United States Department of the Interior

OFFICE OF NATURAL RESOURCES REVENUE

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

DEC 18 2014

Subject: Rescinding the August 8, 2013, Reporter Letter titled Royalty on Gas Used or Lost Along a Pipeline Prior to the Point of Sale

Dear Reporter:

This Reporter Letter replaces the Reporter Letter dated August 8, 2013 regarding gas used or lost along a pipeline prior to the point of sale. The purpose of this letter is to:

1. Clarify the effective date of this guidance;
2. Restate the Office of Natural Resources Revenue's (ONRR) guidance regarding gas used or lost along a pipeline when the gas is sold away from the lease and after processing;
3. Modify ONRR's guidance regarding gas used or lost along a pipeline when the gas is sold away from the lease and prior to processing; and
4. Clarify how to value and report gas sold prior to processing.

Background

ONRR issued a Reporter Letter dated August 8, 2013, that provided guidance on how to value and report royalties on gas used or lost along a pipeline prior to the point of sale. In the months following, ONRR presented on the topic and conducted a workshop with representatives from industry trade associations. In that workshop, and in subsequent letters and meetings, industry representatives shared several concerns, one of which was ONRR's instructions to use product code (PC) 15 in situations when gas is sold prior to processing, and away from the lease. ONRR examined this issue, and is modifying the original guidance. The guidance in the August 8, 2013 Reporter Letter regarding using PC 15 in processed gas situations remains unchanged.

Effective Date

Companies should begin using PC 15 for reporting pipeline fuel/loss for gas sold after processing beginning with the September 2013, sales month (October 2013, reporting month).

Royalties on Natural Gas Used or Lost

ONRR's regulations[1] provide that royalty is due on all gas produced from Federal and Indian leases except for gas used on or for the benefit of the lease and residue gas used to operate a gas processing plant.[2] The regulations do not allow a royalty exemption for gas used or lost in the operation of a transportation system, but they do allow lessees to include certain costs of gas used or lost as part of a transportation allowance.

The volume of gas used and/or lost is generally the difference between the volume of gas measured at the royalty settlement point and the volume of gas measured at the downstream sales meter or at the inlet meter at the gas processing plant. This volume is usually written into your gas gathering, transportation, or processing contract and is usually shown on the statement that corresponds to that contract, under a heading such as:

- Contractual Field Deducts
- Contractual Fuel
- Raw Field Deducts
- Pipeline Use/Usage
- Line Loss
- Fuel Retained
- Compression Fuel
- Lost and Unaccounted, L&U

The few examples above are not an exhaustive list. You should pay royalty on 100 percent of the quantity and quality of production measured at the royalty settlement point.

Valuation of Pipeline Fuel/Loss for Gas Sold After Processing

In most cases, a lessee does not sell the gas used or lost along the pipeline. In those cases, you should value the gas as follows:

- For Federal gas, you should determine the value of such gas under 30 CFR § 1206.152(c).
- For Indian gas produced in an index zone, you should include the value of the gas used or lost as part of the processed gas value when you are performing actual dual accounting and you should value the gas used or lost using the index zone price under 30 CFR 1206.172.
- For Indian gas produced in a non-index zone, you should determine the value under 30 CFR § 1206.174(c).

Reporting of Pipeline Fuel/Loss for Gas Sold After Processing

You should report any royalty-bearing gas the transporter uses or loses prior to processing on the Form ONRR-2014 using PC 15 and transaction code (TC) 01. In a Federal non-arm's-length percentage-of-proceeds (POP) gas sale situation, when you

[1] *See* 30 CFR § 1202.150(b)(1) for Federal gas and 30 CFR § 1202.555 for Indian gas.

[2] When the plant reduces your residue allocation for gas used in the plant, you should add the disallowed portion of gas used in the plant to your residue (PC 03) volume and value when paying royalty.

report the gas sale using PC 03 and 07, you should report any royalty-bearing gas the transporter uses or loses prior to sale on the Form ONRR-2014 using PC 15 and TC 01.

You should not include any MMBtu-equivalent volumes of condensate recovered along the pipeline in the volume and value reported under PC 15. You should report pipeline condensate using PC 05, with the volumes reported as barrels and the value established under the oil regulations at 30 CFR § 1206 Subparts B and C.

The requirement to report and pay royalty on 100 percent of the volume measured at the royalty settlement point is not new. However, the use of PC 15 to report the gas used or lost along a pipeline is new. If you properly included the gas used or lost in your royalty volume and value prior to September, 2013, you do not need to make any retroactive adjustments. However, if you did not include the gas used or lost in your royalty volume and value prior to your receipt of this guidance, you should adjust your royalty reporting using PC 15. In addition, you should use PC 15 to report all gas used or lost along a pipeline prior to processing starting with September, 2013, sales month.

If your reported volume was correct, but you deducted costs of placing the gas into marketable condition, you should adjust your sales value and/or allowances. You do not need to change any product codes.

