SENECA RESOURCES

May 5, 2015

Office of Natural Resources Revenue
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MS 61030A
Denver, CO 80225
Attn: Armand Southall

RE: Comment on Proposed Rule - Consolidated Federal Oil & Gas and Federal & Indian Coal Valuation Reform
Regulation Identification Number 1012-AA13

Seneca Resources Corporation appreciates this opportunity to comment on the Office of Natural Resources Revenue's proposed amendments to its royalty valuation regulations (Docket No. ONRR-2012-0004, RIN 1012-AA13, 80 Fed. Reg. 608 *et seq.*).

Our comments primarily concern the valuation of gas sold under an arm's-length percentage-of-proceeds (POP) contract[1] that would be a sale of unprocessed gas under the current regulations. 30 C.F.R. § 1206.152(a)(1).[2] The preamble to the proposed regulations states that the new valuation rules would not alter the underlying principles of the current regulations or make major changes in the value of arm's-length gas sales. 80 Fed. Reg. 609, col. 1 & 3. This is incorrect with respect to POP contracts, as we explain in greater detail below, where we make the following points:

- The ONRR's intended changes would ignore the percentages agreed upon by parties to an arm's-length POP contract.

- The preamble understates the cost to industry of applying an inflexible 66-2/3 percent limit on processing allowances to POP contracts. The ONRR incorrectly assumes that a "typical" POP contract provides for a 70:30 split between producer and processor.

[1] Our comments apply for the most part not only to true POP contracts (under which the lessee's gross proceeds are a percentage of the purchaser's proceeds derived from selling the residue gas and gas plant products), but also to percentage-of-index and other contracts that would come within the ambit of proposed section 1206.142(a)(2). See 80 Fed. Reg. 619, col. 1 & 2.

[2] Unless otherwise noted, all citations are to sections of the current or proposed regulations in Title 30 of the Code of Federal Regulations.

- Although the preamble states that the substantive requirements of the marketable condition rule would remain unchanged (80 Fed. Reg. 622, col. 2), that is not accurate.

- The ONRR improperly requires lessees under POP contracts to place residue gas and plant products in marketable condition.

The end result of ONRR's intended changes to the treatment of arm's-length POP contracts would burden the lessee with paying royalty on 100% of the gross proceeds received by the POP buyer (as opposed to the lessee's percentage in the POP), while likely denying the lessee an offsetting allowance for the POP buyer's full cost of transforming the lessee's wet gas into residue gas and gas plant products.

The ONRR's Interpretation of the Proposed Regulations Disregards the Existence of POP Contracts and Treats the POP Buyer's Resale as if It Were the Initial Arm's-length Contract.

Under section 17 of the Mineral Leasing Act, royalties are due on the value of the production removed or sold from a lease. 30 U.S.C. § 226. If gas produced on a lease is processed for extraction of natural gas liquids or other valuable commodities, the increase in value is attributable to processing, and not to the production itself. If the value of the production is based on the gross proceeds derived from selling the residue gas and gas plant products, the expense of manufacturing them should be deducted. *United States v. General Petroleum Corp.*, 73 F. Supp. 225, 255 (S.D. Cal. 1946), *aff'd sub nom.*, *Continental Oil Co. v. United States,* 184 F.2d 802 (9th Cir. 1950).

A lessee who sells wet gas under an arm's-length POP contract does not perform the processing itself (as it is typically not equipped to do so), but receives a percentage of proceeds (far less than 100%) from the POP buyer's subsequent sale of the resulting residue gas and gas plant products after processing. Under this arrangement, the lessee realizes less than it would have received if it had done the processing.

Under the current regulations, gas that is sold at the lease under a POP contract is considered to be unprocessed gas for valuation purposes. § 1206.152(a)(1). The value of POP gas is ordinarily equal to the greater of the lessee's gross proceeds under its arm's-length POP contract (*i.e.,* the lessee's portion of the POP) or the value of 100 percent of the residue gas created by processing. § 1206.152(a)(& (b)(1)(i). The processing costs which a POP buyer incurs under an arm's-length POP contract after title passes from the lessee are neither added to nor deducted from the lessee's gross receipts.

The proposed regulations would reclassify POP gas as processed gas. Prop. § 1206.142(a)(2). According to the preamble, the ONRR intends the following result:

> [R]oyalty would be based on 100 percent of the value of residue gas, 100 percent of the value of gas plant products, plus the value of any condensate recovered

> downstream of the point of royalty settlement prior to processing, less applicable transportation and processing allowances.

