Proposed Royalty Valuation Regulations: Federal Oil and Gas and Federal and Indian Coal

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Proposed Rule Published

- The Consolidated Federal Oil & Gas and Federal & Indian Coal Valuation Reform Proposed Rule was published in the *Federal Register* on January 6, 2015
- The public comment period closes March 9, 2015
- ONRR welcomes and encourages your comments and feedback
- ONRR included several specific questions in the proposed rule soliciting your thoughts

Proposed Changes: Definitions

- ONRR proposes to consolidate the definitions from Federal Oil, Federal Gas, Federal Coal, and Indian Coal to provide greater clarity and eliminate redundancy
- Where common terms exist in the four subparts, ONRR modifies the definitions to incorporate the active voice and to use plain and simple language similar to the language reflected in the 2000 Federal crude oil rule
- ONRR added 19 new definitions. Examples include: Coal cooperative, Constraint, and Keepwhole contract (refer to table in *FR*)

Proposed Changes: Federal Oil

- The Federal Oil Rule proposes to simplify and clarify existing regulations by eliminating an unused valuation option (the tendering program) and making available acceptable publications for the New York Mercantile Exchange (NYMEX) and Alaska North Slope (ANS) spot prices on our website instead of the Federal Register

Proposed Changes: Federal Oil

- The Proposed Federal Oil Rule also implements a new "**default provision**" that codifies and strengthens the Secretary's discretion for ONRR to exercise its authority to meet its mandate under 30 U.S.C. 1711 to ensure accurate accounting for Federal oil and gas royalties under the different circumstances it encounters during its compliance verification activities. Under the new "default provision", ONRR may decide value because:
  1. There is misconduct by the lessee or between the lessee and a third party contractor;
  2. The lessee breached its duty to market by selling its oil at a value that is unreasonably low. ONRR may consider a sales price to be unreasonably low if it is 10 percent or more lower than the lowest reasonable measures of market price, such as index prices and prices reported to ONRR for like-quality oil; or
  3. ONRR cannot determine whether the lessee properly valued its oil

Proposed Changes: Federal Oil

Example

- Lessee A sells oil produced in the Gulf of Mexico (GOM) under its arm's-length contract for $60 per barrel and the prevailing market price for oil in that portion of the GOM is $90 per barrel
- If ONRR determines, under the default provision, that lessee A had breached its duty to market by selling its oil at an unreasonably low price (33 1/3 percent less than market price), then ONRR would require the lessee to pay royalty on federal oil based on $90 per barrel
- This new "default provision" is also incorporated in the Federal Gas proposed Subpart and the Federal and Indian Coal proposed Subparts

Proposed Changes: Federal Oil

If ONRR determines value under this new default section, we could consider any information we deem relevant. This proposed section also would enumerate factors ONRR could consider if we decide we will determine value for royalty purposes under this section, which may include, but would not be limited to:

a) The value of like-quality oil/gas/coal in the same field or nearby fields or areas;
b) The value of like-quality gas from the same plant or area;
c) Public sources of price or market information that ONRR deems reliable;
d) Information available and reported to ONRR and information reported to us, including but not limited to, on Form ONRR-2014 and Form ONRR-4054;
e) Costs of transportation or processing, if ONRR determines they are applicable; or
f) Any information ONRR deems relevant regarding the particular lease operation or the salability of the oil/gas/coal

Proposed Changes: Federal Oil

Transportation Allowances

- No allowance for moving oil to the first platform on the Offshore Continental Shelf (OCS) (i.e., rescinds the Associate Director's 1999 Deep Water Policy memo)
- Disallows transportation allowances greater than 50% of the value of oil
- Terminates existing approvals exceeding the 50% limit
- ONRR may determine transportation allowances under §1206.105 (default provision)

Proposed Changes: Federal Oil

<u>Arm’s-Length Transportation Allowances</u>

- Under §1206.105, ONRR will determine allowances for arm’s-length transportation that has no contract
- Transportation allowances must be reported as costs rather than a single factor (eliminating the use of **transportation factors**), thus ensuring the 50% limit is not exceeded (also applies to Federal gas)
- We propose that a lessee must report separately all transportation costs under both arm’s-length and non-arm’s-length sales contracts as a transportation allowance on Form ONRR-2014

