amount of effort by NGSA member companies, and we file them today for the record.

The Consensus Rule adopted by the Federal Gas Valuation Negotiated Rulemaking Committee reflects a balanced compromise among parties with diverse and vested interests. As a consequence, any final rule adopted should not deviate significantly from that agreement.

NGSA also endorses MMS Option 1, as modified by industry. We believe that the adoption of this option is small deviation from the Consensus Rule and also achieves simplification and clarifies the current valuation standards. Implementation of this proposal as the Consensus Rule would reduce the administrative burden imposed on producers and give validity to the negotiated rulemaking process, to which our members have devoted so much effort.

If MMS concludes that it must depart from the Consensus Rule in order to address adequately the concerns raised by certain comments on that proposed rule, then NGSA urges MMS to adopt one of the Unified Industry Proposals, as more fully explained in these attached comments. All segments of the industry worked extensively together to develop these measures to meaningfully address all concerns raised in the public comments on the Consensus Rule. The resulting Unified Industry Proposals are unanimously supported by all segments of the industry and would, if adopted, achieve a workable index-based valuation system.

Given the changing nature of the natural gas industry and the uncertainty that looms under the current valuation regulations, it is imperative that the MMS issue a final rule as expeditiously as possible.

Sincerely,

Patricia A. Hammick

Patricia A. Hammick, Ph.D.

Enclosure

BEFORE THE
DEPARTMENT OF INTERIOR
MINERALS MANAGEMENT SERVICE

In Re: Amendments to Gas Valuation Regulations for Federal Leases
30 CFR Parts 202, 206 and 211
RIN 1010-AC02

COMMENTS OF THE NATURAL GAS SUPPLY ASSOCIATION

The Natural Gas Supply Association (NGSA), is a trade association representing natural gas producers who produce and market the majority of the natural gas produced on Federal leases. Established in 1965, NGSA encourages expanded use of natural gas and a regulatory climate that fosters competitive markets. NGSA believes that its comments should be afforded significant weight in this proceeding, for of the approximate 2200 Federal royalty payors affected by this rule, NGSA speaks for a majority of the affected production. NGSA has participated actively in this proceeding. Through its representative in the Federal Gas Valuation Negotiated Rulemaking Committee (Committee), it has contributed to devising the proposed valuation rule which was noticed for public comment in the Federal Register on November 6, 1995 (hereinafter the "Consensus Rule") by the Minerals Management Service (MMS). It filed written comments in support of the Consensus Rule, and within the recently reconvened Committee session, worked with other industry representatives to develop a number of alternative Unified Industry Proposals for MMS' consideration.

Because NGSA's membership continues to believe establishing a viable Index based gas valuation method is critical to the future health and stability of their domestic gas producing businesses, NGSA submits these comments on MMS' proposed five options, and also comments on the additional options developed in the June 12 - 14, 1996 reconvened Committee session.

<u>Preface / Procedural Background</u>

On May 21, 1996, the MMS issued a Federal Register Notice reopening the public comment period in this matter. Specifically, the agency requested written comments by July 22, 1996 on five MMS devised alternative options for proceeding to a final rulemaking on gas valuation. Subsequently, the MMS extended the time period until August 19, 1996 in a Notice published in Federal Register on July 22, 1996 (61 FR 37865). The MMS developed these five options ostensibly in response to certain adverse written public comments it had received on the Consensus Rule, which had received support from producers representing the overwhelming majority of gas produced on Federal leases.

This Consensus Rule was the consensus recommendation of the Committee. The Committee (consisting of representatives of a broad spectrum of the natural gas industry, MMS staff, and auditors from certain States in which Federal gas leases are located) was originally formed in December, 1993, as an informal group to study the benchmark system and later expanded its scope to include valuation of Federal gas production under arm's-length contracts. In June, 1994, the informal study group was convened at the direction of the Secretary of Interior as the Federal Gas Valuation Negotiated Rulemaking Committee to continue to respond to widespread disagreement over the MMS's current gross proceeds and benchmarking valuation standards, and to a perceived need to clarify those standards and end confusion over their application. These standards have become increasingly unworkable for many producers marketing gas in the post Federal Energy Regulatory Commission (FERC) Order No. 636 marketplace, and difficult for MMS auditors to apply. Members of the Committee worked steadily for 14 months to prepare the Consensus Rule. Many hours and travel budget dollars were spent in the Committee's effort to study, develop and negotiate a workable alternative to the gross proceeds and benchmarking valuation standards. This alternative would allow valuation based upon publicly available published market prices, i.e. Index Pricing.

Although the vast majority of significant Federal royalty payors expressed support for the Consensus Rule, either through their company specific written comments or through their trade association comments, certain negative comments and concerns were filed. The MMS apparently attached great weight to at least certain of these criticisms, because it devised and noticed the aforementioned five options, four of which radically departed from the Consensus Rule, asserting that they were in response to "substantial" adverse comments. Inexplicably, however, these options notably failed to address many of the concerns raised by those small independent producers who filed the majority of the adverse comments. Seemingly, the MMS gave very modest weight to small producer concerns, and no weight to the views of the many who favored the Consensus Rule. MMS attached inordinate weight to the comments of two States, only one of which, Colorado, has substantial quantities of Federal gas affected by the Consensus Rule. The other, Montana, would not likely be affected by the Consensus Rule to any significant degree at all because there is no Index price applicable to Montana production. Therefore, Montana production would likely be valued on the current gross proceeds basis.

In addition to reopening the record for public comment in this proceeding, MMS reconvened the Committee in Denver from June 12 - 14, 1996. The Committee members in that session commented upon the MMS' specific five alternative options, and a few additional options were developed. Of particular note, the entire natural gas industry, from major integrated producers to small, medium and large independents alike, unified behind certain proposed alternatives. Hereinafter, these alternatives will be referenced as the Unified Industry Proposals. These Unified Industry Proposals satisfactorily address those problems with the Consensus Rule which were publicly articulated in the filed written comments, including those independent producer concerns which were not addressed by the MMS's Five Options.

Summary of the NGSA Position

NGSA supported the Consensus Rule when it was initially published for public comment. We continue to support the Consensus Rule. There are many aspects of the rule which are unfavorable to industry, and would be objectionable in isolation; however, as part of a negotiated compromise package which NGSA actively participated in developing, NGSA is willing, and feels bound, to support the end product. It would severely compromise the utility of negotiated rulemaking as a workable procedural tool if every party who participated in the negotiation of a proposed rule attacked the resulting compromise rule because not every point was negotiated in the party's favor. After encouraging parties to embark on a negotiated rulemaking process, MMS should adhere as closely as possible to the Consensus Rule end-product in its Final Rule so as not to jeopardize the viability of this procedural rulemaking tool for the future. MMS has a responsibility to all Federal agencies to ensure the integrity and credibility of the negotiated rulemaking process. Substantial deviation from the Consensus Rule would diminish public trust in the process. This should be a key consideration in MMS's final deliberations.

Nevertheless, NGSA understands that MMS may be required to address in some fashion adverse comments. To do so may entail modifying the Consensus Rule. If MMS determines that in response to the written adverse comments it must modify the Consensus Rule, NGSA urges MMS to proceed expeditiously to a final gas valuation rule which adopts a viable, workable Index-price based valuation alternative, and which adopts as much as possible of the Consensus Rule. Industry, States and MMS have devoted far too much time and effort over the past two years in the negotiated rulemaking process to have the culminating consensus product of this effort lightly cast aside. MMS should bear in mind that industry groups would be understandably reluctant to commit to future negotiated rulemaking exercises with this or any other Federal agency, if the work effort, in the end, is substantially rejected.