80 Fed Reg. 619, col. 3.

The ONRR's intended treatment of POP contracts would essentially ignore them in favor of the POP buyer's arm's-length resale contracts. The lessee is neither privy to nor a party to the POP buyer's resale contracts. This is not a minor course correction; it is a sea change. Not only is the ONRR ignoring an arm's length negotiated contract, but it is ignoring the fact that the lessee does not realize 100% of the value of residue gas and plant products under a POP contract, but only a percentage thereof. The ONRR's proposed rule would therefore increase the financial burden on the lessee by requiring it pay royalty on the percentage of proceeds it receives ***and*** the percentage the POP buyer receives. In addition, if the lessee must report 100% of the gross proceeds from resale as *the lessee's* gross proceeds, presumably it would also report its buyer's processing costs as its own. But how does the lessee determine the amount of any applicable allowances? A typical POP contract does not set forth applicable transportation or processing charges allocated to the lessee, and therefore, it would be next to impossible for a lessee to determine the amount of any transportation or processing allowance to which it is theoretically entitled.

In the preamble, the ONRR assumes that the percentage of gross proceeds accruing to the POP buyer represents the lessee's deductible cost of processing the gas, subject to a 66-2/3 percent limit. 80 Fed. Reg. 636, col. 2–3. The ONRR estimates that the rigid 66-2/3 percent limitation on processing allowances (prop. §1206.160(c)(2)) will be revenue-neutral. 80 Fed. Reg. 636. The estimate is likely incorrect, because it is based on two flawed assumptions: (1) that the POP buyer's share of proceeds is entirely composed of reasonable, actual processing costs; and (2) that a 70:30 lessee-to-buyer split "is typical for POP contracts." 80 Fed. Reg. 636, col. 3.

To be accurate, the first assumption would require that arm's-length POP contracts be re-characterized as arm's-length processing contracts. Yet, POP contracts are inherently different from processing contracts, and the proposed regulations make no provision for such a re-characterization.

The second assumption is unrealistic. We do not know if "typical" in this context means average, median, more common than any other split, or something else. Regardless, Seneca believes that there are numerous arm's-length POP contracts in existence on federal leases that do not award the lessee 70 percent or more of the gross resale proceeds. 50:50 splits are not unusual, depending on the particular circumstances of the field in which the gas is produced (*e.g.,* the POP buyer may be the only available buyer in a field, and therefore, has more leverage to negotiate a greater share of the proceeds for itself). As a result, there will be a significant wealth transfer from lessees to the United States that the estimate ignores. Such an important change is likely to disrupt the economics of existing POP contracts that have less advantageous splits than the ONRR assumes.

In addition, the ONRR's intended treatment of POP contracts conflicts with the language of proposed section 1206.142(c). Under that provision, the value of processed gas would ordinarily be equal to the gross proceeds for residue gas and gas plant products accruing to the lessee or its affiliate under the first arm's-length sales contract, less applicable allowances. Prop. § 1206.142(b) & (c).[3] A lessee that did its own processing before sale would report 100% of the gross proceeds derived from its arm's-length sales, but would deduct its reasonable actual costs of processing from the gross proceeds it derived from sales of gas plant products by a separate line entry on Form ONRR-2014. Prop. §§ 1206.159(a)(1)–(c)(1), 1206.162(a), 1206.163(a). However, a lessee that sold wet gas under an arm's-length POP contract would report the gross proceeds accruing to it under that contract—the first arm's-length contract—without further adjustment. The limiting language in proposed section 1206.142(c)—"accruing to you or your affiliate"—narrows the application of the broad definition of "gross proceeds" in proposed section 1206.20 (80 Fed. Reg. 644, 2d col.) to reach only those proceeds that actually accrue to the lessee (or its affiliate). The percentage of proceeds realized by the unaffiliated POP buyer do not accrue to the lessee under the POP contract. However, the ONRR's intended result would write "accruing to you or your affiliate" out of section 1206.142(c) for POP contracts by requiring the lessee pay royalty on 100% of the value of residue gas and 100% of the value of plant products. This violates longstanding principles governing interpretation of administrative regulations. A "[c]onstruction which gives effect to all of the words of a statute or regulation is preferred over an interpretation which renders some of the statute or regulation ineffective." *First Charter Financial Corp. v. United States*, 669 F.2d 1342, 1350 (9th Cir. 1981). It would take a strained definition of "accrue" to square the language of the proposed regulation with the ONRR's intended treatment of POP contracts.

The Marketable Condition Rule Appears to be Changing. The ONRR Should Explain How.

The definition of marketable condition—and specifically of "a sales contract typical for the field or area"—has evolved in decisions by the Department of the Interior and by federal courts in reviewing those decisions. Seneca respectfully submits that the ONRR should clarify the effect of the marketable condition rule on POP contracts under the proposed regulations. There is no better time or place to provide certainty to Federal lessees than in the regulations themselves or in the preamble to the final regulations.

The proposed regulations would continue to define marketable condition as "lease products which are sufficiently free from impurities and otherwise in a condition that they will be accepted by a purchaser under a sales contract typical for the field or area ...." Prop. § 1206.20, 80 Fed. Reg. 645, col. 1.

