

Barton, Jayne

From: Burhop, Shirley
Sent: Tuesday, December 02, 2003 2:16 PM
To: Davidoff, Robert
Subject: FW: Development of training and guidance

Attachments: FINA and Gas Benchmark analysis Nov 21 2003.doc



FINA and Gas
Benchmark analysis..

Here's Karen's paper, referred to in my summary of yesterday's meeting. She's going to spruce it up with some legal references, but it's what we're modeling the others after.

-----Original Message-----

From: Loomis, F David
Sent: Friday, November 21, 2003 2:45 PM
To: Burhop, Shirley; MRM/Bldg. 85 Mile High Room, Room F201B; Johnson, Brian C; Soderlind, Ellwood; Loomis, F David; Staigle, George; Kepler, Glenn; Kirumakki, Nagaraja; Rodriguez, Nancy; Shirley, Perry; Teel, Sara; tfisher@washakie.net; Summers, Dana; Conway, Karen
Subject: RE: Development of training and guidance

Attached is a file with Karen Conway's analysis on the Fina case and benchmark discussion for gas.

Please let me know what you think.

Karen has my thanks and appreciation for putting this together for us.

Also, for those who want to open the scanned files from MMS, the web site to download the program is:

www.scansoft.com/paperport/viewers

My thanks to Ken Vogel, Brenda Petersen, and Dana Summers for this information.

Dave

-----Original Message-----

From: Shirley.Burhop@mms.gov [mailto:Shirley.Burhop@mms.gov]
Sent: Friday, November 21, 2003 12:45 PM
To: MileHighRoom@mms.gov; Brian.C.Johnson@mms.gov;
esoderlind@wyaudit.state.wy.us; dloomis@spike.dor.state.co.us;
georgestaigle.mms@midconetnetwork.com; Glenn.Kepler@mms.gov;
Nagaraja.Kirumakki@mms.gov; nrodriguez@state.nm.us;
pshirley@frontiernet.net; sara.teel@mms.gov; tfisher@washakie.net
Subject: Development of training and guidance

When: Monday, December 01, 2003 1:00 PM-2:30 PM (GMT-07:00) Mountain Time (US & Canada).

Where: Mile High Room

~~*~*~*~*~*~*~*~*

Hopefully, we will have had a chance to review Karen Conway's paper by then.

Tracking:

Recipient
Davidoff, Robert

Read
Read: 12/2/2003 2:18 PM

November 21, 2003

From: Karen Conway, State of Colorado
To: MMS and STRAC
Subject: Fina and the Benchmarks

In light of the Fina decision there has been some discussion concerning the application of the Federal gas benchmarks.

1. Does the Fina decision impact the application of the gas benchmarks?
 - Because the Fina audit was assessed under the marketing affiliate resales Sec. 206.151, and the related company was a non-marketing affiliate, i.e. purchased from other companies, the benchmarks must apply.
 - The result is that when one Mcf of gas is purchased from an unrelated company the benchmarks must be used.
2. Does this limit the valuations to less than the "gross proceeds accruing to the lessee"? The benchmarks specifically state in Sec. 206.152 (h) Notwithstanding any other provision of this section, under no circumstances shall the value of production for royalty purposes be less than the gross proceeds accruing to the lessee for lease production....
 - After consideration of the benchmarks under a non-arm's-length sale, if the value is less than the gross proceeds then royalties must be paid on the gross proceeds.

Benchmark Analysis

(November 21, 2003)

Unprocessed gas

Regulation:

[Code of Federal Regulations]
[Title 30, Volume 2]
[Revised as of July 1, 2001]
Subpart D--Federal Gas

Sec. 206.152 Valuation standards--unprocessed gas.

(c) The value of gas subject to this section which is not sold pursuant to an arm's-length contract shall be the reasonable value determined in accordance with the first applicable of the following methods:

First benchmark:

(1) The gross proceeds accruing to the lessee pursuant to a sale under its non-arm's-length contract (or other disposition other than by an arm's-length contract), provided that those gross proceeds are equivalent to the gross proceeds derived from, or paid under, comparable arm's-length contracts for purchases, sales, or other dispositions of like-quality gas in the same field (or, if necessary to obtain a reasonable sample, from the same area). In evaluating the comparability of arm's-length contracts for the purposes of these regulations, the following factors shall be considered: price, time of execution, duration, market or markets served, terms, quality of gas, volume, and such other factors as may be appropriate to reflect the value of the gas;

First Valuation Benchmark from the Oil and Gas Payor Handbook, January 1994, unprocessed gas.

Comparability:

- First, use contracts where sellers and purchasers are not affiliated with lessee
- Second, use contracts where sellers are not affiliated with the lessee but purchasers are
- Price
- Time of execution
- Duration of contract
- Market or markets served
- Terms
- Quality of the gas
- Volume
- Other appropriate factors

Equivalency is based on the lowest-priced comparable arm's-length contract.

Analysis

For example:

- Compare company non-arm's-length (NAL) price to Arm's-length (AL) prices in the field or area. If the NAL price is greater than or equal to the lowest price of a comparable AL contract and the price, time of execution, duration of contract, market, terms, quality and volume of gas are equivalent, then the price is acceptable.
- Compare company non-arm's-length (NAL) price to a related company's arm's-length (AL) price for purchases in the field or area. If the NAL price is greater than or equal to the lowest price of a comparable AL contract and the price, time of execution, duration of contract, market, terms, quality and volume of gas are equivalent, then the price is acceptable. If not then go to the second benchmark.

Second Benchmark:

(2) A value determined by consideration of other information relevant in valuing like-quality gas, including gross proceeds under arm's-length contracts for like-quality gas in the same field or nearby fields or areas, posted prices for gas, prices received in arm's-length spot sales of gas, other reliable public sources of price or market information, and other information as to the particular lease operation or the saleability of the gas; or

Second Valuation Benchmark from the Oil and Gas Payor Handbook, January 1994, unprocessed gas.

Used when:

- Lessee's gross proceeds are not equivalent
- Lessee receives no consideration for its gas

Criteria can include:

- Gross proceeds under arm's-length contracts in the field or area
- Published prices
- Spot prices
- Other reliable public sources of price or market information
- Information relevant to that particular lease or saleability of the lessee's gas

Selected criteria should:

- Closely reflect the lessee's circumstances
- Be the most relevant factor

Lessee must notify MMS

Analysis

For example:

- A value determined by consideration of other information relevant in valuing like-quality gas, including gross proceeds under arm's-length contracts for like-quality gas in the same field or nearby fields or areas, posted prices for gas, prices received in arm's-length spot sales of gas, other reliable public sources of price or market information, and other information as to the particular lease operation or the salability of the gas.
- For instance, there is no long-term contract for the field or area and the company contract is long-term, then gross proceeds under short term arm's-length contracts in the field or area may be used. Published prices; spot prices to other reliable public sources of price; or market information; or other relevant information may be used.
- If there is a company that is non-arm's-length to the lessee and they purchase in the same field or area from arm's-length companies, these agreements may be used to value production under the second benchmark because these prices are arm's-length prices in the field or area. This may not be a valid pricing method if this is a captive market.

Third benchmark:

- (3) A net-back method or any other reasonable method to determine value.

Third Valuation Benchmark from the Oil and Gas Payor Handbook, January 1994, unprocessed gas.

- Determined on a case-by-case basis
- **Lessee must notify MMS**

Analysis

For example:

- This may be an arm's-length price in a different field or area adjusted for quality and transportation as long as it is reasonable, or other method.

