Federal Oil and Gas Valuation

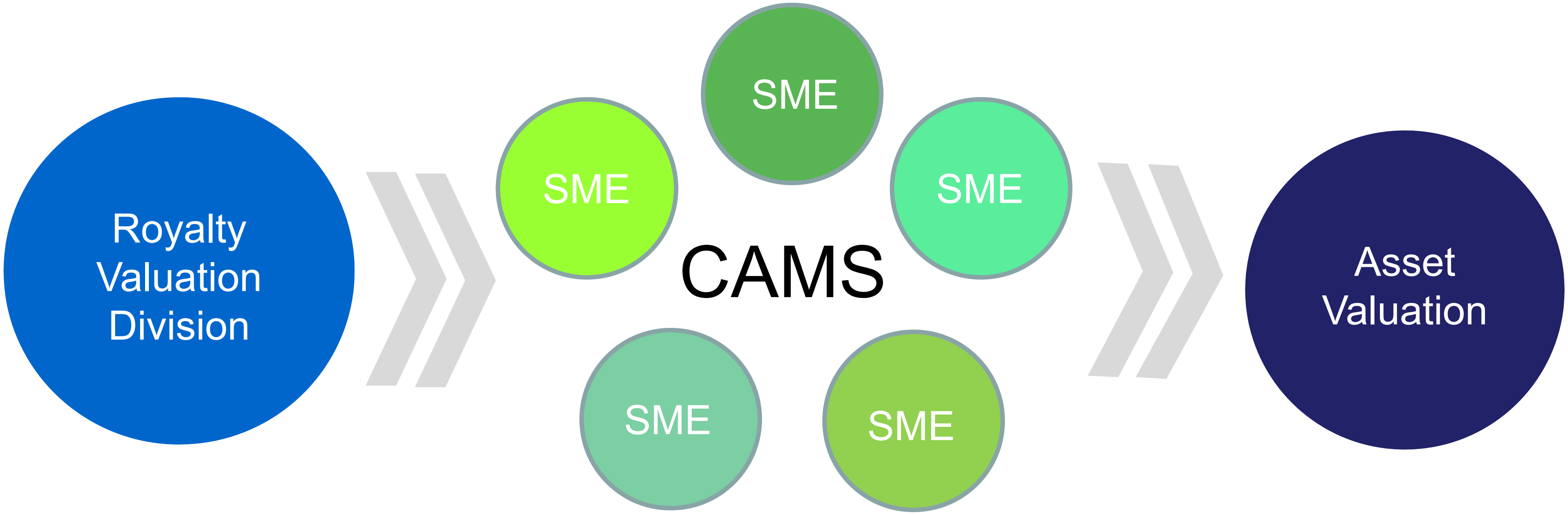
Royalty Valuation | Consistent answers to complex questions

royaltyvaluation@onrr.gov

Disclaimer

This presentation does not constitute formal valuation guidance and does not apply to any specific property, lease, or case. This presentation does not require that you perform any type of restructured accounting, any reporting, or recalculate and pay royalties. The guidance provided in this presentation is not an appealable decision, order, Notice of Noncompliance, or Civil Penalty Notice under 30 C.F.R. Part 1290 Subpart B (2014) or 30 C.F.R. Part 1241 (2014). If ONRR issues you an order, Notice of Noncompliance, or Civil Penalty Notice at a later date based on valuation guidance, your appeal rights will be provided at that time.

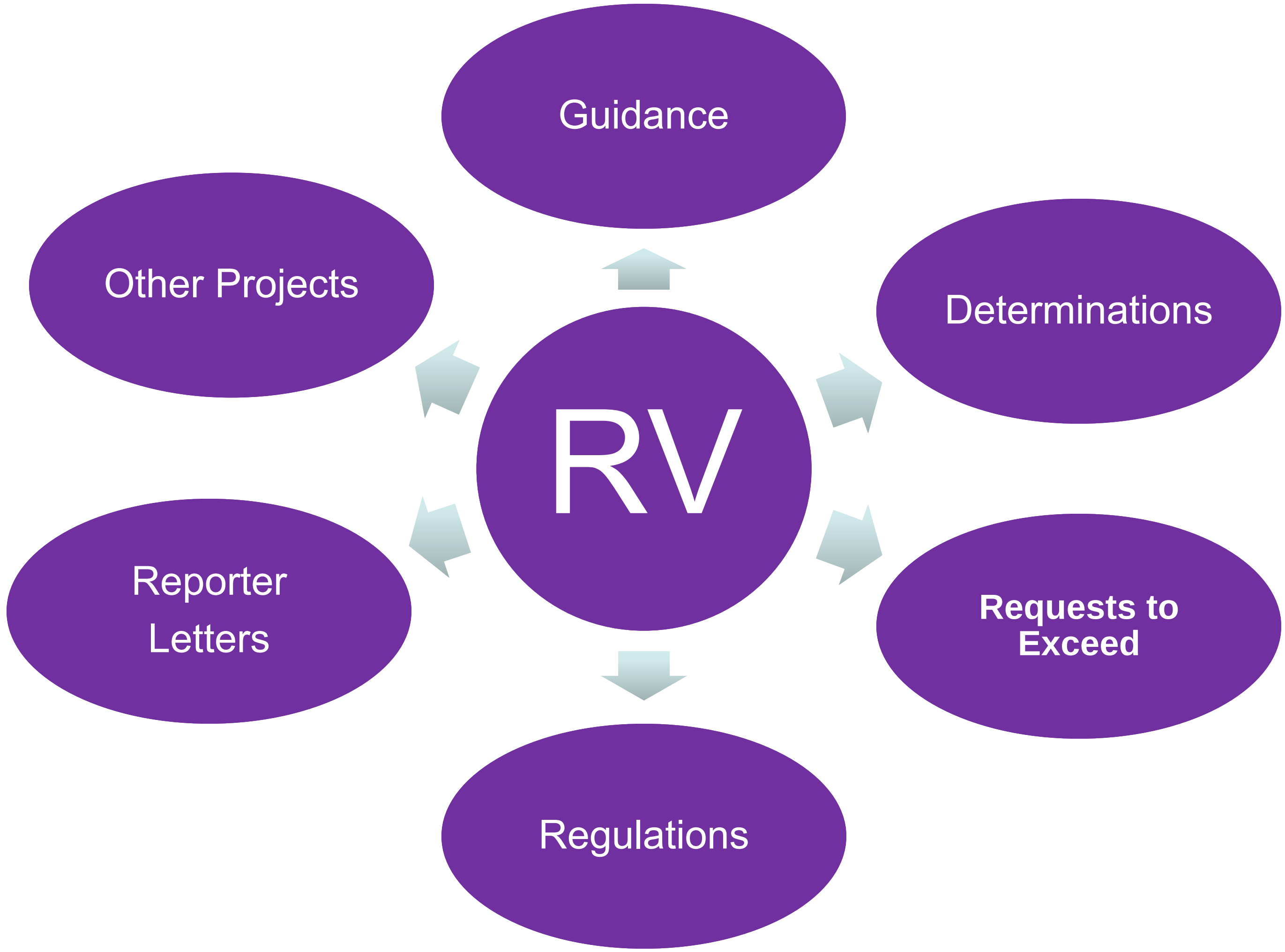
Centralization of the Valuation Function



Who is Royalty Valuation?