Proposed Changes: Federal Oil

- For oil under arm's-length and non-arm's-length transportation contracts, ONRR proposes eliminating the provision that allows lessees to include the costs of carrying line fill on their books
- We propose to eliminate allowing this cost because we believe this is a cost to market the oil we disallow as a deduction under our existing valuation regulations
- Line fill occurs after the royalty measurement point and is necessary for the pipeline operator to get Federal oil production to market. We request comments on whether this is a marketing cost

Proposed Changes: Federal Oil

- For oil transported under non-arm's-length contracts only, the proposed rule implements new provisions related to depreciation of capital costs of a pipeline
- ONRR proposes to eliminate the provision in the current regulations which allows a lessee to reduce the royalty volume measured at the royalty measurement point by actual or theoretical line loss occurring after the royalty measurement point
- This change is consistent with long-standing mineral leasing laws that require royalty on the volume of production removed from the lease

Cost of Capital

- Current rate is 1.3 times S&P BBB bond rate
- Propose changing to 1.0 times S&P BBB bond rate

Proposed Changes: Federal Gas

- ONRR proposes retaining gross proceeds to value arm’s-length sales of Federal gas, same as the current rule
- Consistent with the proposed changes to Federal oil valuation, ONRR is proposing a “default provision” in the Federal gas valuation proposed rule for situations where the Secretary cannot determine the correct value of production because of a variety of factors including, but not limited to, the lessee’s failure to provide documents, or determines the value is wrong because of the lessee’s misconduct, breach of the duty to market, or any other reason

Proposed Changes: Federal Gas

- ONRR also proposes eliminating the existing "benchmarks" used to value non-arm's-length sales and instead proposes providing valuation options consistent with current market practices, including:

  1) Gross proceeds under the affiliate's first arm's-length resale with applicable allowances
     - In the case of multiple arm's-length sales, lessees must use a volume-weighted average value of its arm's-length contracts; or

Proposed Changes: Federal Gas

2) Election to use an Index Price

- Intended when tracing affiliate re-sales to first arm's-length sale is difficult
- Lessee may select one publication no more than once every two years. Proposal is to use index option at a property/lease level
- ONRR proposes a fixed transportation allowance of 5% for OCS sales and 10% for all other areas, but not by less than 10 cents per MMBtu or more than 30 cents per MMBtu
- ONRR proposes these percent reductions based on the average gas transportation rates that lessees have reported to ONRR from 2007 through 2010 for OCS and all other areas

Proposed Changes: Federal Gas

We believe this index price option simplifies the current valuation methodology and provides early certainty

- Many pipelines and service providers now charge producers “bundled” fees that include both deductible costs of transportation and non-deductible costs to place production into marketable condition. Both ONRR and lessees with arm’s-length transportation contracts have found allocating the costs between placing the gas in marketable condition and transportation is administratively burdensome and time consuming
- Similarly, when processing plants charge bundled fees that include non-deductible costs, the cost allocation is administratively burdensome and time consuming

Proposed Changes: Federal Gas

- Allows ONRR to consider an allowance as “unreasonably high” if it is 10% higher than the highest reasonable measures of transportation costs (also applies to Federal and Indian coal)
- Eliminates the provision to include actual or theoretical line loss as a transportation cost (non-arm’s-length)
- Changes the rate of return used to calculate the return on investment applicable to the calculation of non-arm’s-length transportation allowances from 1.3 to 1.0 times the Standard & Poor’s BBB Bond

Proposed Changes: Federal Gas

Processing and Transportation Allowances

- Disallows gas processing allowances in excess of 66 2/3% of the value of the liquids and terminates existing approvals exceeding the 66 2/3% limit
- Terminates extraordinary cost processing allowances under former §1206.158(d)(2). Two companies are currently approved for extraordinary cost process
- Disallows transportation allowances greater than 50% of the value of the gas and terminates existing approvals exceeding the 50% limit
- No allowance for the movement of gas or oil produced on the OCS to the first platform (i.e., rescinds the May 20, 1999, the former MMS's Royalty Management Program Associate Director's issued "Guidance for Determining Transportation Allowances for Production from Leases in Water Depths Greater Than 200 Meters" (Deep Water Policy))