Maximum price regulation, not applicable at the moment:

d)(1) Notwithstanding any other provisions of this section, except paragraph (h) of this section, if the maximum price permitted by Federal law at which gas may be sold is less than the value determined pursuant to this section, then MMS shall accept such maximum price as the value. For purposes of this section, price limitations set by any State or local government shall not be considered as a maximum price permitted by Federal law.

Warranty contract only, warranty contract regulation:

2) The limitation prescribed in paragraph (d)(1) of this section shall not apply to gas sold pursuant to a warranty contract and valued pursuant to paragraph (b)(2) of this section.

Further valuation regulations for unprocessed gas:

e)(1) Where the value is determined pursuant to paragraph (c) of this section, the lessee shall retain all data relevant to the determination of royalty value. Such data shall be subject to review and audit, and MMS will direct a lessee to use a different value if it determines that the reported value is inconsistent with the requirements of these regulations.

(2) Any Federal lessee will make available upon request to the authorized MMS or State representatives, to the Office of the Inspector General of the Department of the Interior, or other person authorized to receive such information, arm's-length sales and volume data for like-quality production sold, purchased or otherwise obtained by the lessee from the field or area or from nearby fields or areas.

(3) A lessee shall notify MMS if it has determined value pursuant to paragraph (c)(2) or (c)(3) of this section. The notification shall be by letter to the MMS Associate Director for Royalty Management or his/her designee. The letter shall identify the valuation method to be used and contain a brief description of the procedure to be followed. The notification required by this paragraph is a one-time notification due no later than the end of the month following the month the lessee first reports royalties on a Form MMS-2014 using a valuation method authorized by paragraph (c)(2) or (c)(3) of this section, and each time there is a change in a method under paragraph (c)(2) or (c)(3) of this section.

(f) If MMS determines that a lessee has not properly determined value, the lessee shall pay the difference, if any, between royalty payments made based upon the value it has used and the royalty payments that are due based upon the value established by MMS. The lessee shall also pay interest on that difference computed pursuant to 30 CFR 218.54. If the lessee is entitled to a credit, MMS will provide instructions for the taking of that credit.

(g) The lessee may request a value determination from MMS. In that event, the lessee shall propose to MMS a value determination method, and may use that method in determining value for royalty purposes until MMS issues its decision. The lessee shall submit all available data relevant to its proposal. The MMS shall expeditiously determine the value based upon the lessee's proposal and any additional information MMS deems necessary. In making a value determination MMS may use any of the valuation criteria authorized by this subpart. That determination shall remain effective for the period stated therein. After MMS issues its determination, the lessee shall make the adjustments in accordance with paragraph (f) of this section.

(h) **Notwithstanding any other provision of this section, under no circumstances shall the value of production for royalty purposes be less than the gross proceeds accruing to the lessee for lease production, less applicable allowances.**

(bold added for emphasis)

Observation:

Many companies are using the Fina decision to refuse to provide contracts. According to Sec. 206.152 (e) (2), they must provide the arms-length contracts.

Any Federal lessee will make available upon request to the authorized MMS or State representatives, to the Office of the Inspector General of the Department of the Interior, or other person authorized to receive such information, arm's-length sales and volume data for like-quality

production sold, purchased or otherwise obtained by the lessee from the field or area or from nearby fields or areas.

Ultimately these arm's-length contracts may be used to determine gross proceeds.

Processed gas

Regulation:

[Code of Federal Regulations]

[Title 30, Volume 2]

[Revised as of July 1, 2001]

Subpart D--Federal Gas

Sec. 206.153 Valuation standards--processed gas.

(c) The value of residue gas or any gas plant product which is not sold pursuant to an arm's-length contract shall be the reasonable value determined in accordance with the first applicable of the following methods:

First benchmark:

(1) The gross proceeds accruing to the lessee pursuant to a sale under its non-arm's-length contract (or other disposition other than by an arm's-length contract), provided that those gross proceeds are equivalent to the gross proceeds derived from, or paid under, comparable arm's-length contracts for purchases, sales, or other dispositions of like quality residue gas or gas plant products from the same processing plant (or, if necessary to obtain a reasonable sample, from nearby plants). In evaluating the comparability of arm's-length contracts for the purposes of these regulations, the following factors shall be considered: price, time of execution, duration, market or markets served, terms, quality of residue gas or gas plant products, volume, and such other factors as may be appropriate to reflect the value of the residue gas or gas plant products;

First Valuation Benchmark from the Oil and Gas Payor Handbook, January 1994, processed gas.

Used when:

- Sales contract is non-arm's-length
- Residue gas or gas plant products are transferred without a contract
- Transaction does not meet the arm's-length criteria

Benchmarks focus on:

- Comparable arm's-length gross proceeds, Published prices, or spot market prices

Comparability:

- First, use contracts where sellers and purchasers are not affiliated with the lessee
- Second, use contracts where sellers are not affiliated with the lessee but purchasers are
- Price
- Time of execution
- Duration of contract
- Market or markets served
- Terms
- Quality of the gas and products
- Volume

- Other appropriate factors

Equivalency is based on the lowest-priced comparable arm's-length contract.

Analysis

For example:

- Compare company non-arm's-length (NAL) price to Arm's-length (AL) prices at the plant. If there are no AL prices at the plant then nearby plants may be used. If the NAL price is greater than or equal to the lowest price of a **comparable** AL contract and the price, time of execution, duration of contract, market, terms, quality and volume of gas are equivalent, then the price is acceptable.
- Compare company non-arm's-length (NAL) price to a **related company's** arm's-length (AL) price for purchases in the field or area at the plant. If there are no AL prices at the plant then nearby plants may be used. If the NAL price is greater than or equal to the lowest price of a **comparable** related company AL contract and the price, time of execution, duration of contract, market, terms, quality and volume of gas are equivalent, then the price is acceptable. If not then go to the second benchmark.

Second benchmark:

(2) A value determined by consideration of other information relevant in valuing like-quality residue gas or gas plant products, including gross proceeds under arm's-length contracts for like-quality residue gas or gas plant products from the same gas plant or other nearby processing plants, posted prices for residue gas or gas plant products, prices received in spot sales of residue gas or gas plant products, other reliable public sources of price or market information, and other information as to the particular lease operation or the saleability of such residue gas or gas plant products; or

Second Valuation Benchmark from the Oil and Gas Payor Handbook, January 1994, processed gas.

Other relevant information

Used when:

- Lessee's gross proceeds are not equivalent
- No comparable arm's-length contracts exist at plant or nearby plant
- Lessee receives no consideration for its gas and gas plant products

Criteria can include:

- Gross proceeds under arm's-length contracts in the field or area
- Published prices
- Spot prices
- Other reliable public sources of price or market information
- Information relevant to that particular lease or salability of lessee's gas and plant products

Selected criteria should:

- Closely reflect the lessee's circumstances
- Be the most relevant factor

Lessee must notify MMS

Analysis

For example:

- A value determined by consideration of other information relevant in valuing like-quality residue gas and plant products, including gross proceeds under arm's-length contracts for like-quality gas in the same field or nearby fields or areas at the plant or a near by plant. This includes a related company's arm's-length sales.
- Residue gas or gas plant products published prices; spot prices to other reliable public sources of price; or market information; or other relevant information may be used.

Third benchmark:

- (3) A net-back method or any other reasonable method to determine value.