- Royalty Valuation
- Subject Matter Experts
  - Engineers
  - Geologists
  - Minerals Revenue Specialists
  - Economists

What We Do


Guidance
Other Projects
Determinations
RV
Reporter Letters
Requests to Exceed
Regulations

Benefits of Guidance

- Supported by Regulations and Case Law
- Cites Lease terms, Regulations, Appeals, Court cases, IBLA decisions and Policy Documents
- All written guidance is reviewed by peer groups and supervisors
- Consistent
- May fix issues before an audit

Valuation Regulations

30 CFR Part 1206

- ◆Federal Oil: § 1206.100 - § 1206.120
- ◆Federal Gas: § 1206.150 - § 1206.160

Electronic Code of Federal Regulations:

http://www.ecfr.gov/

Outline

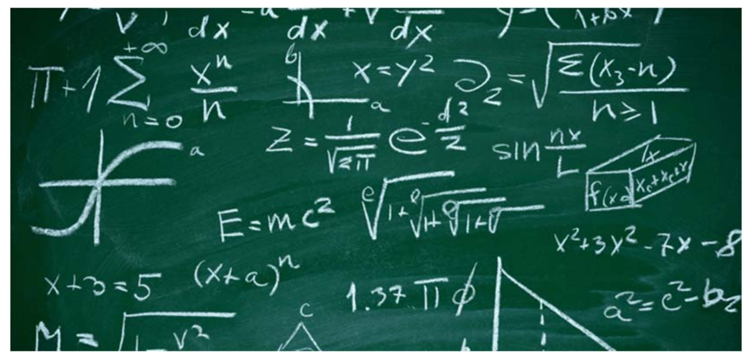
- ONRR Royalty Equation
- General Valuation Principles
- Sales Type Codes
- Oil Valuation
- Gas Valuation
- Allowances
- Contracts
- Bundled Costs
- Fuel

ONRR Royalty Equation

Royalty Due =

[Volume x Unit Value x Royalty Rate] - Allowances

Oil Example:
Volume Sold = 100 bbl
Unit Value= $90/bbl
Royalty Rate = 12.5%
Allowable Transportation Cost = $1.00/bbl

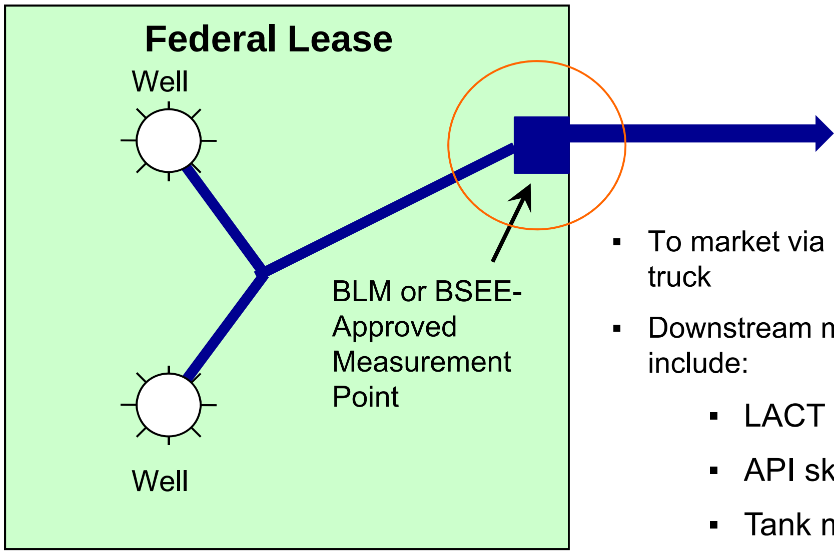


[100 *bbl* * $90/*bbl* * 0.125] – [$1.00/*bbl* * 100 *bbl* * 0.125] = **$1,112.50**

General Valuation Principles

- Royalty is due on the quantity & quality of production as measured at the approved ***Royalty Settlement Point*** when it is severed from the lease
- Arm's-Length (ARMS) or Non-Arm's-Length (NARM)
- Gross proceeds
- Marketable condition

Royalty Measurement Point



- To market via pipeline, rail, or truck
- Downstream metering can include:
    - LACT meter
    - API skid
    - Tank measurements
    - Custody transfer point
    - Plant inlet
    - Refinery inlet
    - Storage inlet

Royalty is due on the quantity & quality of production severed from the lease as measured at the BLM or BSEE approved <u>Royalty Settlement Point</u>

Gas Quality Information

- The "dry" heating value must be used unless water vapor content has been determined
- If the actual water vapor was determined, the "real" or "actual" heating value of the gas stream must be used

Arm's-Length or Non-Arm's-Length?

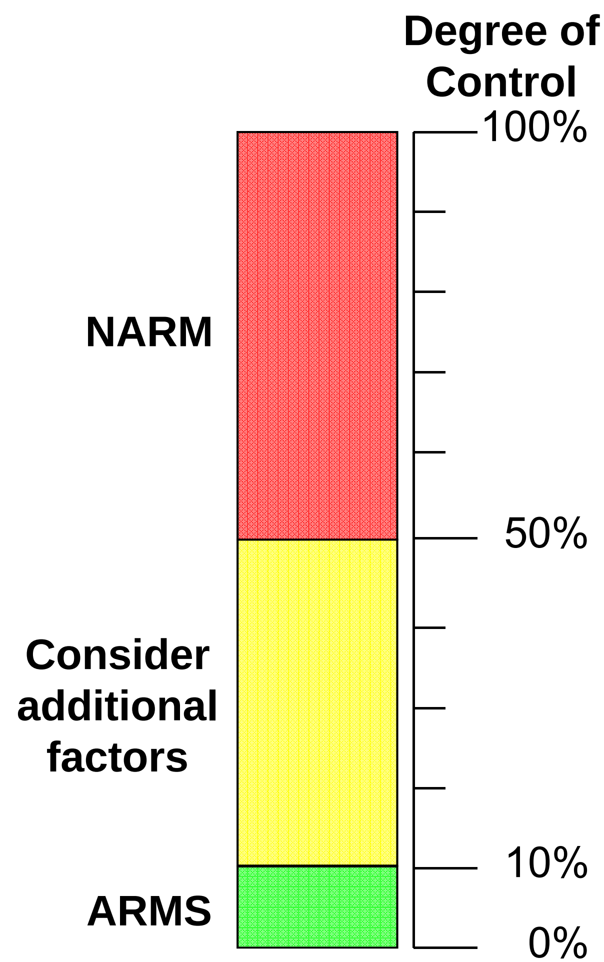
Are the parties…

– Independent?
– Unaffiliated?
    • Determined by degree of control
– Acting with opposing economic interests?

Relation by blood or marriage is automatically a non-arm's length relationship

Affiliation

- Affiliation
  - Entity controls, is controlled by, or is under common control with another entity
- Control
- Opposing Economic Interests
  - Factors outlined in *Vastar Resources, Inc.* 167 I.B.L.A 17 (2005)
    - See paragraph 2 on page 497



Gross Proceeds

Gross Proceeds – “the total monies and other consideration” the lessee receives for disposition of production.

- Value can never be less than gross proceeds accruing to lessee
- Gross proceeds includes:
  - Reimbursements
    - taxes
    - Production-related costs
  - Value of certain services
- Let’s look at an example…

Gross Proceeds Example

You produce 1 barrel of oil from federal land that is adjacent to your backyard and sell it to your neighbor for:

- $20
- 5 chickens
- 1 goat

Gross Proceeds Example

What are your “*total monies and other consideration*”?