In fashioning a Final Rule, MMS should also bear in mind the shared goals of industry, the States and MMS; we all seek administrative efficiency and cost savings. MMS, States and industry have been searching for a) simplification, b) reduction in administrative burden and c) clarity in valuation - i.e. avoiding a quagmire of legal disputes over what components of downstream revenue constitutes market value at the wellhead, and disputes over access to the data of lessees' marketing affiliates. These goals can be achieved if we can move to a workable Index price valuation system, and away from spending government and industry's audit and accounting time and resources attempting to trace and allocate value from increasingly complex post- FERC Order No. 636 transactions.

Any changes to the Consensus Rule should be measured against the four touchstones of 1) achieving simplification, 2) reducing administrative burden, 3) clarifying valuation standards, and 4) insuring the integrity of the negotiated rulemaking process. If changes to the Consensus Rule must be entertained, NGSA supports proceeding either on the basis of: a) any of the Unified Industry Proposals (discussed in more detail below) because all segments of industry solidly support them, they meaningfully address all of the adverse criticism articulated in public written comments, and they compare favorably to most other options when measured against the four touchstones; or b) MMS Option 1 (with those caveats expressed below) because it is closest to the Consensus Rule. As measured against the four above-mentioned touchstones, MMS Options 2 through 5, and all of the options developed by the States and MMS at the reconvened Committee Session, fail and should be discarded. None present a useful basis for a workable valuation system, because none advance the goals.

NGSA further notes the Consensus Rule provides for a delayed implementation date, making the Index valuation system effective on the first January 1 occurring after six months following the adoption of a Final Rule. In light of the need for expeditious implementation of Index valuation, NGSA urges the MMS to change this provision to allow for earlier implementation on the first day of the month occurring six months after the Final Rule is adopted. Companies may need six months of lead time to convert their accounting systems to the new valuation requirements, but there is no need to delay implementation for yet another calendar year. Implementation should not be delayed beyond six months.

Clarification of the Record

Before proceeding to comment on the specific MMS options noticed for public comment, NGSA must clarify the Foster's Study submitted by NGSA in its prior filed comments on the Consensus Rule. NGSA had submitted a study, prepared by Fosters Associates, Inc., which documented that valuing gas on an Index basis should be revenue neutral to MMS. Concerns were raised about possible distortions in the study's results caused by the study's efforts to exclude non-representative, acreage dedicated gas sales contracts from its calculations. Attached for the record as Appendix A is a letter from William G. Foster of Foster's Associates, explaining the negligible effect such exclusion had on the study. Mr. Foster explains that dedicated gas contracts constituted less than 3% of sales volumes for the years covered in the study. Whether the dedicated gas sales were included or excluded from his calculation would not have effected his conclusion that, overall, payment of royalty on an index basis is revenue neutral to MMS. As Mr. Foster further notes, such dedicated gas contracts involve a relatively low and falling proportion of gas production; therefore, their impact on future MMS revenue streams will even further decrease in significance.

Comments on the Five MMS Options published in the May 21, 1996, Federal Register

Option No. 1

Because it most closely tracks the Consensus Rule, Option No. 1 is the most viable of the five MMS options for proceeding to a Final Rule, subject to the revisions suggested below.

Point One proposes to state the Final Rule in "plain English". This apparently reflects MMS's obligation to utilize second person, active voice, bullets and sub-titles, etc., in writing new regulations. Point One was supported by the Committee at the June 12-14 meeting. While NGSA's member companies agree with the concept of drafting rules in "plain English," there is concern that MMS's attempt to comply with "plain English" requirements may result in unintended substantive changes to existing regulations. Specifically, in the Consensus Rule, 30 CFR parts 202 and 206 were restructured in order that Indian leases would not be affected, and in order to retain most of the existing regulations applicable to Federal gas while adding the proposed alternative valuation method. If MMS must now rewrite in "plain English" those portions of parts 202 and 206 that were never intended to be altered, great care must be taken not to make substantive changes. Thus, any redrafting of existing regulations in "plain English" should be accompanied by a clear expression of the lack of intent to make substantive changes. It should also be accompanied by language similar to that which appeared at 60 FR 56007, which acknowledged that incorporation of the Committee's consensus into the existing regulatory framework should not be interpreted or inferred that consensus was reached on longstanding differences of opinion with MMS on the meaning and interpretation of existing regulations, or that said differences of opinion had been waived or withdrawn.

In Point Two, MMS proposes to adopt "minor technical and procedural improvements" suggested in the public comments. At the June 12-14 Committee meeting, MMS clarified that this meant mainly certain suggestions presented in the comments of Shell. Having reviewed the comments of Shell and the 43 others who responded, it remains unclear which of the suggested changes MMS considers to be "minor procedural and technical improvements that would not modify the consensus of the Committee." NGSA cannot support the inclusion of these "improvements" in a Final Rule until the Association and its members have had an opportunity to review and evaluate them.

In Point Three, MMS proposes deleting the second sentence of proposed 30 CFR 202.450(b) which would deny the royalty-free use of gas downstream of the FMP. Such a provision was not part of the original Committee consensus, and was apparently included in the proposed rule by mistake. NGSA's member companies support this change. Deletion of this language was also agreed upon by all at the June 12-14 meeting. *Minutes, June 12-14, 1996*, at 22.

In Point Four, MMS would include a provision for takes-based reporting for 100 percent Federal agreements and stand-alone leases. NGSA's members support this concept, but urge that MMS include an exception to pay on other methods as specified in the original "MMS Proposal on Takes" endorsed by the Committee. This concept was also unanimously supported at the June 12-14 Committee meeting. *Id.*

In Point Five, MMS would grant an additional 6 months beyond the two-year period provided in the Committee consensus in which to calculate and publish the safety net median value for each zone. NGSA opposes this provision, because the two-year audit period was the result of considerable debate and negotiation during the original deliberations of the Committee. The *Minutes* of the August 24-25, and September 12-13, 1994, meetings reflect that industry representatives were concerned with achieving certainty of royalty valuation as soon as possible and therefore advocated a one-year period during which the majority of retroactive adjustments would occur. MMS and the States had concerns about "misreporting" on 2014's and capturing additional value resulting from audits, AFS/PAAS exceptions, and appealed orders to pay. Industry reluctantly agreed to the two-year period, but only upon having received assurances from MMS, including the Deputy Associate Director for Compliance, that necessary audits, processing of appeals, and calculation of the safety net median value could be accomplished "within 2 years after the index year." *Final Report*, at 43 (emphasis supplied). Having taken such pains during the negotiations to assure industry that the safety net calculation could be accomplished within two years, it is unfair for MMS to now assert that an additional 6 months is necessary. NGSA's members urge MMS to honor its commitment to publish the safety net within two years. The result of MMS's failure to do so should be that no additional royalty would be due. At the June 12-14 Committee meeting, state representatives concurred that no additional royalty should be due, but advocated that States should be "kept whole" when the calculation was finally made. ("If no safety net in 2 years, and no money from industry; then credit against receipt sharing." *Minutes, June 12-14, 1996*, at 3.)

MMS has suggested that timely publication of the safety net median value may be delayed in the event of future government shut-downs or furloughs. NGSA's members could support a narrowly applied exception that would, upon notice in the *Federal Register*, provide for additional time to publish the safety net median value, together with the suspension of the accrual of late payment interest, in the event of a governmental *force majeure*, as specifically defined. However, as presently worded, Point Five is overly broad and would allow MMS unlimited discretion to extend the two-year period up to six months. At a maximum, the two-year period should be extended only by a length of time commensurate with the time period associated with the governmental *force majeure*.

In Point Six, the MMS "would require index-based payors to pay royalty on contract settlement proceeds received from settlements entered into after the effective date of the rule." 61 FR 25424. NGSA's members cannot support this broadly worded provision for numerous reasons:

- *First*, whether contract settlement proceeds are royalty bearing is an issue which is the subject of pending litigation. In the event that certain contract settlement proceeds are held by the courts not to be royalty-bearing, Point Six, as presently worded, appears to be an attempt to circumvent such a holding. If that is MMS's intent, NGSA's members oppose it.