Third Valuation Benchmark from the Oil and Gas Payor Handbook, January 1994, processed gas.

Determined on a case-by-case basis

Lessee must notify MMS

Analysis

For example:

- This may be an arm's-length price in a different field or area adjusted for quality and transportation as long as it is reasonable, or other method.

Maximum price regulation, not applicable at the moment:

(d)(1) Notwithstanding any other provisions of this section, except paragraph (h) of this section, if the maximum price permitted by Federal law at which any residue gas or gas plant products may be sold is less than the value determined pursuant to this section, then MMS shall accept such maximum price as the value. For the purposes of this section, price limitations set by any State or local government shall not be considered as a maximum price permitted by Federal law.

Warranty contract only, warranty contract regulation:

(2) The limitation prescribed by paragraph (d)(1) of this section shall not apply to residue gas sold pursuant to a warranty contract and valued pursuant to paragraph (b)(2) of this section.

Further valuation regulations for processed gas:

(e)(1) Where the value is determined pursuant to paragraph (c) of this section, the lessee shall retain all data relevant to the determination of royalty value. Such data shall be subject to review and audit, and MMS will direct a lessee to use a different value if it determines upon review or audit that the reported value is inconsistent with the requirements of these regulations.

(2) Any Federal lessee will make available upon request to the authorized MMS or State representatives, to the Office of the Inspector

General of the Department of the Interior, or other persons authorized to receive such information, arm's-length sales and volume data for like-quality residue gas and gas plant products sold, purchased or otherwise obtained by the lessee from the same processing plant or from nearby processing plants.

(3) A lessee shall notify MMS if it has determined any value pursuant to paragraph (c)(2) or (c)(3) of this section. The notification shall be by letter to the MMS Associate Director for Royalty Management or his/her designee. The letter shall identify the valuation method to be used and contain a brief description of the procedure to be followed. The notification required by this paragraph is a one-time notification due no later than the end of the month following the month the lessee first reports royalties on a Form MMS-2014 using a valuation method authorized by paragraph (c)(2) or (c)(3) of this section, and each time there is a change in a method under paragraph (c)(2) or (c)(3) of this section.

(f) If MMS determines that a lessee has not properly determined value, the lessee shall pay the difference, if any, between royalty payments made based upon the value it has used and the royalty payments that are due based upon the value established by MMS. The lessee shall also pay interest computed on that difference pursuant to 30 CFR 218.54.

If the lessee is entitled to a credit, MMS will provide instructions for the taking of that credit.

(g) The lessee may request a value determination from MMS. In that event, the lessee shall propose to MMS a value determination method, and may use that method in determining value for royalty purposes until MMS issues its decision. The lessee shall submit all available data relevant to its proposal. The MMS shall expeditiously determine the value based upon the lessee's proposal and any additional information MMS deems necessary. In making a value determination, MMS may use any of the valuation criteria authorized by this subpart. That determination shall remain effective for the period stated therein. After MMS issues its determination, the lessee shall make the adjustments in accordance with paragraph (f) of this section.

(h) Notwithstanding any other provision of this section, under no circumstances shall the value of production for royalty purposes be less than the gross proceeds accruing to the lessee for residue gas and/or any gas plant products, less applicable transportation allowances and processing allowances determined pursuant to this subpart.

(Bold added for emphasis)

Observation:

Many companies are using the Fina decision to refuse to provide contracts. According to Sec. 206.153 (e) (2), they must provide the arm's-length contracts.

Any Federal lessee will make available upon request to the authorized MMS or State representatives, to the Office of the Inspector General of the Department of the Interior, or other persons authorized to receive such information, arm's-length sales and volume data for like-quality residue gas and gas plant products sold, purchased or otherwise obtained by the lessee from the same processing plant or from nearby processing plants.

Ultimately these arm's-length contracts may be used to determine gross proceeds.

(i) The lessee 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.

Observation:

According to Sec. 206.153 (i) (2), if gross proceeds have been reduced because of the cost to place the product in marketable condition or the cost to market, the value will be increased. This is applicable to Sec. 206.152 (i)(2) as well. Ultimately if non-arm's-length contracts or arm's-length contracts reduce the value because of these costs then the value will be increased. (See MMS-89-0189-O&G, Xeno, Inc)

Benchmarks and Pop Contract Analysis

Under regulations effective November 1, 1991, Percentage of Proceeds contracts are valued differently than other processed gas depending on the type of contract.

Arm's-Length:

Gas sold under an arm's-length POP contract is valued as unprocessed gas for royalty purposes. Value is based on the greater of the lessee's gross proceeds received under its arm's-length POP contract or a minimum value that is 100% of the value of the residue gas at the tailgate of the plant.

Non-Arm's-Length

Gas sold under non-arm's-length POP contracts continues to be valued as processed gas. However, values of the residue gas and gas plant products are based on the benchmark system and the lessee's processing costs are based on the actual costs to process the gas.

Source: MMS Memorandum dated August 19, 1994 with attached Policy Paper outlining the application of the valuation regulations for gas sold under a POP contract.

History:

Federal Gas Valuation Negotiated Rulemaking Committee:

The rule did not become effective.

MMS & States proposed rulemaking

- a. The weighted average of gross proceeds paid under comparable arm's-length contracts (without any deductions for marketing or placing production in marketable condition) in the field or area between third parties and the lessee or its affiliate; i.e. arm's-length contracts to which the lessee or its affiliate have access. In order to assure that the arm's-length contracts are arrived at in a free and open market, at least 50 percent of the lessee's or affiliate's purchases in the field or area must be under arm's length contracts in order for this benchmark to be used. In evaluating the comparability of arm's-length contracts the following factors will be considered:

- Place of sales
- Time of sale
- Duration of contract
- Volume

A comparable arm's-length contract by volume will be one whose volume is within plus or minus 20 percent of the volume sold pursuant to the non-arm's-length sales being evaluated.

- b. The first bona fide arm's-length sale of the production by the affiliate.
- c. Other relevant matters including, in the following order:

- i. Gross proceeds paid under comparable arm's-length contracts in the same field or nearby fields,
- ii. Prices reported to *FERC* or the relevant public utility commission,
- iii. Netback method, or
- iv. Any other reasonable method to determine value.

MMS and States modified original proposal by the following benchmarking:

- a. Other arm's-length sales by the lessee in the field/area.
- b. Other arm's-length purchases by the lessee's affiliate in the field/area.
- c. Affiliate's arm's-length resale values (excluding direct sales to residential customers).
- d. Other relevant matters.

Kirumakki, Nagaraja

From: Kirumakki, Nagaraja
Sent: Tuesday, December 09, 2003 10:45 AM
To: Burhop, Shirley; Johnson, Brian C; Summers, Dana; Soderlind, Ellwood; Loomis, F David; Staigle, George; Kepler, Glenn; Conway, Karen; Rodriguez, Nancy; Shirley, Perry; Davidoff, Robert; Teel, Sara; Fisher, Terence
Subject: RE: FINA and Gas Benchmark analysis - Indian - 12-05-2003.doc

Your analysis based on Oil & Gas Payor Handbook, January 1994 defines equivalency as the lowest-priced comparable A/L contract.

However, Oil & Gas Payor Handbook Volume III, January 1998, defines equivalency as follows:

Equivalency: The lessee's non-A/L gross proceeds are considered equivalent if y they are not less than the gross proceeds derived from or paid under the most comparable A/L contract in the same field (or area) for like-quality gas.