The proposed regulations would revise the definition of "area" in a manner that overtly changes the breadth of the marketable condition rule. Under current section 1206.151, "*Area* means a geographic region at least as large as the <u>defined</u> limits of an oil and/or gas field, in

[3] As stated in the quotation from the preamble, value would also include the value of any condensate recovered downstream of the point of royalty settlement, but that is not germane to this discussion. Prop. § 1206.142(b)(2).

which oil and/or gas lease products have similar quality, economic, and legal characteristics."[4] The proposed regulation would delete the underscored words and add the following sentence: "Area boundaries are not officially designated and the areas are not necessarily named." Prop. § 1206.20, 80 Fed. Reg. 643, col. 2.

The preamble to the proposed regulations does not explain the ONRR's intent in revising the definition. This is particularly pertinent because the ONRR's conception of what is "typical for the field or area" is evolving. Seneca believes that "field or area" refers to the geographic origin of the lessee's gas, the limits of which are readily defined. The inclusion of "area" broadens the geographic scope of what is "typical" to permit consideration of sales of comparable gas from other nearby fields. Increasingly, however, ONRR has determined what is typical based on specifications for the most common or dominant use of gas from the relevant field or area.[5] But in what we believe is the most expansive case on this topic (*Encana Oil & Gas (USA), Inc.*, 185 IBLA 133 (2014)), the ONRR decided, and the Interior Board of Land Appeals concurred, that "field or area" refers to the field or area *into* which the gas is actually sold, "which may or may not be the field or area where the gas is produced." *Id.* at 140–142.

We do not know the significance of the *Encana* case's formulation. The Board's subsequent gloss on the case suggests that it may not intend to go quite as far as its words indicate. *XTO Energy, Inc.,* 185 IBLA 219, 2015 IBLA LEXIS 4, 25 (2015). Certainly we question whether *Encana's* take on what is "typical for the field or area" is compatible with its language. "Field" under both the existing (§ 1206.101) and proposed (§ 1206.20, 80 Fed. Reg. 644, col. 1) regulations generally refers to a geographic region over one or more subsurface oil and gas reservoirs. Gas can be sold *from* a field but in ordinary parlance is not sold *into* a field. One would not naturally identify the geographic region in which gas is sold as a "field." In short, the ONRR's proposed revision of the definition of "area" will result in inconsistent and uncertain marketable condition determinations.

If the ONRR plans to maintain its revised definition of "area," it would help Federal lessees if the ONRR explained how it currently interprets the phrase "typical for the field or area" and what changes it intends by its revision.

A Lessee Under a POP Contract Should Not be Burdened With Placing Residue and Plant Products in Marketable Condition

Under the current regulation, "processing" is "any process designed to remove elements or compounds (hydrocarbon and non-hydrocarbon) from gas, including absorption, adsorption, or refrigeration. Field processes which normally take place on or near the lease, such as natural

[4] An identical definition appears in section 1206.51, regarding oil produced on Indian leases, and a nearly identical definition appears in section 1206.101, regarding oil produced on federal leases.

[5] See *Amoco Production Co. v. Watson,* 410 F.3d 722, 730 (D.C. Cir. 2005); *J-W Operating Co.,* 159 IBLA 1, at 6 & 12 (2003); *Burlington Resources Oil and Gas Co.,* 183 IBLA 333, 2013 IBLA LEXIS 15, at 45, 50, 52–53 (2012), aff'd sub nom *Burlington Resources Oil & Gas Co. v. United States,* 2014 U.S. Dist. LEXIS 100900, at 12, n.9 (N.D. Okla. 2014).

pressure reduction, mechanical separation, heating, cooling, dehydration, and compression, are not considered processing." § 1206.151. Insofar as germane to this discussion, the proposed regulation would leave this definition intact. Prop. § 1206.20.

Under the current version of the marketable condition rule, a lessee who sells unprocessed gas, including a sale under a POP contract, "must place [the] gas in marketable condition and market the gas for the mutual benefit of the lessee and the lessor at no cost to the Federal Government." § 1206.152(i). The value of unprocessed gas established by its gross proceeds "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 gas in marketable condition or to market the gas." § 1206.152(i). Similarly, a lessee who sells processed gas "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." § 1206.153(i).

By treating gas sold through POP contracts as a sale of "unprocessed gas", the current regulations recognize that the lessee no longer has title to or control over production after its POP buyer takes possession at the wellhead or plant inlet, such that the lessee is not obligated to place residue gas and plant products in marketable condition. Under the proposed rules, however, by treating arm's-length POP contracts as sales of "processed gas", the ONRR improperly places the burden on the lessees to suffer the costs to place residue gas and plant products in marketable condition despite the fact the lessees do not have title to or control over same. See Prop. § 1206.146(a) & (b).

Conclusion

Parties enter into contracts with an understanding of the rules that will govern their relationships, and their reasonable expectations should be respected. Far from being just a little tweak to the existing rules, the changes that the ONRR intends to make to the treatment of POP contracts are likely to be disruptive. Fortunately, the ONRR has not revised the text of the regulations to match its full intent, and that is how it should leave matters. If the ONRR revises the regulations to conform with its plan, the plan should apply only to POP contracts that are entered into after the proposed regulations take effect.

Sincerely,

SENECA RESOURCES CORPORATION

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