- *Second*, with respect to contract settlements entered into prior to the effective date of the Final Rule, the Consensus Rule, at 30 CFR 206.454(a)(6), would require royalty only if the Department's position is ultimately upheld. ("If the lessee receives or received any revenue in connection with reformation or termination of any gas purchase contract that occurred prior to effective date of this rule ... those revenues may be subject to royalty in accordance with the Department's existing precedents at the time a part of such revenue is attributed to later production. If so, royalty will be due on the increment of revenue attributed to future production in addition to any index-based or other value established under this section.." 60 FR 56024 [emphasis supplied]). Thus, Point Six is inconsistent with proposed § 206.454(a)(6).

- *Third*, revenues received by index payors from settlements entered into after the effective date of the Final Rule should not be subject to additional royalty, because such revenue, if paid voluntarily by the purchaser under the contract (rather than pursuant to the settlement of a contract dispute) would not be subject to royalty under the proposed rule.

- In any event, during the original Committee deliberations, it was agreed, as a result of well documented discussion and negotiation, that royalties on pipeline buyout and buydown settlement proceeds should not be included in the safety net calculation. This concept was also agreed upon at the June 12-14 Committee meeting. *Minutes, June 12-14, 1996*, at 22. Assuming *arguendo* that royalties are due on contract settlement proceeds, the Final Rule should require that such royalties be reported separately from regular royalty payments in order that they can be excluded from the safety net calculation.

Point Seven is acceptable, provided that the credit can be effectuated by means of recoupment, credit, offset, or refund, and be based on the actual value upon which royalties were overpaid. During discussion of this issue at the June 12-14 meeting, state representatives stated this was a minor issue and that a credit based on the actual value was acceptable. *Minutes, June 12-14, 1996*, at 3. This area of agreement was inadvertently omitted from the "What We Agree On" list generated on June 14. MMS specifically requested comments on how this credit should be processed. 60 FR 56014. MMS should ensure that the Final Rule reflects the agreement by all parties that this credit should be based on the actual value upon which royalties were paid.

Point Eight, concerning issuance of separate guidance on the reporting of gas valuation methods, is acceptable. Point Eight was endorsed by all at the June 12-14 Committee meeting.

Point Nine, under which MMS would publish a separate rulemaking on benchmark valuation, is acceptable. Point Nine was also considered acceptable by the state representatives at the June 12-14 Committee meeting. In drafting new benchmarks, however, MMS should consider not only comments on the November 6, 1995, proposed rule, but also the discussion which took place during the original deliberations of the

Committee. This discussion is described in detail in the *Minutes* and in the *Final Report*. ("MMS will write a proposed rule that will consider the comments and suggestions made by the committee." *Minutes, January 30-February 3, 1995*, at 19).

Option No. 2

Under this option, MMS proposes to replace the MMS-calculated safety net median value with a safety net value calculated by the index payor based on its own arm's-length sales, including sales by an affiliate. Within a certain tolerance, no royalty adjustments would be required. However, if the difference between the lessee's weighted average index payments and its weighted average pool price exceeded the tolerance, royalty adjustments would be required, resulting either in additional royalty due or a refund. This self-implementing safety net calculation would be subject to future audit. NGSA's members strongly object to Option 2 on the following grounds:

- *First*, the safety net calculation was one of the most extensively negotiated features of the regulatory negotiation. Industry representatives initially opposed a safety net calculation, maintaining that indexes, net of transportation costs, reflected the market value of production at the lease more effectively than any other measure of royalty value. Industry accepted the safety net, only reluctantly, in response to MMS and state concerns about revenue neutrality. ("In essence, the safety net provided MMS and the States assurance that index-based values would not result in substantially lower revenues than those received under gross proceeds while allowing industry the option to report and pay on index. The safety net helped to alleviate some of MMS concerns regarding revenue neutrality associated with an index-based method." *Final Report*, at 41). A safety net calculation based on the index payor's weighted average pool price, *i.e.*, Option No. 2, was proposed on numerous occasions and discussed at length. *Minutes, August 24-25, 1994*, pp. 3-12. Ultimately, however, the concept was abandoned in favor of a calculation based on MMS-2014 information reported by gross proceeds payors. *Minutes, August 24-25, 1994*, pp. 13-15; *Minutes, September 12-13, 1994.* Therefore, Option No. 2, is merely a reiteration of an alternative that was considered earlier and rejected. In order to implement Option No. 2 in a Final Rule, MMS would have to disregard the deliberations of the Committee and repudiate its own assurances that the calculation could be performed by MMS.

- *Second*, under Option No. 2, index-based payments would only be estimated payments which would subsequently be adjusted to gross proceeds. Lessees would be required to trace production through pools consisting of hundreds of downstream sales and transportation contracts, and the resulting weighted average price would be affected during the annual period by thousands of retroactive adjustments.

Since actual tracing would be impossible, various assumptions, allocations and extrapolations would have to be made. Auditing the pool price would be virtually impossible, necessitating the review of hundreds of transactions plus adjustments. Even worse, disputes over gross proceeds, allowable deductions, affiliate resale information, and any assumptions, allocations and extrapolations would arise. In establishing royalty value based on indexes and proceeds, Option No. 2 would require lessees to perform dual accounting. Thus, all of the benefits of the alternative valuation methodology of the Consensus Rule would be lost. Moreover, any anticipated reduction in MMS's administrative burden resulting from shifting the safety net calculation to index payors would be more than offset by the administrative burden of verifying lessees' safety net calculations.

- *Third*, Option No. 2 fundamentally re-trades the concessions made by industry and government parties in developing the Consensus Rule. Industry had sought a wider array of royalty payment options in valuing production disposed of in non-arms length sales. In the give and take of negotiations, industry was persuaded to accept the Consensus Rule, which narrowed industry's options for treating non-arms length sales. The Consensus Rule basically only provided two options: either a) pay at the Index and true up to a safety net median value derived from other sellers' gross proceeds values, or b) pay based upon the gross proceeds of a lessee's marketing affiliate. By MMS Option No. 2, the agency would effectively remove one hard bargain for option and instead, collapse these two options into essentially just one option, namely, to pay on the gross proceeds of the lessee's marketing affiliate.

Option No. 3

Option No. 3 is an attempt by MMS to address concerns expressed by only 3 of 44 commenters, STRAC, Colorado, and Montana.[1] Because many of these concepts were discussed and ultimately rejected by the Committee, NGSA's members oppose this Option.[2]

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[1]. Inasmuch as none of the small volume of Federal gas produced in Montana would be eligible, under the Consensus Rule, to be valued using an index-based methodology, Montana is not "affected" by the index, safety net, safety net caps, or any other aspects of the alternative valuation provisions of this rule. Therefore, Montana's comments on those aspects of the rule by which it is not affected may be afforded no weight under the notice and comment provisions of the *Administrative Procedure Act*, 5 USC 301 *et seq.*

[2]. It should be noted that even the states expressed objections to certain aspects of this option at the June 12-14, Committee meeting. *Minutes, June 12-14, 1996*, at 6.

Point One would require index applied to the wellhead MMBtu, eliminate the option to pay index on residue and gross proceeds on liquids, and eliminate wellhead MMBtu reporting based on the gross proceeds residue gas price. NGSA's members support elimination of the option to value residue on index and liquids on gross proceeds, provided that appropriate transportation allowances are retained. However, the option to value processed gas based on the gross proceeds residue gas price applied to the wellhead MMBtu should not be eliminated for gross proceeds payors.