Use the following factors to evaluate comparability of A/L contracts.

Lessee's must use the most comparable A/L contract to determine value.

The key words here are "the most comparable". The most comparable does not mean the lowest-priced comparable contract. ~~It could be average priced, low priced, or high priced.~~

-----Original Message-----

From: Burhop, Shirley
Sent: Friday, December 05, 2003 12:19 PM
To: Brian Johnson; Dana Summers; Ellwood Soderlind; F David Loomis; George Staigle; Glenn Kepler; Karen Conway; Nagaraja Kirumakki; Nancy Rodriguez; Perry Shirley; Robert Davidoff; Sara Teel; Terence Fisher
Subject: FINA and Gas Benchmark analysis - Indian - 12-05-2003.doc

<< File: FINA and Gas Benchmark analysis - Indian - 12-05-2003.doc >> Brian has other priorities, so I tackled this myself. I welcome any comments or suggestions for improvement. I clearly modeled it closely after Karen's paper.

Barton, Jayne

From: Conway, Karen
Sent: Tuesday, December 09, 2003 11:06 AM
To: Kirumakki, Nagaraja; Burhop, Shirley; Johnson, Brian C; Summers, Dana; Soderlind, Ellwood; Loomis, F David; Staigle, George; Kepler, Glenn; Conway, Karen; Rodriguez, Nancy; Shirley, Perry; Davidoff, Robert; Teel, Sara; Fisher, Terence
Subject: RE: FINA and Gas Benchmark analysis - Indian - 12-05-2003.doc

I couldn't agree more, of course it must be the most comparable contract(s), The comparable contract(s) certainly may be a higher priced contract than the lowest contract in the field or area. Comparability is the most important feature of the selection. I know that you will do a great job of incorporating this in the training. I did use the handbook from 1994 not the Oil & Gas Payor Handbook Volume III, January 1998. We can get together and fine tune the document for training purposes after the meeting next week. You are correct this is very important.

-----Original Message-----

From: Nagaraja.Kirumakki@mms.gov [mailto:Nagaraja.Kirumakki@mms.gov]
Sent: Tuesday, December 09, 2003 10:45 AM
To: Shirley.Burhop@mms.gov; Brian.C.Johnson@mms.gov; dsummers@spike.dor.state.co.us; esoderlind@wyaudit.state.wy.us; dloomis@spike.dor.state.co.us; georgestaigle.mms@midconetwork.com; Glenn.Kepler@mms.gov; kconway@spike.dor.state.co.us; nrodriguez@state.nm.us; perryinwr@yahoo.com; Robert.Davidoff@mms.gov; sara.teel@mms.gov; tfisher@washakie.net
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However, Oil & Gas Payor Handbook Volume III, January 1998, defines equivalency as follows:

Equivalency: The lessee's non-A/L gross proceeds are considered equivalent if y they are not less than the gross proceeds derived from or paid under the most comparable A/L contract in the same field (or area) for like-quality gas.

Use the following factors to evaluate comparability of A/L contracts.

Lessee's must use the most comparable A/L contract to determine value.

The key words here are "the most comparable" . The most comparable does not mean the lowest-priced comparable contract. It could be average priced, low priced or high priced.

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> **Subject:** FINA and Gas Benchmark analysis - Indian - 12-05-2003.doc
>
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Barton, Jayne

From: Conway, Karen
Sent: Friday, December 05, 2003 12:40 PM
To: Burhop, Shirley
Subject: RE: FINA and Gas Benchmark analysis - Indian - 12-05-2003.doc

Attachments: New Benchmark analysis December 4.doc



New Benchmark
analysis Decemb...

Hi Shirley, this is not for general consumption, but here is my analysis for federal gas and oil. I am going through the paper backwards and checking each word, so there may be some corrections. Check it out.

-----Original Message-----

From: Shirley.Burhop@mms.gov [mailto:Shirley.Burhop@mms.gov]
Sent: Friday, December 05, 2003 12:19 PM
To: Brian.C.Johnson@mms.gov; dsummers@spike.dor.state.co.us;
esoderlind@wyaudit.state.wy.us; dloomis@spike.dor.state.co.us;
georgestaigle.mms@midconetwork.com; Glenn.Kepler@mms.gov; kconway@spike.dor.state.co.us;
Nagaraja.Kirumakki@mms.gov; nrodriguez@state.nm.us; pshirley@frontiernet.net;
Robert.Davidoff@mms.gov; sara.teel@mms.gov; tfisher@washakie.net
Subject: FINA and Gas Benchmark analysis - Indian - 12-05-2003.doc

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Fina and the Benchmarks

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December 3, 2003

From: Karen Conway, State of Colorado
To: MMS and STRAC
Subject: Fina and the Benchmarks

In light of the Fina decision there has been some discussion concerning the application of the Federal gas benchmarks.

1. Does the Fina decision impact the application of the gas benchmarks?
 - Because the Fina audit was assessed under the marketing affiliate resales Sec. 206.151, and the related company was a non-marketing affiliate, i.e. purchased from other companies, the benchmarks must apply.
 - The result is that when the related company purchases one Mcf of gas from an unrelated company the benchmarks must be used for valuation.
2. Does this limit the valuation(s) to less than the "gross proceeds accruing to the lessee?" The benchmarks specifically state in Sec. 206.152 (h) Notwithstanding any other provision of this section, under no circumstances shall the value of production for royalty purposes be less than the gross proceeds accruing to the lessee for lease production....
 - After consideration of the benchmarks under a non-arm's-length sale, if the value is less than the gross proceeds then royalties must be paid on the gross proceeds.
3. Does the Fina decision impact the application of the oil benchmarks prior to July 2000?
 - The oil benchmarks are applicable when the lessee sells to a related company and the purchaser is a non-marketing affiliate, a related company that purchases from others.
4. Are there other court decisions that help us determine the use of the benchmarks?
 - Yes, Xeno, MMS-89-0189-O&G, in the Conclusions and Order stated:

Physical treatment, handling operations, measuring, gathering, dehydrating, compressing, separation, and storage are required to place the product into a marketable condition. All of these services are considered necessary to market the product and are to be performed at no cost to the lessor...In the instant case, the reasonable value of the gas is its gross value. No reduction in value is allowed for the cost of any gathering or compression which may have been necessary in order to bring the gas to the market in which it was being sold, regardless of whether that compression or gathering was performed by the lessees, the purchaser of the gas, or some third party.

- The Marathon Oil case, MMS-94-0404-O&G required that in the case of a NAL sale of the residue gas the company must perform accounting for comparison where the value of the unprocessed gas using the NAL unprocessed gas benchmarks must be compared to the value of all products at the tailgate of the plant and royalty paid on the higher of the two.

- In another Marathon Oil case, MMS-92-0077-O&G where Marathon Oil sold to Marathon Production Company (MPC) and then that company sold to Exxon, and Exxon reimbursed MPC for gathering the companies appeal was denied. Quoting a long history of cases the case noted that,

Although, MMS acknowledges that MPC is not the Appellant's marketing affiliate as defined in the new product valuation regulations, that does not relieve Marathon from its obligation to pay royalties on gathering reimbursements received by MPC.... In light of the corporate relationship between Marathon and MPC, Marathon the parent and MPC its wholly-owned subsidiary, Marathon and MPC must be treated as one and the same entity.

