United States Department of the Interior

Office of Natural Resources Revenue
P.O. Box 25165
Denver, CO 80225-0165

AUG 0 8 2013

Subject: Royalty on Gas Used or Lost Along a Pipeline Prior to the Point of Sale

Dear Reporter:

The purpose of this Dear Reporter letter is to provide clarity and guidance on how to value and report natural gas used or lost along a pipeline before being sold. You should pay royalty on the full volume and value of gas used or lost along a pipeline prior to sale using product code (PC) 15 and transaction code (TC) 01 on the Report of Sales and Royalty Remittance Form ONRR-2014.

Royalties on Natural Gas Used or Lost

The Office of Natural Resources Revenue's (ONRR) regulations[1] provide 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 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 volume of production measured at the royalty settlement point.

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[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.

Valuation

In most cases, a lessee never sells 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 the Federal gas valuation benchmarks at 30 CFR § 1206.152(c).
- For Indian gas produced in an index zone, you should include the value of the gas used or lost 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 the Indian gas valuation benchmarks at 30 CFR § 1206.174(c).

Reporting

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. In a Federal arm's-length percent of proceeds (POP) gas sale situation, when you report the gas sale using PC 04, you should increase your gross proceeds to the extent the transporter used that lease gas in equipment to place the gas into marketable condition. In a Federal non-arm's-length POP gas sale situation, when you 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.

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 your receipt of this guidance, 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 the point of sale starting the month following your receipt of this letter.

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

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 from the lease.[3] The regulations provide that ONRR will allow the costs of compression, dehydration, and treatment of gas only

[3] *See* 30 CFR § 1206.156 for Federal gas and 30 CFR § 1206.177 for Indian gas.

when they are required for transportation and exceed the services necessary to place the gas into marketable condition.[4] 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. You may include actual line losses in the transportation allowance, but you may only include theoretical line losses in arm's-length transportation situations.[5]

You should allocate the transportation costs among all products being transported.[6] You may not take a transportation allowance that exceeds fifty percent of the value of the product being transported without ONRR approval.[7]

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.

Audit Information

Consistent with 30 CFR §1217.50, ONRR will initiate and conduct audits of Federal and Indian leases to ensure accurate reporting of royalty 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 merely 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 (2012) or 30 CFR Part 1241 (2012). 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).

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

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

Sincerely,

James D. Steward
Program Director
Financial and Program Management