A. $20

B. The chickens and the goat

C. $20 and the market value of the 5 chickens and 1 goat

Marketable Condition

- Lessee is responsible for placing production in marketable condition at no cost to the lessor

- Common costs include:
  - Oil: separation; free of impurities
  - Gas: gathering; compressing; sweetening; and dehydrating

- Cannot reduce royalties by transferring the costs on to the purchaser for a lesser sales value

- Add to proceeds if sold in less than marketable condition

ONRR defines "gathering" more specifically than industry. For ONRR, gathering means moving production to a central accumulation point. Industry, however, uses the term gathering when referring to any movement up to the main transmission pipeline.

Outline

- ~~ONRR Royalty Equation~~
- ~~General Valuation Principles~~
- Sales Type Codes
- Oil Valuation
- Gas Valuation
- Allowances
- Contracts
- Bundled Costs
- Fuel

Sales Type Codes

- Value is established at the time production is sold or removed from lease
- How product is sold or removed dictates the sales type code (STC)
- Multiple sales methods – multiple lines
- Relates to *sales* contract, NOT transportation or processing contract

Sales Type Codes

- 4-digit alpha-numeric code
- **Required** for the following transaction codes:
  - TC 01, 11, 12, 14, 15, 41, 53, 54
- **Optional** for the following transaction codes:
  - TC 06, 10, 13, 31, 37, 38, 39, 40, 42
- **Not required** for rent, minimum royalty, other annual obligations, or any other transaction codes

Sales Type Codes

Code	Description
ARMS	Arm's-length transactions
NARM	Non-arm's-length transactions
POOL	Pooled sales, both ARMS and NARM. Includes NGLs derived from pooled gas
RIKD	Royalty-in-kind deliveries
OINX	For Federal oil valued based on index price
APOP	ARMS percentage-of-proceeds contract
NPOP	NARM percentage-of-proceeds contract
Codes assigned as needed	Other codes will be added as future valuation agreements are negotiated with individual companies

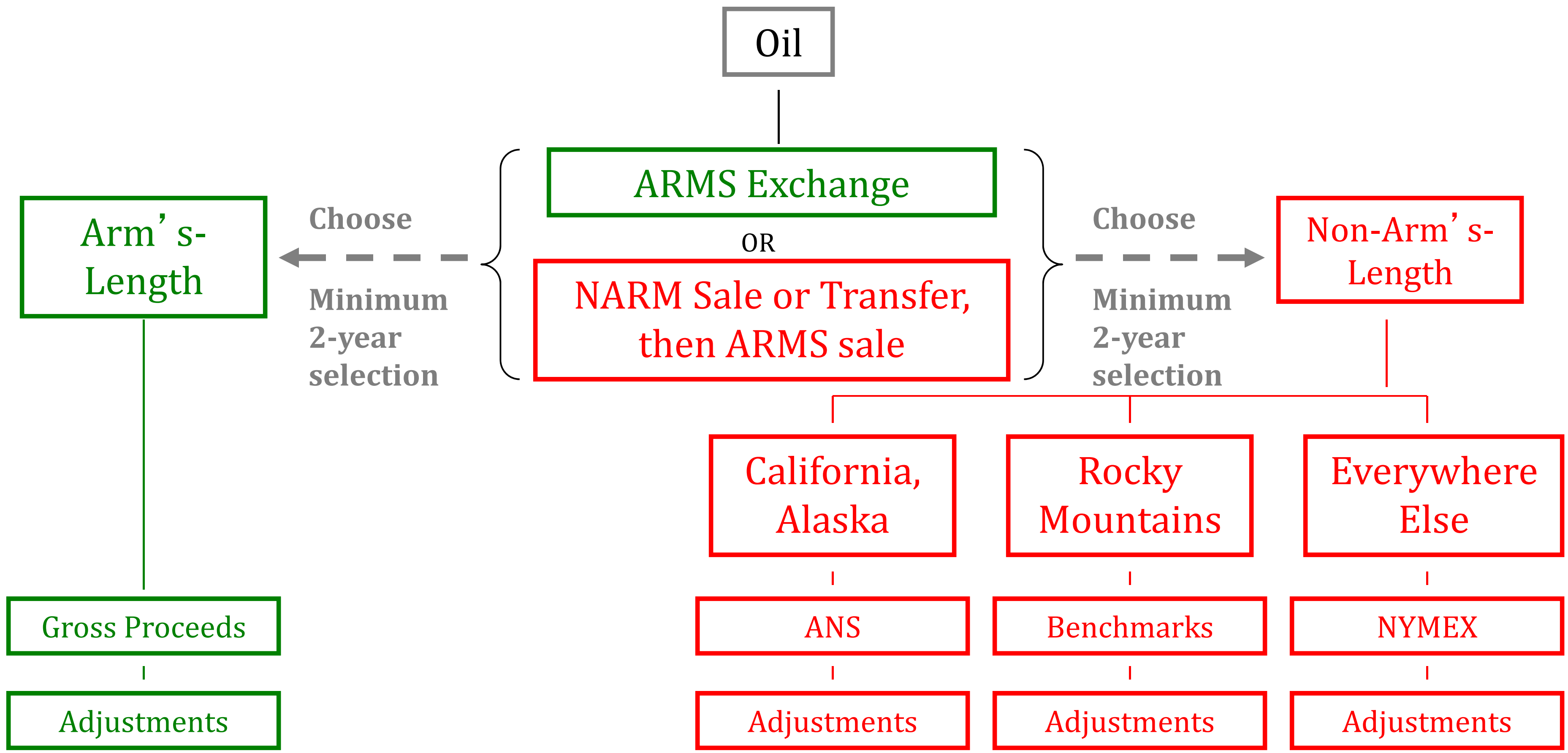
Federal

Oil Valuation

30 CFR § 1206.100 - § 1206.120

Oil Valuation

Oil Valuation Decision Tree



Oil Valuation | Arm's-Length

- Generally accept **gross proceeds** under ARMS sales contracts
- If you **sell or transfer oil** to affiliate and affiliate sells ARMS, may use either ARMS or NARM rules--must use election for 2 years
- If you sell under **ARMS exchange agreement(s)**, may use either ARMS or NARM rules--must use election for 2 years

Oil Valuation | Non-Arm's-Length

Three Regions	Valuation Methodology
California or Alaska  	ANS average spot price
Rocky Mountain Region • MT, ND, SD, WY, CO*, & UT* 	Valuation benchmarks
Rest of the Country • Other states • Outer Continental Shelf (OCS) • *Four Corners region of CO & UT	NYMEX with the roll