In conclusion, there are a multitude of court cases and regulations that support the benchmarks and accounting for comparison and these can and should be used when determining royalty liabilities for NAL transactions.

Benchmark Analysis

(December 3, 2003)

Unprocessed gas

Regulation:

[Code of Federal Regulations]

[Title 30, Volume 2]

[Revised as of July 1, 2001]

Subpart D--Federal Gas

Sec. 206.152 Valuation standards--unprocessed gas.

(c) The value of gas subject to this section which is not sold pursuant to an arm's-length contract shall be the reasonable value determined in accordance with the first applicable of the following methods:

First benchmark:

(1) The gross proceeds accruing to the lessee pursuant to a sale under its non-arm's-length contract (or other disposition other than by an arm's-length contract), provided that those gross proceeds are equivalent to the gross proceeds derived from, or paid under, comparable arm's-length contracts for purchases, sales, or other dispositions of like-quality gas in the same field (or, if necessary to obtain a reasonable sample, from the same area). In evaluating the comparability of arm's-length contracts for the purposes of these regulations, the following factors shall be considered: price, time of execution, duration, market or markets served, terms, quality of gas, volume, and such other factors as may be appropriate to reflect the value of the gas;

First Valuation Benchmark from the Oil and Gas Payor Handbook, January 1994, unprocessed gas.

Comparability:

- First, use contracts where sellers and purchasers are not affiliated with lessee
- Second, use contracts where sellers are not affiliated with the lessee but purchasers are
- Price
- Time of execution
- Duration of contract
- Market or markets served
- Terms
- Quality of the gas
- Volume
- Other appropriate factors

Equivalency is based on the lowest-priced comparable arm's-length contract.

Analysis

For example:

- Compare the company's non-arm's-length (NAL) price to Arm's-length (AL) price in the field or area. If the NAL price is greater than or equal to the lowest price of a comparable AL contract and the price, time of execution, duration of

contract, market, terms, quality and volume of gas are equivalent, then the price is acceptable.

- Compare the company's NAL price to a related company's AL price for purchases in the field or area. If the NAL price is greater than or equal to the lowest price of a comparable AL contract and the price, time of execution, duration of contract, market, terms, quality, and volume of gas are equivalent, then the price is acceptable. If not then go to the second benchmark.

Second Benchmark:

(2) A value determined by consideration of other information relevant in valuing like-quality gas, including gross proceeds under arm's-length contracts for like-quality gas in the same field or nearby fields or areas, posted prices for gas, prices received in arm's-length spot sales of gas, other reliable public sources of price or market information, and other information as to the particular lease operation or the saleability of the gas; or

Second Valuation Benchmark from the Oil and Gas Payor Handbook, January 1994, unprocessed gas.

Used when:

- Lessee's gross proceeds are not equivalent
- Lessee receives no consideration for its gas

Criteria can include:

- Gross proceeds under arm's-length contracts in the field or area
- Published prices
- Spot prices
- Other reliable public sources of price or market information
- Information relevant to that particular lease or saleability of the lessee's gas

Selected criteria should:

- Closely reflect the lessee's circumstances
- Be the most relevant factor

Lessee must notify MMS

Analysis

For example:

- A valuation determined by like-quality gas in the same field or nearby fields, including gross proceeds under arm's-length contracts, posted prices for gas, prices received in arm's-length spot sales of gas, other reliable public sources of price or market information, and other information as to the particular lease operation or the salability of the gas.

- For instance, there is no long-term contract for the field or area and the company contract is long-term, then gross proceeds under short-term arm's-length contracts in the field or area may be used.
- If a company is non-arm's-length to the lessee and they purchase in the same field or area from arm's-length companies, these agreements may be used to value production under the second benchmark because these prices are arm's-length prices in the field or area. This may not be a valid pricing method if this is a captive market.

Third benchmark:

- (3) A net-back method or any other reasonable method to determine value.

Third Valuation Benchmark from the Oil and Gas Payor Handbook, January 1994, unprocessed gas.

- Determined on a case-by-case basis
- **Lessee must notify MMS**

Analysis

For example:

- This may be an arm's-length price in a different field or area adjusted for quality and transportation as long as it is reasonable, or another method could be used.

Maximum price regulation, not applicable at the moment:

d)(1) Notwithstanding any other provisions of this section, except paragraph (h) of this section, if the maximum price permitted by Federal law at which gas may be sold is less than the value determined pursuant to this section, then MMS shall accept such maximum price as the value. For purposes of this section, price limitations set by any State or local government shall not be considered as a maximum price permitted by Federal law.

Warranty contract only, warranty contract regulation:

2) The limitation prescribed in paragraph (d)(1) of this section shall not apply to gas sold pursuant to a warranty contract and valued pursuant to paragraph (b)(2) of this section.

Further valuation regulations for unprocessed gas:

(e)(1) Where the value is determined pursuant to paragraph (c) of this section, the lessee shall retain all data relevant to the determination of royalty value. Such data shall be subject to review and audit, and MMS will direct a lessee to use a different value if it determines that the reported value is inconsistent with the requirements of these regulations.

(2) Any Federal lessee will make available upon request to the authorized MMS or State representatives, to the Office of the Inspector General of the Department of the Interior, or other person authorized to receive such information, arm's-length sales and volume data for like-quality

production sold, purchased or otherwise obtained by the lessee from the field or area or from nearby fields or areas.

(3) A lessee shall notify MMS if it has determined value pursuant to paragraph (c)(2) or (c)(3) of this section. The notification shall be by letter to the MMS Associate Director for Royalty Management or his/her designee. The letter shall identify the valuation method to be used and contain a brief description of the procedure to be followed. The notification required by this paragraph is a one-time notification due no later than the end of the month following the month the lessee first reports royalties on a Form MMS-2014 using a valuation method authorized by paragraph (c)(2) or (c)(3) of this section, and each time there is a change in a method under paragraph (c)(2) or (c)(3) of this section.

(f) If MMS determines that a lessee has not properly determined value, the lessee shall pay the difference, if any, between royalty payments made based upon the value it has used and the royalty payments that are due based upon the value established by MMS. The lessee shall also pay interest on that difference computed pursuant to 30 CFR 218.54. If the lessee is entitled to a credit, MMS will provide instructions for the taking of that credit.

(g) The lessee may request a value determination from MMS. In that event, the lessee shall propose to MMS a value determination method, and may use that method in determining value for royalty purposes until MMS issues its decision. The lessee shall submit all available data relevant to its proposal. The MMS shall expeditiously determine the value based upon the lessee's proposal and any additional information MMS deems necessary. In making a value determination MMS may use any of the valuation criteria authorized by this subpart. That determination shall remain effective for the period stated therein. After MMS issues its determination, the lessee shall make the adjustments in accordance with paragraph (f) of this section.

(h) **Notwithstanding any other provision of this section, under no circumstances shall the value of production for royalty purposes be less than the gross proceeds accruing to the lessee for lease production, less applicable allowances.**

(bold added for emphasis)

Observation:

Many companies are using the Fina decision to refuse to provide contracts. According to Sec. 206.152 (e) (2), they must provide the arms-length contracts.

Any Federal lessee will make available upon request to the authorized MMS or State representatives, to the Office of the Inspector General of the Department of the Interior, or other person authorized to receive such information, arm's-length sales and volume data for like-quality production sold, purchased or otherwise obtained by the lessee from the field or area or from nearby fields or areas.

Ultimately these arm's-length contracts may be used to determine gross proceeds.