- *First*, wellhead MMBtu reporting was negotiated as part of a single package for both index payors and gross proceeds payors. During these discussions, industry made significant concessions in order to accommodate various MMS and state concerns, including: (1) abandoning two separate safety nets for processed and unprocessed gas in favor of a single safety net containing unprocessed gas, processed gas, and NGL's; (2) increasing the true-up percentage in recognition that there may sometimes be uplift due to processing and perceived difficulties in auditing gas plants; and (3) abandoning various options, including residue on gross proceeds and NGL's on index. ("Using the objectives of simplicity, fairness, and reduced administrative cost, the committee agreed that there should be only one safety net calculation. In addition, the committee agreed that gross proceeds lessees should have the option to value their processed gas on a wellhead MMBtu basis. However, in order to limit lessees' options, the committee agreed that gross proceeds-based lessees must remain on a gross proceeds valuation basis." *Final Report*, at 62.) In view of the concessions industry made in order to gain the administrative ease of wellhead MMBtu reporting, it would be grossly unfair if this option were eliminated for gross proceeds payors.

- *Second*, wellhead MMBtu reporting for processed gas would significantly reduce the administrative burden both for gross proceeds-based lessees <u>and</u> MMS. A valuation methodology which would permit <u>only index payors</u> the benefit of simplified reporting would discriminate against gross proceeds payors. Such discrimination is unacceptable to industry, and would also appear to be inconsistent with views expressed by the States, who opposed options that might favor index payors and discriminate against gross proceeds payors. ("The STRAC recommends that MMS make an in-depth review of all the options and elections to ensure that they are justified for all, <u>equal to all</u>...." *Comments of the State and Tribal Royalty Audit Committee, February 5, 1996*, at 7, incorporated by reference by Montana in its comments [emphasis supplied]. "[T]he proposed rule discriminates against gross proceeds payors." *Comments of the Board of Land Commissioners, State of Colorado, February 2, 1996*, at 2.) Yet Point One would deny gross proceeds payors, and MMS, the benefit of simplified processed gas reporting. Contrary to STRAC's assertion, it is the elimination of the option, rather than retaining it, which would result in discrimination.

Point Two would remove the safety net caps. The state commenters maintain that elimination of the caps is justified on the grounds that: (1) caps limit true-up to market value, and (2) caps result in a double adjustment inasmuch as the median value on the safety net calculation protects index payors from pricing anomalies contained in the gross proceeds-based MMS-2014's. *Comments of State and Tribal Royalty Audit Committee, February 5, 1996*, at 3. On the contrary, caps do not limit true-up to market value; they limit true-up to proceeds. During the Committee deliberations, industry representatives maintained that market value at the lease was better approximated by index, net of transportation, than by proceeds from hundreds of remote sales artificially allocated back to the lease. Because the Committee members disagreed on which of the two best represented market value, the safety net cap was negotiated in order to recognize a middle ground between two opposing views of market value. The cap was also necessitated because MMS and the States insisted on collecting interest on true-up payments, and because no downward adjustments would be allowed in the event index payments exceeded the safety net. *Final Report*, at 42. ("The concept of a cap on the safety net calculation was developed by the committee for several reasons, which included: 1) the risk of litigation by both parties would be split equally, 2) disputes regarding Order No. 636 components in gross proceeds valuation, and 3) <u>if no cap, index valuation would be equivalent to gross proceeds</u>." *Id.* [emphasis supplied]. Thus, the cap is not a double adjustment to value and it should not be discarded. It was <u>never</u> intended to address pricing anomalies. Rather, it was negotiated in recognition of disputes concerning market value, late payment interest on true-up payments, and the "higher of" valuation requirement placed on index payors. Industry was forced to make significant concessions with respect to these disputes. Therefore, removing the safety net caps without reciprocal concessions to industry would be grossly unfair.

Point Three would retain the weighted average method but eliminate the "fixed index" method for determining the index pricing point (IPP). However, a "weighted average only" method was discussed and rejected. During the Committee deliberations, industry representatives advocated, for the sake of simplicity, an arithmetic average of IPP's based on physical connection rather than actual flow. Concerned about disparate markets and "no flow' situations, MMS and the States supported either a weighted average based on actual flow or the highest IPP. Industry maintained that weight averaging IPP's based on physical flow would require tracing and would therefore be overly complex and burdensome; further, for gas sold at or before reaching a split or multiple connect, industry maintained that weight-averaging would be impossible. Industry opposed using the highest IPP because higher priced markets were often constrained or merely anomalous. In the end, in order to get a method that would allow the selection of a single IPP rather than a weighted average of numerous IPP's based on tracing, industry conceded to an election of weighted average or the fixed index method. ("[T]he States, industry, and MMS compromised by allowing lessees to elect between two options ... for a period of two years. The committee believed that using the highest or second highest IPP was the best way to achieve simplicity and at the same time ensure a sufficient value for royalty, In other words, paying at a higher price index was a cost of simplicity." *Final Report* at 23 [emphasis supplied].) Therefore, eliminating this option will actually increase complexity. NGSA opposes Point Three unless adjustments to the methodology are made to accommodate industry's need for a simple alternative to determine the IPP.

Point Four would change the safety net from a median value to the weighted average of all arm's-length gross proceeds in the zone. Such a change would be unacceptable to NGSA's members. During the original deliberations, this alternative was discussed and ultimately rejected in favor of a median value on the grounds that a weighted average calculation could easily be skewed if there were a disproportionate number of sales at above-market, or below-market, prices. A median value calculation similar to major portion analysis was considered a more reliable indicator. ("[T]he committee agreed to use the median value method currently used for determining major portion for Indian gas. This median value method was chosen primarily to eliminate the effect of pricing anomalies in the gross proceeds reported to MMS." *Final Report*, at 42.)

Point Five would provide for transportation allowance deductions consistent with determination of the IPP using the weighted-average method set forth in Point Three. As general matter, it is recognized that the transportation allowance should be consistent with the selected IPP. However, because NGSA's members strongly oppose the elimination of the fixed index method without replacing it with another simple method that would avoid tracing (e.g., arithmetic average), Point Five is unacceptable. Further, because a simplified IPP selection method will inevitably include "no flow" situations, transportation allowances cannot be limited to the actual rate paid. The maximum IT rate should be allowed in "no flow" situations. Lessees should be allowed to deduct a *de minimis* rate.

In Point Six, MMS proposes to distinguish between transportation and gathering at the facility measurement point (FMP). NGSA's members oppose Point Six. The definitions of transportation and gathering recommended by the Committee resulted from extensive discussion and negotiation. In acquiescing to the "identifiable/measurable production" distinction, (an approach conceptualized and advocated by MMS), industry conceded, for the sake of compromise, its position that the distinction should be based on the function of the line. The record clearly indicates that a "bright line" test at the FMP was considered and rejected by the Committee, most notably because such a test would be particularly inappropriate in offshore situations, where the FMP may be located a great distance from the lease. ("The facility measurement point should not determine transportation or gathering." *Minutes, March 21-23, 1994,* at 7.) Further, in order to address concerns about revenue neutrality, the existing 50% limitation on transportation allowances was retained. *Final Report*, at 72. In any event, Point Six was rejected by all at the June 12-14 Committee meeting, and the distinction contained in the Consensus Rule was included on the "What We Agree On" list. *Minutes, June 12-14, 1996*, at 22.

Option No. 4

Point One, which would provide for a self-implementing safety net based on the lessee's own gross proceeds or affiliate resale proceeds, is identical to Option No. 2, discussed *supra*, and NGSA's objections are reiterated here.

Point Two is almost identical to Option No. 3, Point One, except that gross proceeds payors would retain the option to apply a gross proceeds-based residue value to the wellhead MMBtu with a self-implementing safety net based on their own residue and NGL gross proceeds. As previously stated, NGSA's members support the elimination of the option to pay index on residue and gross proceeds on NGL's. Further, while NGSA supports retaining the option of gross proceeds payors to apply a gross proceeds residue price to the wellhead MMBtu, its members oppose the self-implementing safety net calculation because it effectively requires dual accounting.