Valuation of Pipeline Fuel/Loss for Gas Sold Prior to Processing

ONRR's regulations provide that royalty for unprocessed gas shall be computed on the basis of the quantity and quality of the gas at the royalty settlement point.[3] They also provide that, in situations when the value a lessee receives is based on a quantity and/or quality of gas that is different from what was measured at the royalty settlement point, the value received should be adjusted to account for the differences in quantity and/or quality.[4] Also, when the royalty value is based on a lessee's gross proceeds, the lessee must increase its gross proceeds to the extent that they were reduced because the purchaser was performing services necessary to place the gas into marketable condition.[5]

When you need to adjust your royalty value as described above, you should value the disallowed fuel as follows:

- For Federal gas, you should determine the value of such gas under CFR § 1206.152(c).
- For Indian gas produced in a non-index zone, you should determine the value of such gas under 30 CFR § 1206.174(c).

[3] *See* 30 CFR § 1206.154(a)(1) for Federal gas and 30 CFR § 1206.175(a) for Indian gas.
[4] *See* 30 CFR § 1206.154(a)(2).
[5] *See* 30 CFR § 1206.152(i) for Federal gas and 30 CFR § 1206.174(h) for Indian gas.

Reporting of Pipeline Fuel/Loss for Gas Sold Prior to Processing

In the previous Reporter Letter dated August 8, 2013, ONRR instructed companies to report PC 15 in situations when gas was sold prior to processing away from the lease, and gas was used or lost along the pipeline prior to the downstream sales point. We are modifying this guidance for gas sold prior to processing as explained below.

You should report gas sold prior to processing on Form ONRR-2014 using PC 04 and TC 01. You should report the volume (Mcf), heat content (MMBtu), and the full value of the gas measured at the royalty settlement point. Although ONRR has modified the reporting requirements, royalty is still due on the full quantity and quality of gas measured at the royalty settlement point, which may include the value of fuel used downstream of the lease. While ONRR has decided not to require PC 15 reporting for unprocessed gas at this time, ONRR will carefully monitor proper payment of royalties on unprocessed gas and gas used or lost along a pipeline. If ONRR finds through our audit and compliance work that many lessees are not in compliance, ONRR will reconsider this decision.

For companies who may have already changed their systems to report the gas used or lost using PC 15 in situations when the gas is sold prior to processing, those companies may continue to report using PC 15.

Transportation Allowances

After you have paid royalty on the full volume and value of gas measured at the royalty settlement point, you may take a transportation allowance for your reasonable, actual costs to transport the gas to a sales point away the lease.[6] The regulations provide that ONRR will allow the costs of compression, dehydration, and treatment of gas only when they are required for transportation and exceed the services necessary to place the gas into marketable condition.[7] Gas used along a pipeline system is usually for one of these services. Consequently, you may only include the cost of the used gas as part of a transportation allowance when the transporter uses it to compress, dehydrate, or treat the gas beyond the marketable condition requirement. For arm's-length transportation, you may include actual and theoretical line losses in the transportation allowance. For non-arm's-length transportation, you may only include actual line losses in the transportation allowance.[8]

You should allocate the transportation costs among all products being transported.[9] You may not take a transportation allowance that exceeds fifty percent of the value of the product being transported without ONRR approval.[10]

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[6] *See* 30 CFR § 1206.156 for Federal gas and 30 CFR § 1206.177 for Indian gas.
[7] *See* 30 CFR § 1206.157(f)(9) for Federal gas and 30 CFR § 1206.178(f)(9) for Indian gas.
[8] *See* 30 CFR § 1206.157(f)(7) for Federal gas and 30 CFR § 1206.178(f)(7) for Indian gas.
[9] *See* 30 CFR § 1206.156(b) for Federal gas and 30 CFR § 1206.177(b) for Indian gas.
[10] *See* 30 CFR § 1206.156(c) for Federal gas and 30 CFR § 1206.177(c) for Indian gas.

Failure to Properly Report

The ONRR stresses the importance of correctly reporting and paying royalty on gas used or lost along a pipeline. Please note that if you knowingly or willfully misreport royalties, ONRR may assess civil penalties under 30 U.S.C. § 1719 and 30 C.F.R. Part 1241 of up to $25,000 per day, per violation.

As a result of this Reporter Letter, ONRR considers Federal and Indian oil and gas lessees to be on notice of the requirement to properly report and pay royalties on gas used or lost along a pipeline. Therefore, if ONRR finds a lessee to not be in compliance with the guidance provided in this letter, that lessee may be subject to civil penalties.

Audit Information

Consistent with 30 CFR §1217.50, ONRR will initiate and conduct audits of Federal and Indian leases to ensure accurate reporting of production and timely and accurate payment of revenues due.

Guidance Information

This letter does not require you to perform any type of restructured accounting or require you to recalculate and pay royalties. It is valuation guidance and general information for reporting and paying royalties on gas used or lost along a pipeline.

This letter is not an appealable decision, order, Notice of Noncompliance, or Civil Penalty Notice under 30 CFR Part 1290 Subpart B (2011) or 30 CFR Part 1241 (2011). If ONRR issues you an order, Notice of Noncompliance, or Civil Penalty Notice at a later date in accordance with the matters addressed in this letter, we will provide your appeal rights at that time.

Please note that the citations refer to ONRR's current published regulations. If these regulations change, please use the most recent applicable version. For detailed regulatory language, please visit http://ecfr.gpoaccess.gov and select Title 30 - Mineral Resources, Chapter XII (1200).

If you have questions, or need valuation assistance, please contact ONRR's Royalty Valuation Office via electronic mail at RoyaltyValuation@onrr.gov.

Sincerely,

JD Steward

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