Benchmark Analysis

(December 3, 2003)

Processed gas

Regulation:

[Code of Federal Regulations]

[Title 30, Volume 2]

[Revised as of July 1, 2001]

Subpart D--Federal Gas

Sec. 206.153 Valuation standards--processed gas.

(c) The value of residue gas or any gas plant product which is not sold pursuant to an arm's-length contract shall be the reasonable value determined in accordance with the first applicable of the following methods:

First benchmark:

(1) The gross proceeds accruing to the lessee pursuant to a sale under its non-arm's-length contract (or other disposition other than by an arm's-length contract), provided that those gross proceeds are equivalent to the gross proceeds derived from, or paid under, comparable arm's-length contracts for purchases, sales, or other dispositions of like quality residue gas or gas plant products from the same processing plant (or, if necessary to obtain a reasonable sample, from nearby plants). In evaluating the comparability of arm's-length contracts for the purposes of these regulations, the following factors shall be considered: price, time of execution, duration, market or markets served, terms, quality of residue gas or gas plant products, volume, and such other factors as may be appropriate to reflect the value of the residue gas or gas plant products;

First Valuation Benchmark from the Oil and Gas Payor Handbook, January 1994, processed gas.

Used when:

- Sales contract is non-arm's-length
- Residue gas or gas plant products are transferred without a contract
- Transaction does not meet the arm's-length criteria

Benchmarks focus on:

- Comparable arm's-length gross proceeds, Published prices, or spot market prices

Comparability:

- First, use contracts where sellers and purchasers are not affiliated with the lessee
- Second, use contracts where sellers are not affiliated with the lessee but purchasers are
- Price
- Time of execution
- Duration of contract
- Market or markets served
- Terms
- Quality of the gas and products
- Volume

- Other appropriate factors

Equivalency is based on the lowest-priced comparable arm's-length contract.

Analysis

For example:

- Compare the company's NAL price to AL prices at the plant. If there are no AL prices at the plant then nearby plants may be used. If the NAL price is greater than or equal to the lowest price of a **comparable** AL contract and the price, time of execution, duration of contract, market, terms, quality and volume of gas are equivalent, then the price is acceptable.
- Compare the company's NAL price to a **related company's** AL price for purchases in the field or area at the plant. If there are no AL prices at the plant then nearby plants may be used. If the NAL price is greater than or equal to the lowest price of a **comparable** related company AL contract and the price, time of execution, duration of contract, market, terms, quality and volume of gas are equivalent, then the price is acceptable. If not then go to the second benchmark.

Second benchmark:

(2) A value determined by consideration of other information relevant in valuing like-quality residue gas or gas plant products, including gross proceeds under arm's-length contracts for like-quality residue gas or gas plant products from the same gas plant or other nearby processing plants, posted prices for residue gas or gas plant products, prices received in spot sales of residue gas or gas plant products, other reliable public sources of price or market information, and other information as to the particular lease operation or the saleability of such residue gas or gas plant products; or

Second Valuation Benchmark from the Oil and Gas Payor Handbook, January 1994, processed gas.

Other relevant information

Used when:

- Lessee's gross proceeds are not equivalent
- No comparable arm's-length contracts exist at plant or nearby plant
- Lessee receives no consideration for its gas and gas plant products

Criteria can include:

- Gross proceeds under arm's-length contracts in the field or area
- Published prices
- Spot prices
- Other reliable public sources of price or market information
- Information relevant to that particular lease or salability of lessee's gas and plant products

Selected criteria should:

- Closely reflect the lessee's circumstances

- Be the most relevant factor

Lessee must notify MMS

Analysis

For example:

- A value determined by consideration of other information relevant in valuing like-quality residue gas and plant products, including gross proceeds under arm's-length contracts for like-quality gas in the same field or nearby fields or areas at the plant or a near by plant. This includes a related company's arm's-length sales or purchases.
- Residue gas or gas plant products published prices; spot prices and other reliable public sources of price; or market information; or other relevant information may be used.

Third benchmark:

- (3) A net-back method or any other reasonable method to determine value.

Third Valuation Benchmark from the Oil and Gas Payor Handbook, January 1994, processed gas.

Determined on a case-by-case basis

Lessee must notify MMS

Analysis

For example:

- Valuation may be based on an arm's-length price in a different field or area adjusted for quality and transportation as long as it is reasonable, or other method.

Maximum price regulation, not applicable at the moment:

- (d)(1) Notwithstanding any other provisions of this section, except paragraph (h) of this section, if the maximum price permitted by Federal law at which any residue gas or gas plant products may be sold is less than the value determined pursuant to this section, then MMS shall accept such maximum price as the value. For the purposes of this section, price limitations set by any State or local government shall not be considered as a maximum price permitted by Federal law.

Warranty contract only, warranty contract regulation:

- (2) The limitation prescribed by paragraph (d)(1) of this section shall not apply to residue gas sold pursuant to a warranty contract and valued pursuant to paragraph (b)(2) of this section.

Further valuation regulations for processed gas:

- (e)(1) Where the value is determined pursuant to paragraph (c) of this section, the lessee shall retain all data relevant to the determination of royalty value. Such data shall be subject to review and audit, and MMS will direct a lessee to use a different value if it determines upon review or audit that the reported value is inconsistent with the requirements of these regulations.

(2) Any Federal lessee will make available upon request to the authorized MMS or State representatives, to the Office of the Inspector General of the Department of the Interior, or other persons authorized to receive such information, arm's-length sales and volume data for like-quality residue gas and gas plant products sold, purchased or otherwise obtained by the lessee from the same processing plant or from nearby processing plants.

(3) A lessee shall notify MMS if it has determined any value pursuant to paragraph (c)(2) or (c)(3) of this section. The notification shall be by letter to the MMS Associate Director for Royalty Management or his/her designee. The letter shall identify the valuation method to be used and contain a brief description of the procedure to be followed. The notification required by this paragraph is a one-time notification due no later than the end of the month following the month the lessee first reports royalties on a Form MMS-2014 using a valuation method authorized by paragraph (c)(2) or (c)(3) of this section, and each time there is a change in a method under paragraph (c)(2) or (c)(3) of this section.

(f) If MMS determines that a lessee has not properly determined value, the lessee shall pay the difference, if any, between royalty payments made based upon the value it has used and the royalty payments that are due based upon the value established by MMS. The lessee shall also pay interest computed on that difference pursuant to 30 CFR 218.54. If the lessee is entitled to a credit, MMS will provide instructions for the taking of that credit.

(g) The lessee may request a value determination from MMS. In that event, the lessee shall propose to MMS a value determination method, and may use that method in determining value for royalty purposes until MMS issues its decision. The lessee shall submit all available data relevant to its proposal. The MMS shall expeditiously determine the value based upon the lessee's proposal and any additional information MMS deems necessary. In making a value determination, MMS may use any of the valuation criteria authorized by this subpart. That determination shall remain effective for the period stated therein. After MMS issues its determination, the lessee shall make the adjustments in accordance with paragraph (f) of this section.

(h) Notwithstanding any other provision of this section, under no circumstances shall the value of production for royalty purposes be less than the gross proceeds accruing to the lessee for residue gas and/or any gas plant products, less applicable transportation allowances and processing allowances determined pursuant to this subpart.

(Bold added for emphasis)

Observation:

Royalty must be paid on the gross proceeds accruing to the lessee. Many companies are using the Fina decision to refuse to provide contracts. According to Sec. 206.153 (e) (2), they must provide the arm's-length contracts.