Point Three would determine the IPP using the closest index pricing point to which the gas physically flows. This is appropriate for single connects, and would also be possible for multiple connects. However, during the original deliberations, the Committee concluded that for split connects (often market centers) there is no "closest" IPP. NGSA's members therefore oppose Point Three.

Point Four would provide for transportation allowance deductions consistent with the closest IPP, as set forth in Point Three. As general matter, it is recognized that the transportation allowance should be consistent with the selected IPP. However, using the closest IPP is unworkable for split connects. Therefore, Point Four is unacceptable to NGSA's members. As stated above, NGSA's members could support either the Consensus Rule or, for the sake of simplicity, an arithmetic average of IPP's for split and multiple connects, and the determination of transportation allowances consistent with the IPP selection method. Because a simplified IPP selection method will inevitably include "no flow" situations, transportation allowances cannot be limited to the actual rate paid. The maximum IT rate should be allowed in "no flow' situations. Lessees should be allowed to deduct a *de minimis* rate.

Point Five is identical to Point Six of Option No. 3, discussed *supra*, and NGSA's objections are reiterated here.

Option No. 5

Under this option, the alternative valuation options recommended by the Committee would not be implemented. NGSA strongly opposes this option, as a whole, because it departs the most from the consensus of the Committee, and because implementation of this option would repudiate two years of effort by the Committee and frustrate the negotiated rulemaking process.

In Point One, MMS proposes that the current gross proceeds-based valuation regulations be maintained, and that the valuation benchmarks for non-arm's-length sales set forth at

30 CFR 206.152(c) and 206.153(c) (1995) be modified as set forth at 61 FR 25424-25425. NGSA's member companies strenuously object to the benchmarks set forth in Point One for many reasons articulated by industry representatives when the same proposal was made by MMS and the States during the January 30-February 3, 1995, Committee meeting. In addition, Point One, considered to be more objectionable than the existing benchmarks, is unacceptable for the following reasons:

- *First,* MMS's legal right to determine royalty value based on the first arm's-length sale by a lessee's affiliate has never been established, and is certainly contested by NGSA's member companies. Although MMS has long required that minimum value for royalty purposes be the gross proceeds accruing to the lessee from the sale of gas, the term "lessee" is defined by statute and by regulation as "any person to whom the United States, an Indian tribe, or an Indian allottee, issues a lease, or any person who has been assigned an obligation to make royalty or other payments required by the lease." 30 USC 1702(7); 30 CFR 206.151. "The term 'lessee' is specific and cannot be expanded to include an affiliate of the lessee." *Shell Oil Co. (On Reconsideration),* 132 IBLA 354, 357 (May 11, 1995). Thus, MMS has no authority to deem the proceeds received by a lessee's affiliate to be the gross proceeds accruing to the lessee from the sale of gas. Yet MMS would establish as the second benchmark the first bona-fide arm's-length sale by the affiliate. 61 FR 25425. NGSA's members urge MMS not to do so.

- *Second*, MMS has interpreted its own regulations to require determination of royalty value based on an affiliate's resale proceeds in only two specific situations: (1) resale by the affiliate in the same field as the first sale from the lessee to the affiliate (*Policy Paper: Valuation of Sales to Affiliates* [October 14, 1993]) and (2) resale by a "marketing affiliate," *i.e.,* an affiliate of the lessee whose function is to acquire only the lessee's production and to market that production (30 CFR 206.151). In proposing a valuation scheme that would require greater dependence on an affiliate's resale proceeds, MMS appears to be shifting the royalty valuation point farther downstream from the lease. Yet at the same time, it steadfastly refuses to share in the considerable risk and expense associated with participation in these new downstream gas markets. MMS's movement away from compromise on this issue is in apparent conflict with its duty under the *Negotiated Rulemaking Act* to "negotiate in good faith to reach a consensus on the proposed rule." 5 USC 583.

- *Third*, calculating royalty value based on an affiliate's resale proceeds would place an enormous administrative burden on lessees, who would be required to trace gas downstream through hundreds of separate sales and recalculate royalty value each time retroactive adjustments were recorded for each downstream disposition. Such royalty calculations would be virtually impossible to verify upon audit. These problems, all described in great detail in the original Committee deliberations, would be much worse in instances where the lessee owned a minority interest in an affiliated company, joint venture, alliance, or co-op, and was dependent on another entity for information necessary to calculate royalty value. In addition, disputes about what revenues are part of gross proceeds and what costs are deductible in a post-FERC 636 environment would inevitably arise.

- *Fourth*, although the Committee failed to reach consensus on improved valuation benchmarks, the enormous advantage of the Consensus Rule was that it eliminated the need for the valuation benchmarks in most instances. ("The majority of the problems associated with the current benchmark system have been solved through the committee's development of the index method and the associated safety net. ... [A]t least 95 percent of all Federal gas is produced in zones where, under the committee recommendation, non-arm's-length production must be valued on the index method." *Final Report*, at 53.) One result of discarding the alternative valuation options of the Consensus Rule would be that all non-arm's-length transactions would continue to be valued under the benchmarks. The enormous benefits realized by the Consensus Rule would be lost, and the likelihood of valuation disputes and legal challenges would therefore increase.

- *Fifth*, in proposing the benchmarks set forth in Point One, MMS has failed to consider the discussion which took place during the original deliberations of the Committee. This discussion is described in detail in the Minutes of the January 30-February 3, 1995, meeting. MMS has also disregarded the "Industry Proposal" appearing at pp. 54-55 of the *Final Report*. ("The committee did not reach consensus on the issue of improved benchmarks. MMS will write a proposed rule that will consider the comments and suggestions made by the committee." *Minutes, January 30-February 3, 1995*, at 19.) MMS should honor its commitment to consider the comments and suggestions made by the Committee. It is encouraged to fashion new benchmarks in such a manner as to (1) establish royalty value based on arm's-length sales occurring at or near the lease, (2) avert legal disputes over gross proceeds, FERC 636 transportation, and affiliated sales, and (3) avoid impracticable, overly complex netbacks from untraceable downstream sales occurring at multitudinous locations far from the field or lease.

In Point Two, MMS would adopt the Committee's recommendation for entitlements-based reporting, but with no exception for small producers, allowing MMS-approved exceptions only under limited circumstances. NGSA's members oppose this proposal because it fails to provide a meaningful exception to entitlements, an objection which appeared frequently in the public comments submitted on the November 6, 1995, proposed rule. The need for a meaningful and practical exception to entitlements reporting for mixed agreements was also agreed upon by all at the June 12-14 Committee meeting and was included on the "What We Agree On" list. *Minutes, June 12-14, 1996*, at 22.

In Point Three, MMS proposes inclusion of a provision for takes-based reporting for 100 percent Federal leases and stand-alone leases. NGSA's members support this concept, but urge that MMS include an exception to pay on other methods as specified in the original "MMS Proposal on Takes" endorsed by the Committee. This concept was also unanimously supported at the June 12-14 Committee meeting and is included on the "What We Agree On" list. *Minutes, June 12-14, 1996*, at 21.

Point Four is identical to Point Six of Option No. 3, discussed *supra*, and NGSA's objections are reiterated here.

Comments on Additional Proposals at the June 12-14, 1996 Committee Meeting

At the June 12-14, 1996, Committee meeting, numerous alternative proposals were introduced.

New Mexico Proposal

1. For split/multiple connects, determine the IPP using the weighted average method. This is identical to Option No. 3, Point 3, discussed *supra,* and NGSA's objections are reiterated here. As stated before, eliminating the simplification options in favor of weighted average based on actual flow would increase complexity.