Oil Valuation | Non-Arm’s-Length

Rocky Mountain Region Benchmarks

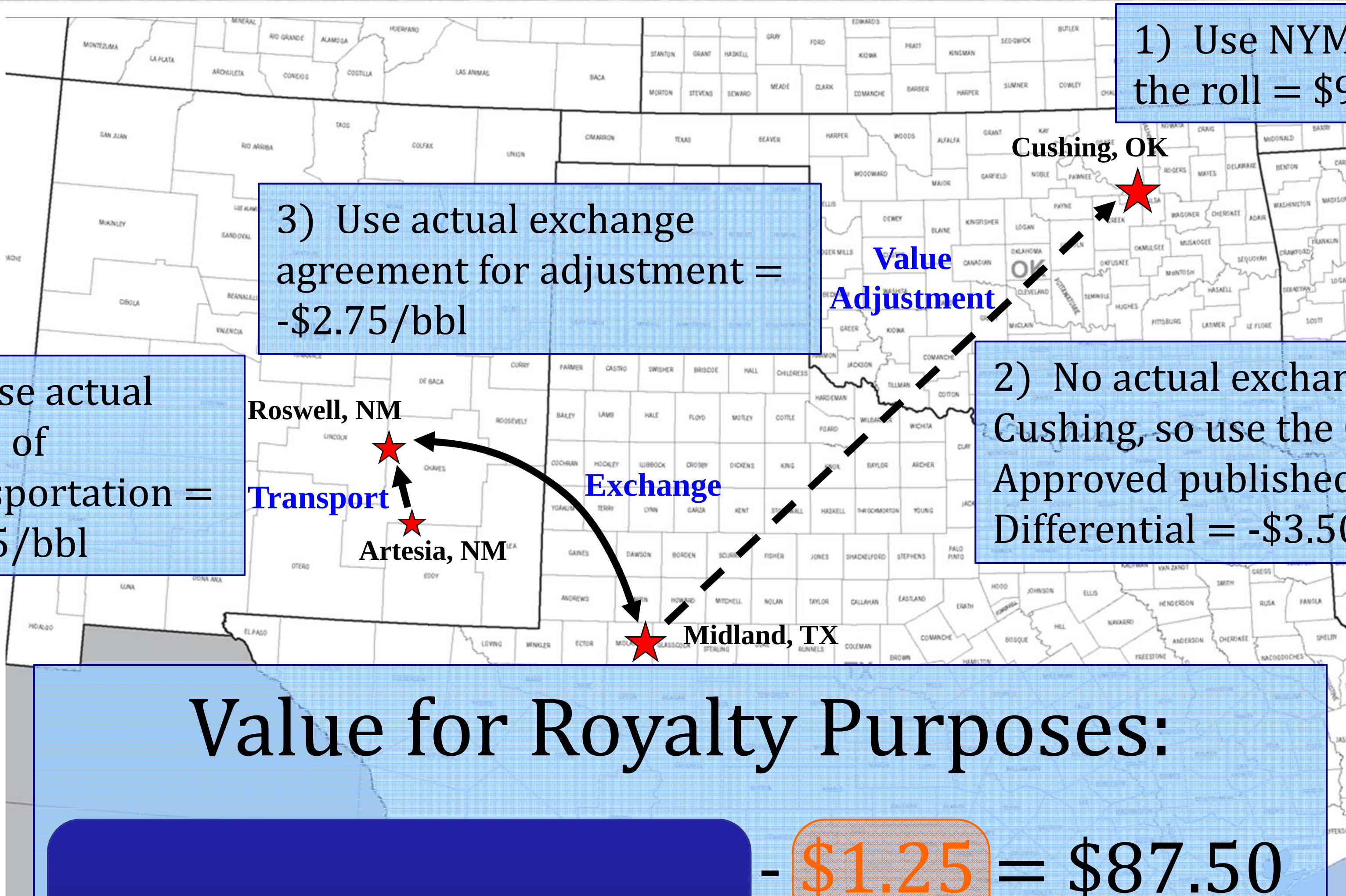
- ONRR-approved tendering program
- Average of ARMS sales/purchases in field or area
  - 2 years
- Cushing WTI NYMEX price without the roll adjusted for location and quality
  - 2 years
- ONRR-approved alternative

Oil Valuation - Adjustments

When value is determined using NYMEX or ANS Spot Prices, you may adjust for:

- Value between lease and market center
  - Transport costs or exchange differential (cannot take both)
- Value between market center and Cushing (for NYMEX)
  - Exchange differential or published differentials
- Quality - use exchange agreements or quality banks at the market center. If there are none, use:
  - Gravity tables in pricing bulletins
  - Sulfur differential of 5¢ per 0.1 percent

Oil Valuation Example



1) Use NYMEX with the roll = $95/bbl

2) No actual exchange to Cushing, so use the ONRR-Approved published WTI Differential = -$3.50/bbl

3) Use actual exchange agreement for adjustment = -$2.75/bbl

4) Use actual costs of transportation = $1.25/bbl

Value for Royalty Purposes:

Adjusted Price for Sales Value - $1.25 = $87.50

Transportation Allowance

Oil Valuation | Publications

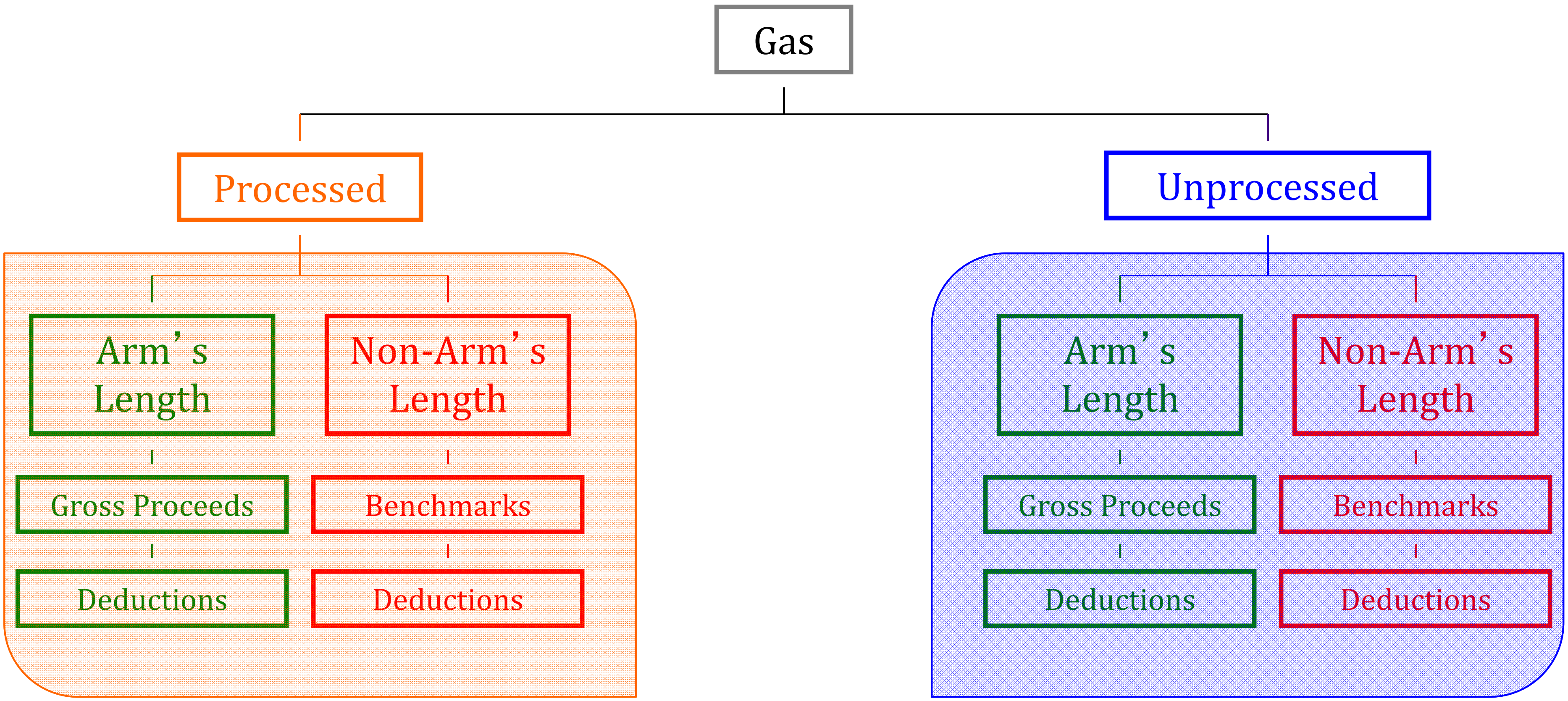
- Publications must be approved by ONRR
- Criteria for selection in 30 CFR § 1206.104
- Announced in the *Federal Register*, June 13, 2000, page 37043
  - Platt's Oilgram Price Report
  - Petroleum Argus Americas Crude
  - Bloomberg Oil Buyers Guide Petroleum Price Supplement

Federal

Gas Valuation

30 CFR § 1206.150 - § 1206.160

Gas Valuation Decision Tree



Definition of Processing

30 CFR § 1206.151 (Definitions)

Processing means any process designed to remove elements or compounds (hydrocarbon and nonhydrocarbon) from gas, including absorption, adsorption, or refrigeration. Field processes which normally take place on or near the lease, such as natural pressure reduction, mechanical separation, heating, cooling, dehydration, and compression are not considered processing. The changing of pressures and/or temperatures in a reservoir is not considered processing.