Any Federal lessee will make available upon request to the authorized MMS or State representatives, to the Office of the Inspector General of the Department of the Interior, or other persons authorized to receive such information, arm's-length sales and volume data for like-quality residue gas and gas plant products sold, purchased or otherwise obtained by the lessee from the same processing plant or from nearby processing plants.

Ultimately these arm's-length contracts may be used to determine gross proceeds.

(i) The lessee 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.

Observation:

According to Sec. 206.153 (i) if gross proceeds have been reduced because of the cost to place the product in marketable condition or the cost to market, the value will be increased. This is applicable to Sec. 206.152 (i) as well. Ultimately if non-arm's-length contracts or arm's-length contracts reduce the value because of these costs then the value will be increased. (See MMS-89-0189-O&G, Xeno, Inc)

Benchmark Analysis
(December 3, 2003)
Accounting for Comparison

This regulation directly impacts the non-arm's-length contracts and transfers to plants when the residue gas is not sold pursuant to an arm's-length contract:

Sec. 206.155 Accounting for comparison.

(a) Except as provided in paragraph (b) of this section, where the lessee (or a person to whom the lessee has transferred gas pursuant to a non-arm's-length contract or without a contract) processes the lessee's gas and after processing the gas the residue gas is not sold pursuant to an arm's-length contract, the value, for royalty purposes, shall be the greater of (1) the combined value, for royalty purposes, of the residue gas and gas plant products resulting from processing the gas determined pursuant to Sec. 206.153 of this subpart, plus the value, for royalty purposes, of any condensate recovered downstream of the point of royalty settlement without resorting to processing determined pursuant to Sec. 206.102 of this subpart; or (2) the value, for royalty purposes, of the gas prior to processing determined in accordance with Sec. 206.152 of this subpart.

Analysis

For example:

- If after the transfer or sale of gas to a related company the residue gas is sold NAL then the value will be calculated on the greater of the value of all the products after processing or the value of the gas prior to processing (measured at the BLM approved measurement point), and the value will be calculated under the benchmarks for unprocessed gas in Sec. 206.152.

- In the Marathon Oil case, MMS-94-0404-O&G the company was required to calculate the accounting for comparison and was not relieved of this duty even though it owned less than 50 percent of the plant and argued that the purchaser, although a related party, should be considered arm's-length.

Benchmark Analysis
(December 3, 2003)
Benchmarks and Pop Contract Analysis

Under regulations effective November 1, 1991, Percentage of Proceeds contracts are valued differently than other processed gas depending on the type of contract.

Arm's-Length:

Gas sold under an arm's-length POP contract is valued as unprocessed gas for royalty purposes. Value is based on the greater of the lessee's gross proceeds received under its arm's-length POP contract or a minimum value that is 100% of the value of the residue gas at the tailgate of the plant.

Non-Arm's-Length:

Gas sold under non-arm's-length POP contracts continues to be valued as processed gas. However, values of the residue gas and gas plant products are based on the benchmark system and the lessee's processing costs are based on the actual costs to process the gas.

Source: MMS Memorandum dated August 19, 1994 with attached Policy Paper outlining the application of the valuation regulations for gas sold under a POP contract.

History:

Federal Gas Valuation Negotiated Rulemaking Committee:

The rule did not become effective.

MMS & States proposed rulemaking

a. The weighted average of gross proceeds paid under comparable arm's-length contracts (without any deductions for marketing or placing production in marketable condition) in the field or area between third parties and the lessee or its affiliate; i.e. arm's-length contracts to which the lessee or its affiliate have access. In order to assure that the arm's-length contracts are arrived at in a free and open market, at least 50 percent of the lessee or affiliate's purchases in the field or area must be under arm's length contracts in order for this benchmark to be used. In evaluating the comparability of arm's-length contracts the following factors will be considered:

- Place of sales
- Time of sale
- Duration of contract
- Volume

A comparable arm's-length contract by volume will be one whose volume is within plus or minus 20 percent of the volume sold pursuant to the non-arm's-length sales being evaluated.

- b. The first bona fide arm's-length sale of the production by the affiliate.
- c. Other relevant matters including, in the following order:

- i. Gross proceeds paid under comparable arm's-length contracts in the same field or nearby fields,
- ii. Prices reported to FERC or the relevant public utility commission,
- iii. Netback method, or
- iv. Any other reasonable method to determine value.

MMS and States modified original proposal by the following benchmarking:

- a. Other arm's-length sales by the lessee in the field/area.
- b. Other arm's-length purchases by the lessee's affiliate in the field/area.
- c. Affiliate's arm's-length resale values (excluding direct sales to residential customers).
- d. Other relevant matters.

Benchmark Analysis

(December 3, 2003)

Regulation:

[Code of Federal Regulations]

[Title 30, Volume 2]

[Revised as of July 1, 1999]

Subpart C--Federal Oil

Sec. 206.102 Valuation standards.

(c) The value of oil production from leases subject to this section which is not sold pursuant to an arm's-length contract shall be the reasonable value determined in accordance with the first applicable of the following paragraphs:

First benchmark:

(1) The lessee's contemporaneous posted prices or oil sales contract prices used in arm's-length transactions for purchases or sales of significant quantities of like-quality oil in the same field (or, if necessary to obtain a reasonable sample, from the same area); provided, however, that those posted prices or oil sales contract prices are comparable to other contemporaneous posted prices or oil sales contract prices used in arm's-length transactions for purchases or sales of significant quantities of like-quality oil in the same field (or, if necessary to obtain a reasonable sample, from the same area). In evaluating the comparability of posted prices or oil sales contract prices, the following factors shall be considered: Price, duration, market or markets served, terms, quality of oil, volume, and other factors as may be appropriate to reflect the value of the oil. If the lessee makes arm's-length purchases or sales at different postings or prices, then the volume-weighted average price for the purchases or sales for the production month will be used;

First Valuation Benchmark from the Oil and Gas Payor Handbook, January 1994, oil valuation.

Lessee's contemporaneous posted prices or oil sales contract prices used in arm's-length transactions.

Lessee's price must be:

- Comparable to other contemporaneous arm's-length prices
- Used to purchase significant quantities of like-quality oil
- Used to purchase production in the same field or area

Comparability is based on:

- Price
- Duration of contract
- Market or markets served
- Terms
- Quality
- Volume
- Other appropriate factors

Analysis

For example:

- If a company sells to a related company, a NAL transaction, and the related company purchases from other companies in the field then the NAL price must be compared to other AL purchase prices.
- If a company sells under a NAL contract and also sells production arm's-length then the NAL price would be compared to the AL price.
- If the NAL price is less than the AL price and there are two or more sales of significant quantities then a volume-weighted average AL price is used to compare the value.
- If the company has a posting for the field or area the posting is compared to other postings for the field or area. The posting must be comparable to postings used in AL contracts so if there are premiums in the field or area then the premiums would be included in the comparison.
- If the NAL prices meet the comparison used then the NAL contract may be used to value the oil.

Second benchmark:

(2) The arithmetic average of contemporaneous posted prices used in arm's-length transactions by persons other than the lessee for purchases or sales of significant quantities of like-quality oil in the same field (or, if necessary to obtain a reasonable sample, from the same area);

Second Valuation Benchmark from the Oil and Gas Payor Handbook, January 1994, oil valuation.

Arithmetic average of contemporaneous posted prices used in arm's-length transactions by persons other than the lessee.