2. Determine the location differential/transportation allowance based on weighted average and actual flow. The location differential would equal lessee's actual costs to IPP. In No Flow situations, index would be applied at the wellhead with no location differential. For non-arm's-length/non-jurisdictional transportation, the allowance would equal lessee's actual cost, or the *de minimis* rate with MMS approval. As stated in Option No. 3, Point Five, *supra*, determining the IPP and location differential based on weighted average and actual flow requires tracing and would be overly complex and burdensome. NGSA's prior objections to Option No. 3, Point Five, are reiterated here. As a general matter, NGSA's members strongly oppose, and dispute the legality of any method which would attempt to establish value for royalty purposes based upon prices at sales points remote from the lease without providing for a transportation allowance. Further, requiring prior MMS approval in order to deduct a *de minimis* rate would only increase complexity and the lessee's and lessor's administrative burden while providing no additional benefit, since the *de minimis* rate is a minimal MMS-calculated rate.

3. Delete options for index payors to pay index on a wellhead MMBtu, and for gross proceeds payors to pay the gross proceeds residue price on a wellhead MMBtu. Retain 50% safety net cap. NGSA's members strongly oppose this proposal. In order to gain the administrative ease of wellhead MMBtu reporting, industry made significant concessions to accommodate MMS and state concerns about revenue neutrality, possible uplift due to processing, and excessive options. See, *Final Report*, at 62; Minutes, *January 30-February 3, 1995*. In addition, elimination of wellhead MMBtu reporting from the alternative methodology would increase complexity, not simplicity.

4. Delete deepwater exceptions. NGSA's members strongly oppose this suggestion on numerous grounds. *First*, neither New Mexico, nor any other state, is in any manner affected by the Consensus Rule to the extent that it pertains to deepwater leases. As such, NGSA urges that only the comments of those who have an interest in deepwater production be considered by MMS. *Second*, it is undeniable that substantial costs are incurred by lessees to transport deepwater production to a shelf tie-in. The record indicates that the Committee recognized that, due to the substantial actual costs for transportation incurred by deepwater producers, it would be inequitable to expect them to true-up to a safety net median value reflecting only "shelf to shore" transportation costs. The effect of eliminating the additional location differential adjustment for deepwater leases would be to value deepwater production for royalty purposes at the shelf tie-in, rather than at the lease. NGSA's members strongly oppose, and dispute the legality of, any methodology that would ignore transportation costs in determining royalty value. *Third*, denying deepwater lessees a transportation allowance would result in enormous revenue increases and unjust enrichment of the government at the expense of deepwater lessees.

5. If MMS fails to calculate the safety net in two years, it must keep the States whole, *i.e.*, calculate and pay interest to the States as if additional royalties had been paid. NGSA's comments on Option No. 1, Point Five, are reiterated here. To the extent that no additional royalty is due from lessees as a result of MMS's failure to timely calculate the safety net, NGSA's members have no position on whether the States should be kept whole by MMS.

6. No exception for gross proceeds payors to value small volumes of non-sale (NAL) dispositions on NAL benchmarks rather than index. NGSA disagrees. At the June 12-14, 1996, Committee meeting, the exception was supported by all and added to the "What We Agree On" list.

7. Committee consensus would apply to gathering and transportation. NGSA agrees.

Wanda's Proposal

1. Value royalties on index in accordance with the Consensus Rule, including wellhead MMBtu reporting, but **without** a location differential or transportation allowance. Eliminate the safety net calculation and associated true-up. For the sake of simplicity, NGSA supports elimination of the safety net. The safety net requirement adds unnecessary complexity and uncertainty to the alternative valuation methodology, but NGSA has supported it as part of a total package as a means of addressing MMS concerns about revenue neutrality. NGSA's members strongly oppose any methodology that would ignore transportation costs in determining royalty value. *First*, such a regulation would in effect move the royalty valuation point from its proper place, the lease, to the IPP, which can be located far away. In light of existing precedents, legal challenges would no doubt ensue if such a regulation were promulgated. *Second*, inasmuch as this concept was suggested more than once during the original Committee deliberations and rejected, adopting it in a Final Rule would require that MMS disregard the Committee consensus. *Third*, this concept is based on an unsupported assumption that Federal lessees are realizing "uplift over index" equivalent to their transportation costs. *Minutes, April 25-27, 1994*, at 11. There is no record support for this assumption, and NGSA members disagree with it based not only on considerable experience, but upon a study which examined Federal gas royalties paid in several areas, net of transportation allowances, and concluded, "[T]he use of published index prices in calculating royalty payments for gas sold under non-dedicated contracts (in lieu of actual prices) would not reduce royalty payments to the MMS." Foster Associates Inc., *Published Price Indices as the Basis of Federal Royalty Payments*, December, 1995, at 5. *Fourth*, assuming *arguendo* that "uplift equals transportation" for all Federal lessees collectively, the same cannot be said for individual lessees. Factors such as distance to IPP vary enormously among lessees and among dispositions. Thus, elimination of the transportation allowance would have a disproportionate impact on individual lessees, depending on their transportation costs, the proportion of "index plus" to "index minus" sales in their portfolios, and a host of other factors. The commerciability of Federal leases would be significantly affected. The adverse impacts of such a proposal cannot be over-emphasized.

2. No exception for gross proceeds payors to value small volumes of non-sale (NAL) dispositions on NAL benchmarks rather than index. NGSA disagrees. At the June 12-14, 1996, Committee meeting, the exception was supported by all and added to the "What We Agree On" list.

3. Committee consensus would apply to gathering and transportation. NGSA agrees.

Unified Industry Proposal No. 1 (Option No. 6)

Retain the Committee's index-based method but simplify the rule as follows:

1. Write the Final Rule in plain English.

2. Include a provision for takes basis reporting for 100% Federal agreements and stand-alone leases. Also, an exception would be provided to pay on other methods when all of the parties agree as specified in the Committee Report.

3. For mixed agreements reporting, the exception would be expanded to an average of 500 barrels of oil per month per well or 3,000 MCF per month per well, or combination thereof, determined by dividing the average daily production from all wells on a lease by the number of such wells. For the producer who pays on a takes basis, the time period to reconcile to entitlements would be extended to two (2) years. For adjustments to entitlement based payments, reciprocal interest would apply to the amount of the adjustment, i.e., the producer pays interest when adjustments are made for undertakes and the MMS pays interest when adjustments are made for overtakes. Interest would not begin to accrue on the adjustment amount until the first month following the two-year period.

4. Delete the second sentence in proposed 30 CFR 202.450(b), which otherwise would deny royalty-free use of gas downstream of the FMP.

5. MMS would issue separate guidance on the reporting of gas valuation consistent with the recommendations of the Royalty Policy Committee's Subcommittee on Royalty Reporting and Production Accounting.

6. The Index Pricing Point would be determined by using any single valid publication. The producer would select the single valid publication on a zone-by-zone basis, at the beginning of every year.

7. Index would be applied to the wellhead MMBtu less a location differential to the appropriate Index Pricing Point. There would be no option to value residue gas on index. For split connects or multiple connections the producer would use either a weighted average or an arithmetic average of the published indices from any single valid publication less the applicable location differential. [Refer to the Committee Report, Index Pricing Point (IPP), on page 18, which provides as follows:

    A single connect is where the IPP is established before the pipeline to which the well, lease, platform central delivery point, or plant (collectively referred to as well) is physically connected, interconnects with other pipelines. For a single connect, the index pricing point will be the first pipeline interconnect for which there is a valid published index.

A split connect is defined as more than one pipeline connected directly to the well. A multiple connection is defined as one pipeline connected to the well, but that pipeline splits prior to an index point. (These definitions are illustrated on page 19).