Gas Valuation | Processed vs. Unprocessed

Processed

- Gas that is processed
- Gas that is sold ARMS prior to processing, but rights to processed gas are reserved or exercised
- Any gas not covered under the unprocessed rules

Unprocessed

- Gas that is not processed
- Gas that is processed, but sold ARMS prior to processing and no rights to processed gas are reserved or exercised

Gas Valuation | Royalty

Processed

- **Royalty is paid on:**
  - Residue gas value
  - Gas plant products value
  - Condensate value recovered downstream of the royalty settlement point and prior to processing
- **Less allowable deductions:**
  - Transportation
  - Processing

Unprocessed

- **Royalty is paid on:**
  - Unprocessed gas volume at the approved royalty measurement point (x) unit price
- **Less allowable deductions:**
  - Transportation

Gas Valuation | ARM vs. NARM

Value for Arm's-Length Contracts	Value for Non-Arm's-Length Contracts
• Generally accept gross proceeds	• First Applicable of 3 ordered benchmarks • ***Dual Accounting*: If you or your affiliate process your gas and then sell the residue gas under a non-arm's-length contract, you must perform dual accounting under 30 CFR § 1206.155.**

Gas Valuation | NARM | 3 Benchmarks

If your non-arm's-length gross proceeds are equivalent to gross proceeds from your arm's-length sales or purchases of like-quality gas from the same field or area, you could use the arm's-length price for non-arm's-length gas.

A value determined by considering information relevant in valuing like-quality gas (unprocessed or residue and plant products), including gross proceeds from arm's-length sales, posted prices, spot market prices, and the like.

A net-back method or other reasonable method to determine value.

Transportation & Processing Allowances

Royalty Due =

[Volume x Price x Royalty Rate] - Allowances

Netting

- *Netting* means the deduction of an allowance from the sales value by reporting a net sales value, instead of correctly reporting the deduction as a separate entry on Form MMS–2014.

When is it ok to net?

- A. Never.
- B. When you have an arm's-length POP Contract
- C. When you have a transportation factor.
- D. Periodically when the urge strikes.

Transportation & Processing Allowances

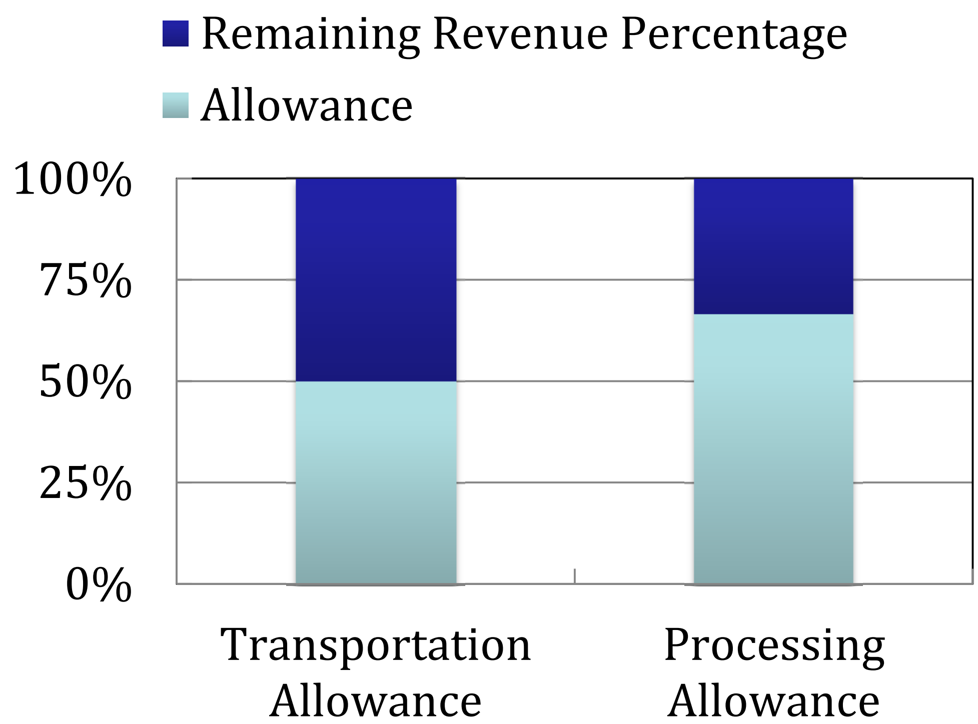
Arm’s-Length Contracts	Non-Arm’s-Length Contracts

• Based on actual costs (contract charges)	• Based on lessee’s actual operating and capital costs for the pipeline or plant
	  • Rate of return for O&G *Transportation* allowances = 1.3 * Standard & Poor’s BBB Bond Rate
	  • For Gas Processing, = 1 * BBB Bond Rate

Transportation & Processing Allowances

Allowance Limits

- **50%** transportation
- **66 $^{2}/_{3}$%** processing
- May request exception from ONRR
- *Combination of transportation and processing allowance cannot exceed **99%** of the value of the product*



ONRR defines "gathering" more specifically than industry. For ONRR, gathering means moving production to a central accumulation point. Industry, however, uses the term gathering when referring to any movement up to the main transmission pipeline.

Oil Transportation | Allowable Charges

ARMS Line Loss: actual or theoretical

Line Fill

Quality bank administration fees

NARMS Line Loss: actual only

ARMS only:

Cost of a letter of credit

Fees paid for loading or unloading

Transfer fees paid to a hub operator

ARMS only:

Fees paid for required short-term storage (less than 30 days)

ARMS only: Fees paid to pump oil to another carrier's system or vehicle as required by a tariff

Payment for volumetric deduction to cover shrinkage

Gas Transportation | Examples of Specific Charges

Allowed

- Unused firm demand costs
- ARMS only: Costs of securing a letter of credit
- ARMS Line loss fees (in volume or value): actual or theoretical loss
- NARM Line loss fees (in volume or value): actual loss only

Disallowed

- Fees paid to brokers
- Fees paid to scheduling service providers
- Internal Costs

Gas Transportation | Non-Arm's-Length Exception

Non-Arm's-Length exception to calculating actual costs.

You may request an exception if:

- You meet two criteria:
  1. Transportation system must have a tariff filed with FERC
  2. Third parties are paying prices to ship their gas
- With ONRR approval, you may deduct the lesser of:
  - The tariff amount, OR
  - The volume-weighted-average of third party prices

OCSLA Section 6 Leases

The State of Louisiana and Texas issued oil and gas leases for submerged offshore lands prior to the enactment of the Outer Continental Shelf Lands Act (OCSLA) (43 U.S.C. § § 1331 *et seq)* (Aug. 7, 1953).

The OCSLA provides that the outer continental shelf lands are in the Federal domain and thus subject to Federal oil and gas leasing.

However, Section 6 of the OCSLA (43 U.S.C. § 1335), essentially provides that existing leases issued by Louisiana and Texas would be maintained as Federal leases and are subject to the original provisions as provided on the state lease forms. We now generally refer to these as “Section 6 leases.”