Must be used to purchase:

- Significant quantities of like-quality oil
- Production in the same field or area

Analysis

For example:

- Significant quantities would be determined by the relevant facts in each case using the auditor's judgment.
- If there are posted prices used in arm's-length transactions and these also contained premiums then the premium would be added to the calculation.

Third benchmark:

(3) The arithmetic average of other contemporaneous arm's-length contract prices for purchases or sales of significant quantities of like-quality oil in the same area or nearby areas;

Third Valuation Benchmark from the Oil and Gas Payor Handbook, January 1994, oil valuation.

Arithmetic average of other contemporaneous arm's-length contract prices in the area.

Must be used to purchase:

- Significant quantities of like-quality oil
- Production in the same area or nearby areas

Analysis

For example:

- Significant quantities would be determined by the relevant facts in each case using the auditor's judgment.
- Production located in the same area and nearby areas would be acceptable if the quality was adjusted to be comparable and contemporaneous AL contract prices were available. Confidentiality would have to be protected.
- Premiums would be included.

Fourth benchmark:

(4) Prices received for arm's-length spot sales of significant quantities of like-quality oil from the same field (or, if necessary to obtain a reasonable sample, from the same area), and other relevant matters, including information submitted by the lessee concerning circumstances unique to a particular lease operation or the saleability of certain types of oil;

Fourth Valuation Benchmark from the Oil and Gas Payor Handbook, January 1994, oil valuation.

Arm's-length spot sales prices and other relevant matters.

- Used when no arm's-length posted prices or sales contracts exist in the same field, area, or nearby areas.
- Lessee must notify MMS

Analysis

For example:

- If there are AL spot prices for this field or area and in the auditor's judgment, after reviewing the relevant facts, then the spot price, if greater than the NAL price, may be used to value the oil.
- If there are no spot prices for the field, but the oil is transported to a nearby field or area and there are spot prices in this location, these may be used in the valuation of the oil.

Fifth benchmark:

(5) A net-back method or any other reasonable method to determine value;

Valuation Benchmark from the Oil and Gas Payor Handbook, January 1994, oil valuation.

Netback or other reasonable valuation method

- Determined on a case-by-case basis
- Lessee must notify MMS

Analysis

For example:

- If none of the other benchmarks apply then alternative methods, such as netting back the price using a transportation differential from a refinery that purchases from others, and adjusting for quality in order to value the production, or another logical method could be used for valuation.

Further regulations:

(6) For purposes of this paragraph, the term lessee includes the lessee's designated purchasing agent, and the term contemporaneous means postings or contract prices in effect at the time the royalty obligation is incurred. (d) Any Federal lessee will make available, upon request to the authorized MMS or State representatives, to the Office of the Inspector General of the Department of the Interior, or other persons authorized to receive such information, arm's-length sales and volume data for like-quality production sold, purchased, or otherwise obtained by the lessee from the field or area or from nearby fields or areas.

Observation:

According to Sec. 206.102 (c) (6) **it is noted that the term lessee includes the lessee's designated purchasing agent, and that could be a related company. This section also requires the lessee (and designated purchasing agent) to provide the relevant contract information on the AL sales for the field or area or from nearby fields or areas.**

Further regulations:

(e)(1) Where the value is determined pursuant to paragraph (c) of this section, the lessee shall retain all data relevant to the determination of royalty value. Such data shall be subject to review and audit, and MMS will direct a lessee to use a different value if it determines that the reported value is inconsistent with the requirements of these regulations. (2) A lessee shall notify MMS if it has determined value pursuant to paragraph (c)(4) or (c)(5) of this section. The notification shall be by letter to the MMS Associate Director for Royalty Management or his/her designee. The letter shall identify the valuation method to be used and contain a brief description of the procedure to be followed. The notification required by this paragraph is a one-time notification due no later than the end of the month following the month the lessee first reports royalties on a Form MMS-2014 using a valuation method authorized by paragraph (c)(4) or (c)(5) of this section and each time there is a change from one to the other of these two methods.

Observation:

This section **requires** that the lessee provide and retain all information relevant to the valuation determination in order for the information to be reviewed.

(f) If MMS determines that a lessee has not properly determined value, the lessee shall pay the difference, if any, between royalty payments made based upon the value it has used and the royalty payments that are due based upon the value established by MMS. The lessee shall also pay interest on the difference computed pursuant to 30 CFR 218.54. If the lessee is entitled to a credit, MMS will provide instructions for the taking of that credit.

(g) The lessee may request a value determination from MMS. In that event, the lessee shall propose to MMS a value determination method and may use that value for royalty payment purposes until MMS issues a value determination. The lessee shall submit all available data relevant to its proposal. MMS shall expeditiously determine the value based upon the lessee's proposal and any additional information MMS deems necessary. In making a value determination,

MMS may use any of the valuation criteria authorized by this subpart. That determination shall remain effective for the period stated therein. After MMS issues its determination, the lessee shall make the adjustments in accordance with paragraph (f) of this section.

(h) Notwithstanding any other provision of this section, under no circumstances shall the value of production, for royalty purposes, be less than the gross proceeds accruing to the lessee for lease production, less applicable allowances determined pursuant to this subpart.
(Bold added for emphasis)

Observation:

Royalty must be paid on the gross proceeds accruing to the lessee.

(i) The lessee is required to place oil in marketable condition at no cost to the Federal Government unless otherwise provided in the lease agreement or this section. Where the value established under this section is determined by a lessee's gross proceeds, that value shall 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 oil in marketable condition.

Observation:

According to Sec. 206.102 (i), if gross proceeds have been reduced because of the cost to place the product in marketable condition or the cost to market, the value will be increased. Ultimately if NAL contracts or AL contracts reduce the value because of these costs then the value will be increased. (See MMS-89-0189-O&G, Xeno, Inc.)

Further regulations:

(j) Value shall be based on the highest price a prudent lessee can receive through legally enforceable claims under its contract. Absent contract revision or amendment, if the lessee fails to take proper or timely action to receive prices or benefits to which it is entitled, it must pay royalty at a value based upon that obtainable price or benefit. Contract revisions or amendments shall be in writing and signed by all parties to an arm's-length contract. If the lessee makes timely application for a price increase or benefit allowed under its contract but the purchaser refuses, and the lessee takes reasonable measures, which are documented, to force purchaser compliance, the lessee will owe no additional royalties unless or until monies or consideration resulting from the price increase or additional benefits are received. This paragraph shall not be construed to permit a lessee to avoid its royalty payment obligation in situations where a purchaser fails to pay, in whole or in part or timely, for a quantity of oil.

(k) Notwithstanding any provision in these regulations to the contrary, no review, reconciliation, monitoring, or other like process that results in a redetermination by MMS of value under this section shall be considered final or binding as against the Federal Government or its beneficiaries until the audit period is formally closed.

(l) Certain information submitted to MMS to support valuation proposals, including transportation allowances or extraordinary cost allowances, is exempted from disclosure by the Freedom of Information Act, 5 U.S.C. 552, or other Federal law. Any data specified by law to be privileged, confidential, or otherwise exempt, will be maintained in a confidential manner in accordance with applicable laws and regulations. All requests for information about determinations made under this part are to be submitted in accordance with the Freedom of Information Act regulation of the Department of the Interior, 43 CFR part 2.

NAL oil sales from July 1, 2000 changed the method of valuation and no longer fall under the benchmarks.