To determine the index in the case of split/multiple connects, the lessee has two options:

1. Weighted Average - Calculate the volume weighted average (based on confirmed nominations - either first of the month or total for the month, applied consistently, with no prior period adjustments for allocation or corrections to actual flows) of all the index pricing points to which the well is physically connected, or

and add the following:

2. An arithmetic average of all the physical connections based on the single valid publication.]

8. Gross proceeds payors would have the option for all Federal leases inside or outside an index zone, on an annual basis to elect to apply a gross-proceeds based gas value to the wellhead MMBtu less applicable transportation with no safety net. Producers would still pay on gross proceeds on arm's-length dedicated contracts.

9. For all arm's-length and/or jurisdictional transportation, the location differential would parallel the Index Pricing Point valuation methodology. For transportation that is both non-arm's-length, and non-jurisdictional, the producer would use the Committee's recommendation. The *de minimis* transportation rate would apply to both gross proceeds and index payors and would not require prior MMS approval.

10. Retain the Committee's recommendations concerning the distinction between transportation and gathering.

11. In order to relieve those paying on gross proceeds from a higher audit burden and relieve the MMS of the administrative burden of auditing the gross proceeds MMS-2014's prior to calculating the safety net, the MMS would calculate the safety net price using only unaudited gross proceeds as reported on MMS-2014's, including any out of period adjustments but only for the index year for which the safety net is being calculated. The index payors would true up to 75% of the difference between the index payors weighted average index based value and the median price for unaudited gross proceeds on a zone-by-zone basis. Any safety net adjustment required as a result of any comparison would be accomplished by a one line entry on a zone-by-zone basis. The alternative valuation method would not shift the audit burden to the gross proceeds payors.

12. If the safety net is not published within one (1) year following the end of the index year, then no additional royalty would be due and the index would become the final safety net.

13. Any royalties paid for gas contract settlements proceeds would not be considered gross proceeds for safety net calculation purposes.

14. Gross proceeds payors would be allowed to value small volumes of gas sold non arm's-length in accordance with its arm's-length transactions and would not be required to use index pricing.

NGSA strongly supports this proposal. It addresses concerns about the administrative burden of calculating the safety net by relieving MMS of the requirement to audit gross proceeds-based MMS-2014 reports in order to calculate the safety net median value. It addresses the need for simplification by eliminating the option to pay residue on index and liquids on gross proceeds, and by expanding the lessee's ability to report and pay processed gas royalty on a wellhead MMBtu. It addresses the need for a meaningful exception to entitlements reporting on mixed agreements. In order to address concerns about revenue neutrality and to offset any reduction in revenues which may occur as a result of varying from the Consensus Rule, this proposal contains a substantial increase in the safety net cap.

Unified Industry Proposal No. 2 (Option No. 7)

Modify Unified Industry Proposal No. 1 as follows:

11. In order to relieve those paying on gross proceeds from a higher audit burden and relieve the MMS of the administrative burden of auditing the gross proceeds MMS-2014's prior to calculating the safety net, the MMS would calculate the safety net price using only unaudited gross proceeds as reported on MMS-2014's, including any out of period adjustments but only for the index year for which the safety net is being calculated. The index payors would true up to **90%** of the difference between the index payors weighted average index based value and the median price for unaudited gross proceeds on a zone-by-zone basis. Any safety net adjustment required as a result of any comparison would be accomplished by a one line entry on a zone-by-zone basis. The alternative valuation method would not shift the audit burden to the gross proceeds payors.

14. Gross proceeds payors would be allowed to value small **non-arm's-length, non-sale dispositions of royalty-bearing** volumes of gas **(for example, off-lease fuel)** in accordance with its arm's-length transactions and would not be required to use index pricing.

NGSA strongly supports this proposal. Like Unified Industry Proposal No. 1, it addresses concerns about the administrative burden of calculating the safety net by relieving MMS of the requirement to audit gross proceeds-based MMS-2014 reports in order to calculate the safety net median value. It addresses the need for simplification by eliminating the option to pay residue on index and liquids on gross proceeds, and by expanding the lessee's ability to report and pay processed gas royalty on a wellhead MMBtu. It addresses the need for a meaningful exception to entitlements reporting on mixed agreements. In order to address concerns about revenue neutrality and to offset any reduction in revenues which may occur as a result of varying from the Consensus Rule, this proposal contains an even more substantial increase in the safety net cap.

Unified Industry Proposal No. 3 (Option No. 8)

Modify Unified Industry Proposal No. 1 as follows:

8. Gross proceeds payors would have the option for all Federal leases inside or outside an index zone, on an annual basis to elect to apply a gross-proceeds based gas value to the wellhead MMBtu less applicable transportation with **a 30% true-up to 101% of** the safety net median value. Producers would still pay on gross proceeds on arm's-length dedicated contracts.

11. In order to relieve those paying on gross proceeds from a higher audit burden and relieve the MMS of the administrative burden of auditing the gross proceeds MMS-2014's prior to calculating the safety net, the MMS would calculate the safety net price using only unaudited gross proceeds as reported on MMS-2014's, including any out of period adjustments but only for the index year for which the safety net is being calculated. The index payors, would true up to **50% or 65% (as set forth originally in the Committee recommendation)** of the difference between the index payors weighted average index based value and **101% of the safety net median value** for unaudited gross proceeds on a zone-by-zone basis. **(MMS could audit gross proceeds payors, but adjustment reason codes of 40+ would not go into safety net. Adjustments due to exception processing would be included.)** Any safety net adjustment required as a result of any comparison would be accomplished by a one line entry on a zone-by-zone basis. The alternative valuation method would not shift the audit burden to the gross proceeds payors.

12. If the safety net is not published within **two (2) years** following the end of the index year, then no additional royalty would be due and the index would become the final safety net.

NGSA strongly supports this proposal. Like Unified Industry Proposal No. 1, it addresses concerns about the administrative burden of calculating the safety net by relieving MMS of the requirement to audit gross proceeds-based MMS-2014 reports in order to calculate the safety net median value. It addresses the need for simplification by eliminating the option to pay residue on index and liquids on gross proceeds, and by expanding the lessee's ability to report and pay processed gas royalty on a wellhead MMBtu. It addresses the need for a meaningful exception to entitlements reporting on mixed agreements. In order to address concerns about revenue neutrality and to offset any reduction in revenues which may occur as a result of varying from the Consensus Rule, this proposal contains a 1% increase in the safety net median value.

MMS/State Proposal (Option No. 9)

1. Index/No Location Differential/No Safety Net. This proposal is identical to Point One of Wanda's Proposal, discussed *supra*, and NGSA's comments are reiterated here.

2. Determine the IPP using the weighted average method. This proposal is identical to Option No. 3, Point Three, discussed *supra,* and NGSA's objections are reiterated here. As stated before, eliminating the simplification options (fixed index or arithmetic average) in favor of weighted average based on actual flow would increase complexity.

3. The Index Pricing Point would be determined by using any single valid publication. NGSA agrees. At the June 12-14 Committee meeting, all agreed on this concept and it was added to the "What We Agree On" list. *Minutes, June 12-14, 1996*, at 22.

4. Use the Committee consensus for gathering/compression. NGSA agrees. At the June 12-14 Committee meeting, all agreed on this concept and it was added to the "What We Agree On" list. *Id.*

5. For index payors, allow wellhead MMBtu reporting on processed gas. For the sake of simplicity, NGSA strongly supports this concept.

6. For mixed agreements, producers whose total monthly royalty payments on Federal leases total less than $5000.00 qualify to pay on takes. This number was literally picked from thin air. There was no effort to determine that this figure constitutes a meaningful and practical exception to entitlements for small producers. NGSA opposes this provision and supports the exception set forth in the Unified Industry Proposals. Only the Unified Industry Proposals contain a meaningful exception to entitlements. At the June 12-14 Committee meeting, all agreed on this concept and it was added to the "What We Agree On" list. *Id.*

7. No location differential. NGSA opposes and reiterates its response to No. 1 of this proposal, above.

MMS/State Modified Proposal (Option No. 10)

1. Index payors would true up to 100% (no safety net cap) of the MMS calculated safety net value. The safety net value would be the weighted average of a stratified sample of arm's-length gross proceeds (including affiliate resale proceeds) accruing to gross proceeds payors and index payors in the zone. The safety net would be published in two years based on audited product codes 03 and 04.