Because of the unique nature of these lease forms and their interpretation, please contact our office for guidance.

Coalbed Methane

- Unique reporting requirements on the OGOR & 2014 reports
- Key Resources
  - *Amoco Production Co. v. Watson* (D.C Cir. 2005) (See pgs 12-19 for a good discussion on CBM marketable condition)
  - *Devon Energy Corp - October 9, 2003 Valuation Determination* (upheld in *Devon Energy Corp.* v. *Kempthorne,* 551 F.3d 1030 (D.C. Cir. 2008))
  - 30 CFR § § 1206.152(i) and 1206.153(i)
  - Current Dear Reporter Letter dated Oct 4, 2005
    - http://www.onrr.gov/FM/PDFDocs/20051004.pdf
  - ONRR *Minerals Revenue Reporter Handbook*
    - http://www.onrr.gov/FM/PDFDocs/RevenueHandbook.pdf

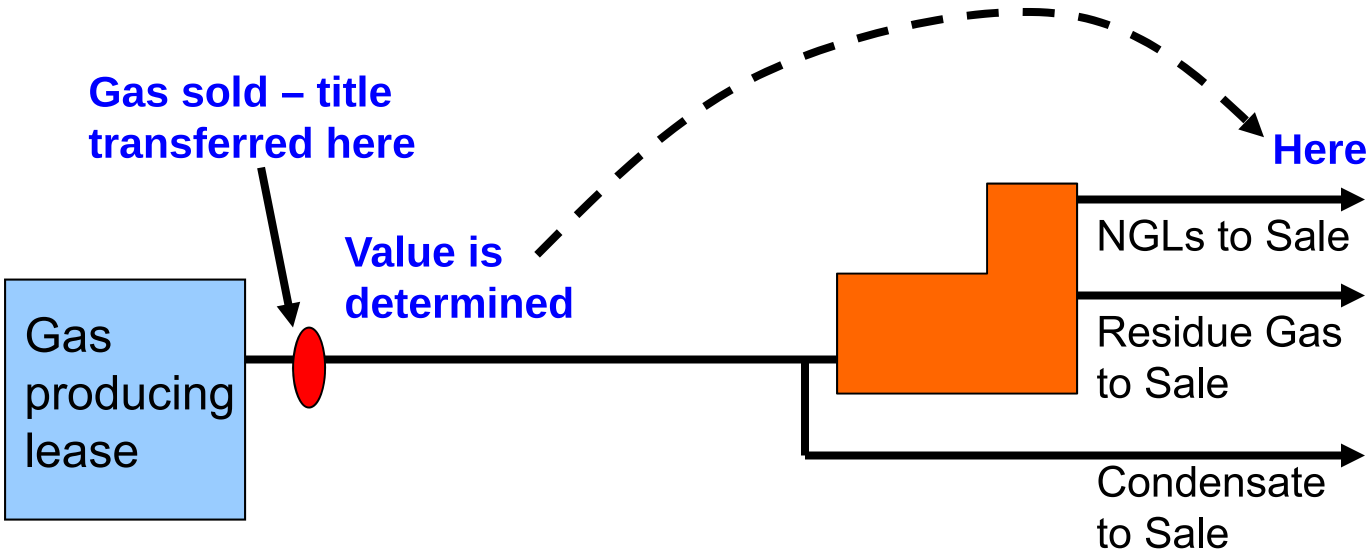
Coalbed Methane Random Quiz

- Is Coalbed Methane Ever Processed?
- A. Yes
- B. No
- C. This is a trick question!
- D. What about the Fruitland Coal Fm.?

Percentage-of-Proceeds (POP) Contracts

For ONRR, a POP contract is a contract:

1. For the sale of gas,
2. Prior to processing,
3. Value is based on a percentage of the purchaser's proceeds resulting from processing



POP Contracts | Arm’s-Length

- Federal Arm’s-Length (APOP) royalties are based on the ***greater of***:
  - Gross Proceeds under the POP contract, **or**
  - Value of 100 % of the residue gas attributable to the property
- APOP Contract Transportation Costs
  - If there are charges in your APOP sales contract related to transportation, they may be deducted from your gross proceeds, and should not be claimed as allowances.
  - However, the royalties paid may not be less than 100% of the value of the residue gas

POP Contracts | Non-Arm's-Length

- Federal Non-Arm's-Length (NPOP) royalties are based on processed gas proceeds, sum of:
  - ➕ Residue gas value
  - ➕ Gas plant products value
  - ➕ Condensate value recovered downstream of royalty settlement point and prior to processing
  - ➖ Less applicable allowances*

***You must report your affiliate's reasonable, actual costs of transportation and processing separately.**

Keep Whole Contracts

Producer X Delivers 1000 MMBtus to Processor Y's Gas Plant

Producer X Receives 1000 MMBtus at the Plant Outlet

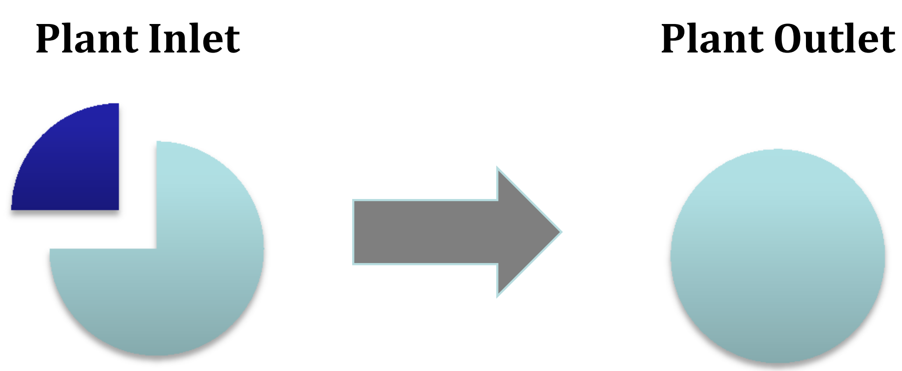
Residue + Makeup Gas to Producer X

NGLs to Processor Y Sales

In Exchange for Processing and/or other Services, Processor Y Keeps all NGLs Recovered from Producer X's Gas

Keep Whole Contracts

- Valued and reported as **<u>Processed Gas</u>**
- Royalty also due on condensate recovered by service provider prior to processing
- Processing costs are:
  - ➕ Value of any NGL's kept by the processor, less
  - ➖ Value of make-up residue gas provided by processor
    - Processing may include the cost of make-up gas paid for by the producer



What is Unbundling?

- **Unbundling = the process of taking a gas transportation and/or processing fee and determining the *allowed* and *disallowed* costs for Royalty Reporting and Payment. Includes**:
  - **Determining marketable condition**
  - **Separating the Gathering/Transportation Fees from Processing Fees**
  - **Applying the appropriate Unbundling Cost Allocations (UCAs)* to the fees you are charged for transportation, gathering, compression, dehydration, treatment, and processing**

**Note: A UCA is the percent of a fee that is allowable (there will likely be a different percentage for Transportation and Processing)*

What is Expected of Industry

- Properly Report and Pay Royalties
- Correctly calculate **transportation** and **processing** allowances
    - Option 1 – Take no allowance
    - Option 2 - Unbundle
        - –Calculate your own UCAs
        - –Use ONRR UCAs if available

Applying the Unbundling Cost Allocations (UCAs)

("*Understanding" the Disclaimer*)

The ONRR Unbundling website can be found at:

http://www.onrr.gov/unbundling/default.htm

To enter the website, you must read the Disclaimer and then select the "I Understand" box

ONRR Unbundling

DISCLAIMER FOR ONRR UNBUNDLING WEBSITE

Non-Arm's-Length Agreements

Lessees transporting and processing Federal and Indian natural gas under **non-arm's-length agreements** are obligated to comply with the regulations for claiming allowances for transportation and processing costs, including 30 C.F.R. § 1206.157(b) and §1206.159(b) *(Federal)* and 30 C.F.R. § 1206.178(b) and § 1206.180(b) *(Indian)*. In this case, lessees must base their transportation and processing allowance on their reasonable actual costs and may not use the values posted on this website.