Proposed Changes: Federal Gas

- Under the Deep Water Policy, ONRR considered a subsea manifold located on the OCS in deep water to be a "central accumulation point" regardless of whether it was actually a central accumulation or treatment point as ONRR's regulations require
- Since ONRR issued the Deep Water Policy, lessees have been deducting the costs of moving bulk production from the subsea manifold to the platform where the oil and gas first surface. In addition, lessees have attempted to expand the Deep Water Policy to deem subsea wellheads "central accumulation points" and take transportation allowances from the sea bed floor to the first platform where the bulk production surfaces
- Thus, lessees have taken transportation allowances under the Deep Water Policy, in some instances, for movement ONRR considers non-deductible "gathering" under its regulations

Proposed Changes: Federal Gas

- We have determined that the Deep Water Policy is inconsistent with our regulatory definition of gathering and Departmental decisions interpreting that term. Therefore, we propose to rescind the Deep Water Policy in this rulemaking
- We propose to accomplish this by making two changes. First, consistent with *Kerr-McGee,* we propose to add to the definition of "gathering" that any movement of bulk production from the wellhead to a platform offshore is gathering, not allowable transportation
- Second, we propose to add a new paragraph that states "[f]or gas produced on the OCS, the movement of gas from the wellhead to the first platform is not transportation"
- We also make this change to proposed Federal oil

Proposed Changes: Federal Gas

- Under the proposed rule, ONRR will consider gas that you or your affiliate do not sell or otherwise dispose of under an arm's-length contract before processing "processed gas"
- We propose to value POP contracts, percentage-of-index contracts, casing head gas contracts, and contracts with any such variations of payment based on volumes or value of those products as processed gas. Under the current regulations, these contracts are generally valued as unprocessed gas

Accounting for Comparison (Dual Accounting)

- ONRR requests comments on whether we need this requirement for two reasons:
  - First, the proposed rule recognizes the real market value of gas today is the combined value of its constituent components—residue gas and gas plant products. And, the proposed regulations value gas sold on that basis as processed gas. There appears to be a limited market for unprocessed gas, unless it is sold based upon the constituent products contained therein, hence accounting for comparison may not be needed
  - Second, because the criteria that triggers dual accounting—a non-arm's-length sale of residue gas after processing—is not used to value gas under this proposed rule, dual accounting may no longer be appropriate because the residue gas is valued based on the first arm's-length sale or index-based option

Summary of Royalty Impacts and Costs

Rule Provision	Industry	Federal	State	State 8(g)
Gas - replace benchmarks				
Affiliate Resale	($2,010,000)	$1,390,000	$605,000	$13,500
Index	($11,300,000)	$7,820,000	$3,400,000	$75,700
NGLs - replace benchmarks				
Affiliate Resale	($256,000)	$191,000	$63,000	$1,850
Index	($1,200,000)	$896,000	$295,000	$8,650
Gas transportation limited to 50%	($4,170,000)	$2,890,000	$1,260,000	$27,900
Processing allowance limited to 66⅔ %	($5,440,000)	$4,060,000	$1,340,000	$39,200
POP contracts limited to 66⅔ %	$0	$0	$0	$0
Extraordinary processing allowance	($18,500,000)	$9,250,000	$9,250,000	$0
BBB bond rate change for gas transportation	($1,640,000)	$1,140,000	$494,000	$11,000
Eliminate deepwater gathering	($20,500,000)	$20,500,000	$0	$0
Oil Transportation limited to 50%	($6,430,000)	$5,810,000	$594,000	$27,100
Oil and gas line losses	($4,570,000)	$4,130,000	$422,000	$19,200
Oil line fill	($1,710,000)	$1,540,000	$158,000	$7,190
BBB bond rate change for oil transportation	($2,380,000)	$2,150,000	$220,000	$10,000
Coal - non-arm's length netback & coop sales	$0	$0	$0	$0
Total	($80,100,000)	$61,800,000	$18,100,000	$241,000

Summary of Royalty Impacts and Costs

- The royalty impacts to the industry represent **0.8 to 1.0 percent** of total Federal oil, gas and coal royalties collected in Calendar Year 2010
- As a benefit, industry will also experience reduced annual administrative costs of $3.61 million
- The Federal Government will also experience reduced administrative costs due to the anticipated reduction in costly valuation disputes, appeals, and related challenges. This cost could be substantial, but cannot be quantified at this time

We Love Comments

Please review the Proposed Rule and send us your comments

http://www.regulations.gov/#!docketDetail;D=ONRR-2012-0004

ONRR thanks you!

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