NGSA opposes elimination of the safety net caps for the reasons noted in the response to Option No. 3, Point Two, *supra*. NGSA opposes basing the safety net calculation on a weighted average, rather than a median value, for the reasons noted in response to Option 3, Point Four, *supra*. NGSA opposes the stratified sample safety net methodology on several grounds. *First*, and most important, such a method would be virtually impossible to implement. In instances where the stratified sample included sales from pools, MMS would be required to calculate the applicable pool price from hundreds of separate sales and transportation transactions recorded by the lessee or its affiliate. In order to do so, auditors would be forced to extrapolate based on numerous assumptions with which lessees would likely take issue. Thus, this proposal would increase MMS's administrative burden and the likelihood of technical challenges by many orders of magnitude, compared to a safety net based on MMS-2014 data. *Second*, such a method would give rise to legal disputes regarding gross proceeds, allowable deductions, affiliate resales, etc. The Consensus Rule, Option No. 1, and the Unified Industry Proposals, each substantially avoid these disputes and are therefore far superior to this proposal. *Third*, since the proposed method depends on sampling, MMS's sampling techniques would likely be challenged. Such a methodology could easily be gamed in such a manner as to consider only the highest priced sales and/or lowest transportation costs. *Fourth*, in light of the many difficulties associated with this methodology, it is unlikely that such a safety net value would ever be calculated and published by MMS on a timely basis.

2. <u>Determine the IPP using the weighted average method</u>. This proposal is identical to Option No. 3, Point Three, discussed *supra*, and NGSA's objections are reiterated here. As stated before, eliminating the simplification options in favor of weighted average based on actual flow would increase complexity

3. <u>The Index Pricing Point would be determined by using any single valid publication.</u> NGSA agrees. At the June 12-14 Committee meeting, all agreed on this concept and it was added to the "What We Agree On" list.

4. <u>Use the Committee consensus for gathering/compression.</u> NGSA agrees. At the June 12-14 Committee meeting, all agreed on this concept and it was added to the "What We Agree On" list.

5. <u>In order to report and pay processed gas royalty on a wellhead MMBtu basis, add 2% to the applicable index or gross proceeds residue price</u>. NGSA's members strongly oppose this proposal. It incorrectly assumes, without evidentiary support, that there is always a 2% uplift in value from processing. More important, the concept of an "Index + X" methodology was considered during the original Committee deliberations and ultimately rejected. The Committee agreed that it would be impossible to determine the value of "X".

6. <u>For mixed agreements, producers whose total monthly royalty payments on Federal leases total less than $5000.00 qualify to pay on takes</u>. This number was literally

picked from thin air. There was no effort to determine that this figure constitutes a meaningful and practical exception to entitlements for small producers. NGSA opposes this provision and supports the exception set forth in the Unified Industry Proposals. Only the Unified Industry Proposals contain a meaningful exception to entitlements. At the June 12-14 Committee meeting, all agreed on this concept and it was added to the "What We Agree On" list.

7. Arm's-length and jurisdictional transportation allowances should be based on the actual rate paid. Non-arm's-length, non-jurisdictional transportation allowances should be limited to actual costs, or a *de minimis* rate with prior MMS approval. NGSA opposes this concept and recommends the Committee consensus. As general matter, it is recognized that the transportation allowance should be consistent with the IPP selection method. However, because NGSA's members strongly oppose the elimination of the fixed index method without replacing it with another simple method that would not necessitate tracing (*e.g.*, arithmetic average), this proposal is unacceptable. Further, because a simplified IPP selection method will inevitably include "no flow" situations, transportation allowances cannot be limited to the actual rate paid. The maximum IT rate should be allowed in "no flow" situations. Lessees should be allowed to deduct a *de minimis* rate, subject to audit, without having to secure prior MMS approval, since it is an MMS-calculated rate.

Conclusion

NGSA's members cannot support Options Nos. 2, 3, 4, 5, 9, 10, the New Mexico Proposal, or Wanda's Proposal. These options share many common characteristics which make them completely unacceptable. *First*, no single option equitably addresses all of the public comments received on the Consensus Rule. *Second*, although predicated on a need for greater simplicity, each of these options would result in greater complexity and an increased administrative burden, *e.g.*, IPP selection and transportation allowance based on physical flow, safety net calculation based on lessee's own gross proceeds or affiliate's resale, elimination of option for gross proceeds payors to pay gross proceeds residue gas price at wellhead MMBtu, requirement of prior MMS approval to deduct *de miminis* rate. *Third*, these options offer no new solutions but merely reiterate concepts that were previously considered and rejected, e.g., Index+X%, Index with No LD. In order to implement any of these options, MMS would have to completely disregard the deliberations and the consensus of the Committee. *Fourth*, these options are based on the erroneous assumption that elections enable lessees to minimize their royalty obligation. In fact, numerous safeguards were built into the elections to prevent gaming, *e.g.*, 2-year election on a zone-wide basis. Thus, if any of these options were implemented as a Final Rule, it would be highly doubtful whether any Federal lessee would elect to use the alternative valuation methodology.

NGSA supports the Consensus Rule, Option No. 1 (if modified as suggested), or Unified Industry Proposals Nos. 1, 2 or 3. If modified in accordance the "What We Agree On" list of June 14, 1996, each of these options would substantially address the concerns expressed in the comments on the Consensus Rule without destroying the original Committee consensus. Because of the "higher of" safety net mechanism, the "escape hatch," and the manner in which index prices are based on third party sales, adopting an alternative valuation methodogy consistent with these options exposes MMS to little downside risk of changes in the gas market. Each of these options would enable MMS to disgard the alternative valuation methodology without further rulemaking if index prices were no longer valid in a zone. Therefore, NGSA exhorts MMS to proceed with publishing a Final Rule consistent with these options as expeditiously as possible, delaying the effective date no longer than 6 months after publication.

Dated: August 16, 1996

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SENIOR VICE PRESIDENT

May 17, 1996

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Washington, D.C. 20005

Dear John:

This letter responds to your questions about our handling of dedicated natural gas in the report entitled Published Price Indices as the Basis of Federal Royalty Payments. As stated in the report, we attempted to exclude dedicated gas by the use of a price range, because we did not have access to contract provisions to verify dedication. We purposely chose a wide price range to represent non-dedicated gas, in order to keep as much volume in the study as possible. We assumed the gas volumes to be dedicated if the sales price was either greater than 130 percent or less than 70 percent of the appropriate index price. We confirmed the reasonableness of this assumption during our interviews with producers during this research project.

In fact, the range captured a very large proportion of the OCS and Rocky Mountain gas. Stated otherwise, the dedicated gas volume excluded from the price comparisons was relatively small. Table 4 on page 29 of the report shows the dedicated volumes (both high and low priced) excluded from the price comparisons. These volumes fall significantly over the three-year period, and by 1994 the dedicated volumes represent only 2.5 percent of the Gulf of Mexico volume and 2.5 percent of the Rocky Mountain volume. If we had included these transactions in the analysis, the actual sales prices would have increased slightly -- by $.02 to $.04 per Mcf in the Gulf and about $.01 per Mcf in the Rocky Mountain area over the three-year period. The assumption is that the dedicated gas contracts are older vintage contracts, with generally higher pricing provisions. Given this consideration and the relatively low and falling proportion of dedicated gas volumes, I believe that the conclusions reached in the report continue to be valid.

If you have any questions, please do not hesitate to contact me.

Sincerely yours,

Bill

William G. Foster