Arm's-Length Agreements

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ONRR provides the UCAs on this website based on the best information available to ONRR at the time of publication. If ONRR receives more accurate information, then ONRR will update and modify the UCAs. You may use these UCAs ***as estimates*** for later time periods until such time as ONRR provides updated information. When ONRR updates or modifies information you may be subject to additional royalty obligations, or a credit, and associated interest under the provisions at 30 CFR 1206.156(d) (for transportation allowances) and 1206.158(e) (for processing allowances). When ONRR updates the UCAs for a specific year you should adjust previously submitted royalty lines only for that specific year. Do not change previously reported data until ONRR publishes actual values. You should use the most recent UCAs as estimates for future reporting months.

Cancel

Applying the Unbundling Cost Allocations (UCAs)
(*ONRR Unbundling website*)

The ONRR Unbundling website can be found at:

http://www.onrr.gov/unbundling/default.htm

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Unbundling Information

How to use the published Unbundling Cost Allocations (UCAs)

Example:

1. ONRR publishes UCAs for 2010.
2. You use 2010 UCAs to estimate 2011, 2012, and 2013.
3. ONRR publishes UCAs for 2011 and 2012.
4. You replace estimated values for 2011 and 2012 (there is no change for 2013).
5. You use 2012 (most current) UCAs for future reporting period estimates.

Reporter Letters

- Royalty on Gas Used or Lost Along a Pipeline Prior to the Point of Sale (PDF) — (8/8/2013)
- Guidance on Valuing Gas for Royalty Purposes — Transportation Systems and Processing Plants - Onshore Federal Leases (PDF) — (10/6/2010)
- Guidance on Valuing Gas for Royalty Purposes — Manzanares Gas System, San Juan Basin, New Mexico (PDF) — (10/7/2009)

For assistance or questions please send an e-mail to: onrrunbundling@onrr.gov

System/Plants Table

Show 10 entries Table Search:

Name with Document Link	Type	Operator	Location	Doc Date
San Juan Conventional Transportation System - Ignacio Plant (PDF)	Trans/Plant	Williams	NM	01/21/2014
Manzanares Transportation System (PDF)	Trans	Williams	NM	11/25/2013
San Juan (Blanco) Plant (PDF)	Plant	CononcoPhillips	NM	10/18/2013

QUICK LINKS
Unbundling Home
Methodology
E-Blasts and Updates

An Example of the Unbundling Process

(*Identify Data Needs*)

More detailed information is available on the ONRR Unbundling website

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A A A

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QUICK LINKS

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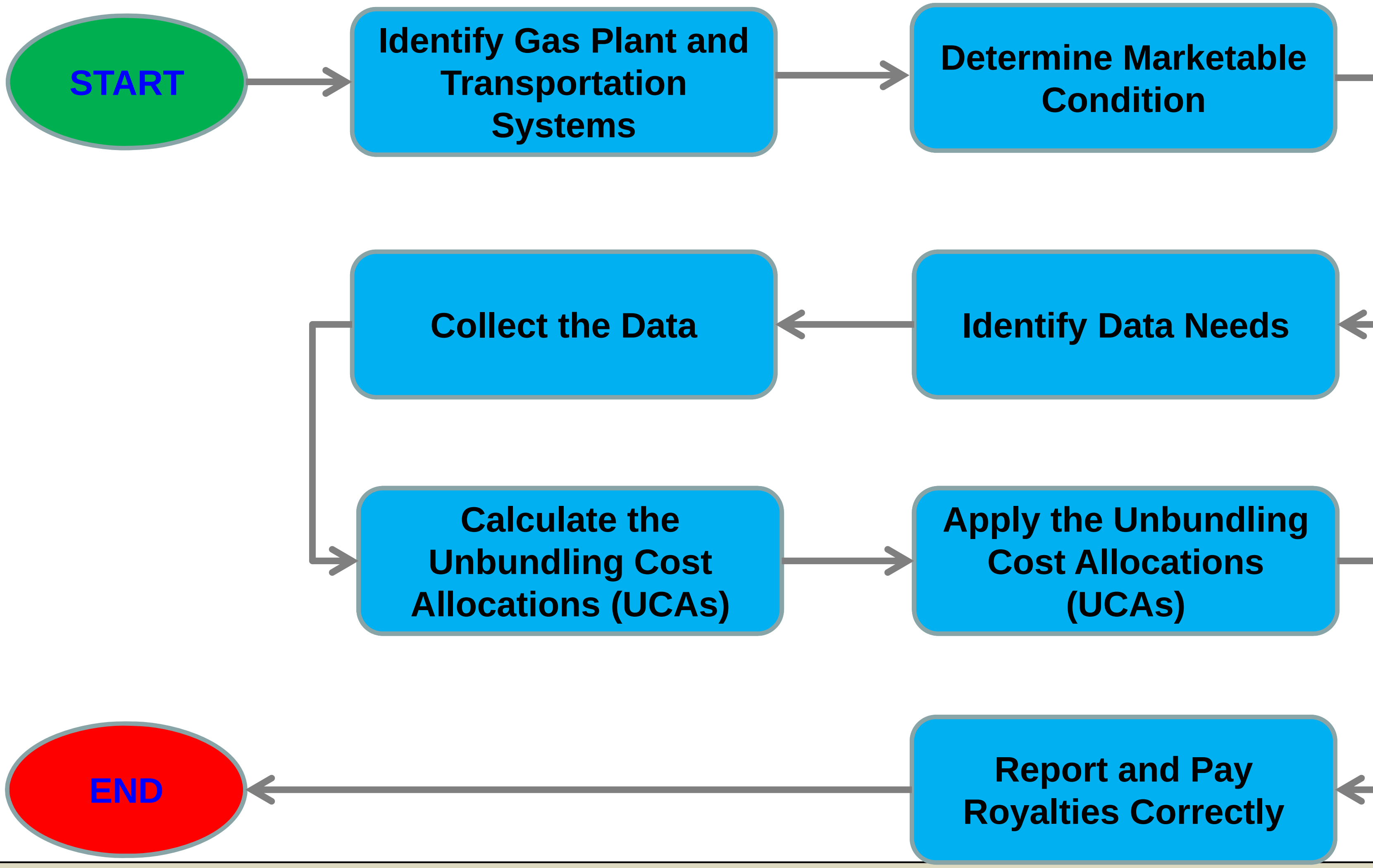
E-Blasts and Updates

The Unbundling Process

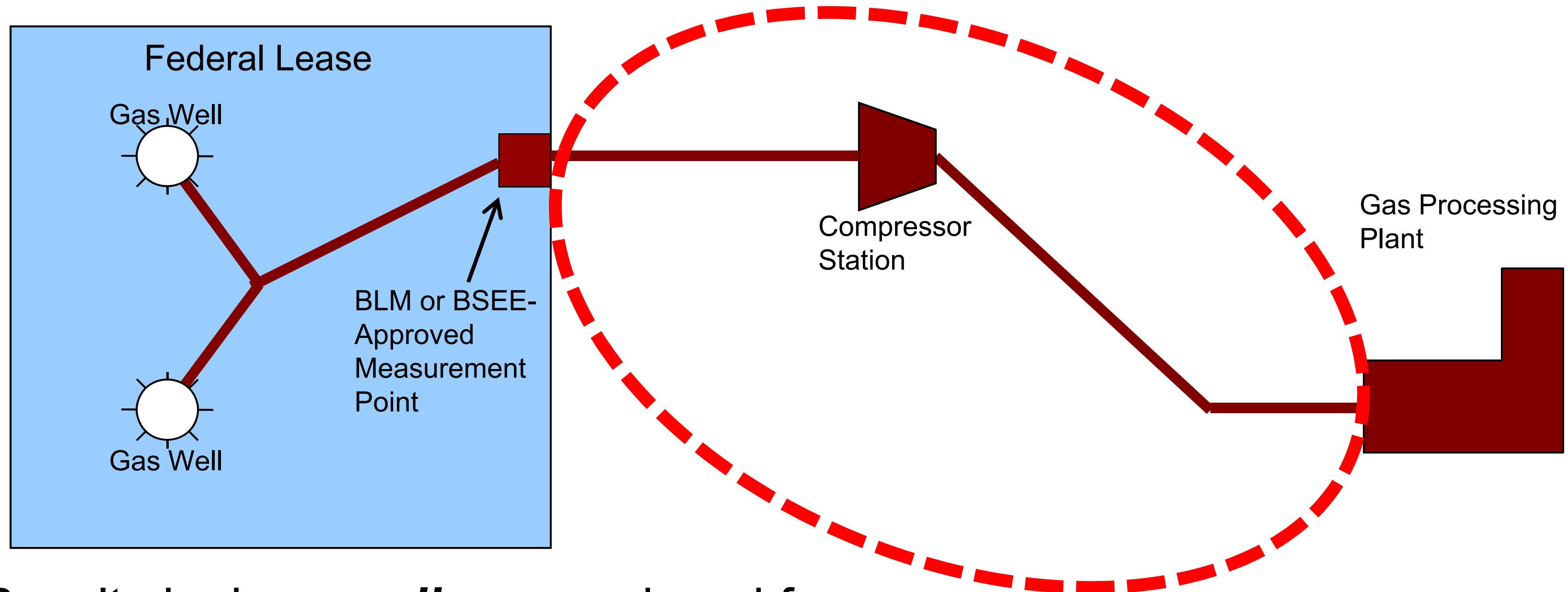


Communications | ONRR Mailbox

Mailbox Exclusively for Questions and Requests Regarding Unbundling

onrrunbundling@onrr.gov

Gas Used or Lost Along a Pipeline: Understanding the Issue

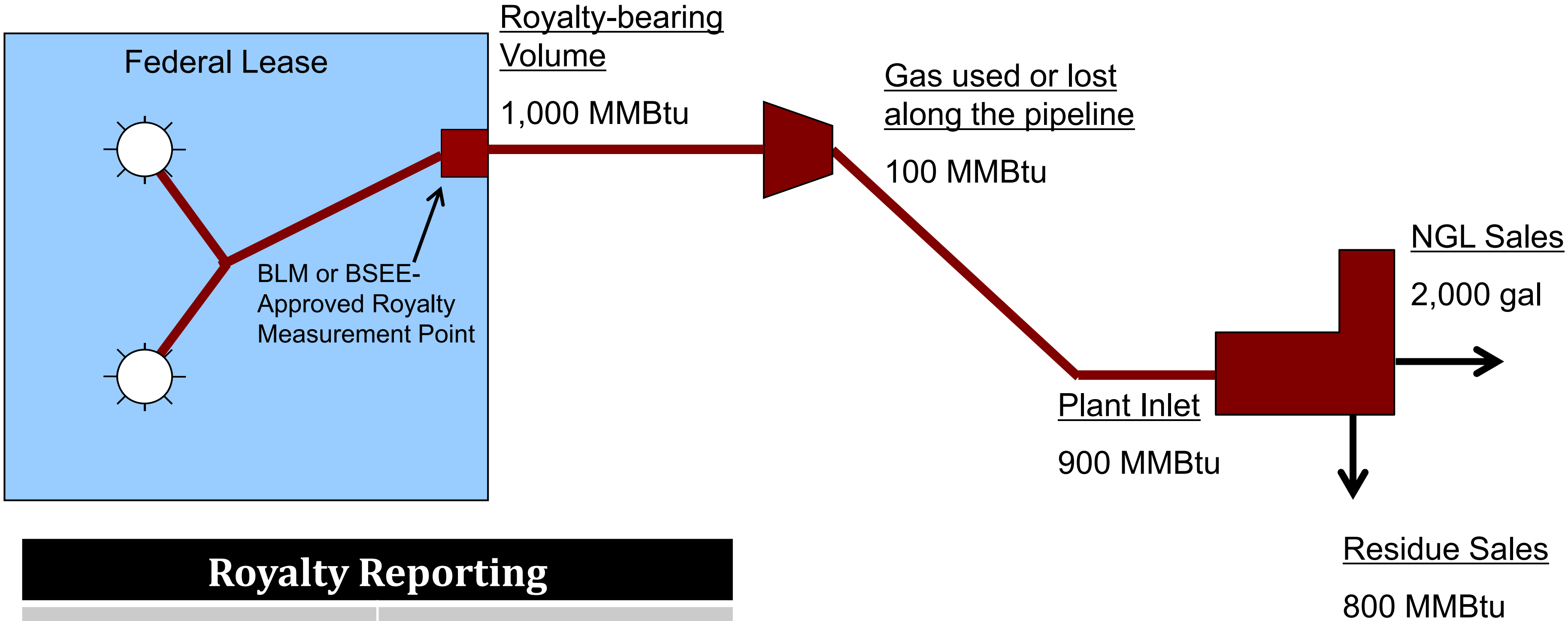


Royalty is due on ***all*** gas produced from a Federal lease, except:

- Beneficial use (gas used on lease)
- A reasonable amount of residue gas used to operate a gas plant

<u>Federal Gas</u>
30 CFR 1202.150(a) and (b)(1), 30 CFR 1202.151(b)
<u>Indian Gas</u>
30 CFR 1202.555

Gas Used or Lost Along a Pipeline: An Example



Royalty Reporting	
Product Code	Sales Volume
03	800 MMBtu
07	2,000 gal
15	100 MMBtu

The allowable portion of gas used or lost may be included in the transportation allowance.

Gas Used or Lost Along a Pipeline: Key Points

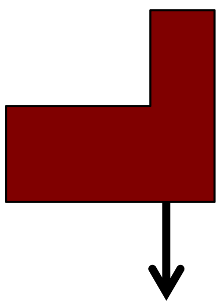
- Royalty has always been due on 100 percent of the volume measured at the approved royalty measurement point
- The cost of allowable fuel may be included in the transportation allowance
- Using PC 15 is the only new requirement
- **Resources:**
  - http://onrr.gov/DearRep.htm
    - http://onrr.gov/PDFDocs/Field-Fuel-Valuation-and-Reporting.pdf
  - http://onrr.gov/ReportPay/training/default.htm
    - http://onrr.gov/About/PDFDocs/ChrisCareyCOPASFieldFuelPresentationFINAL20131216.pdf

Plant Fuel

<u>From the reporter letter:</u>
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.

Total Fuel used = 140 MMBtu

Disallowed Fuel = 40 MMBtu



Residue Sales

1,000 MMBtu

<u>Multiple Choice Question</u>

The residue gas sales MMBtu reported on the ONRR form 2014 should be:

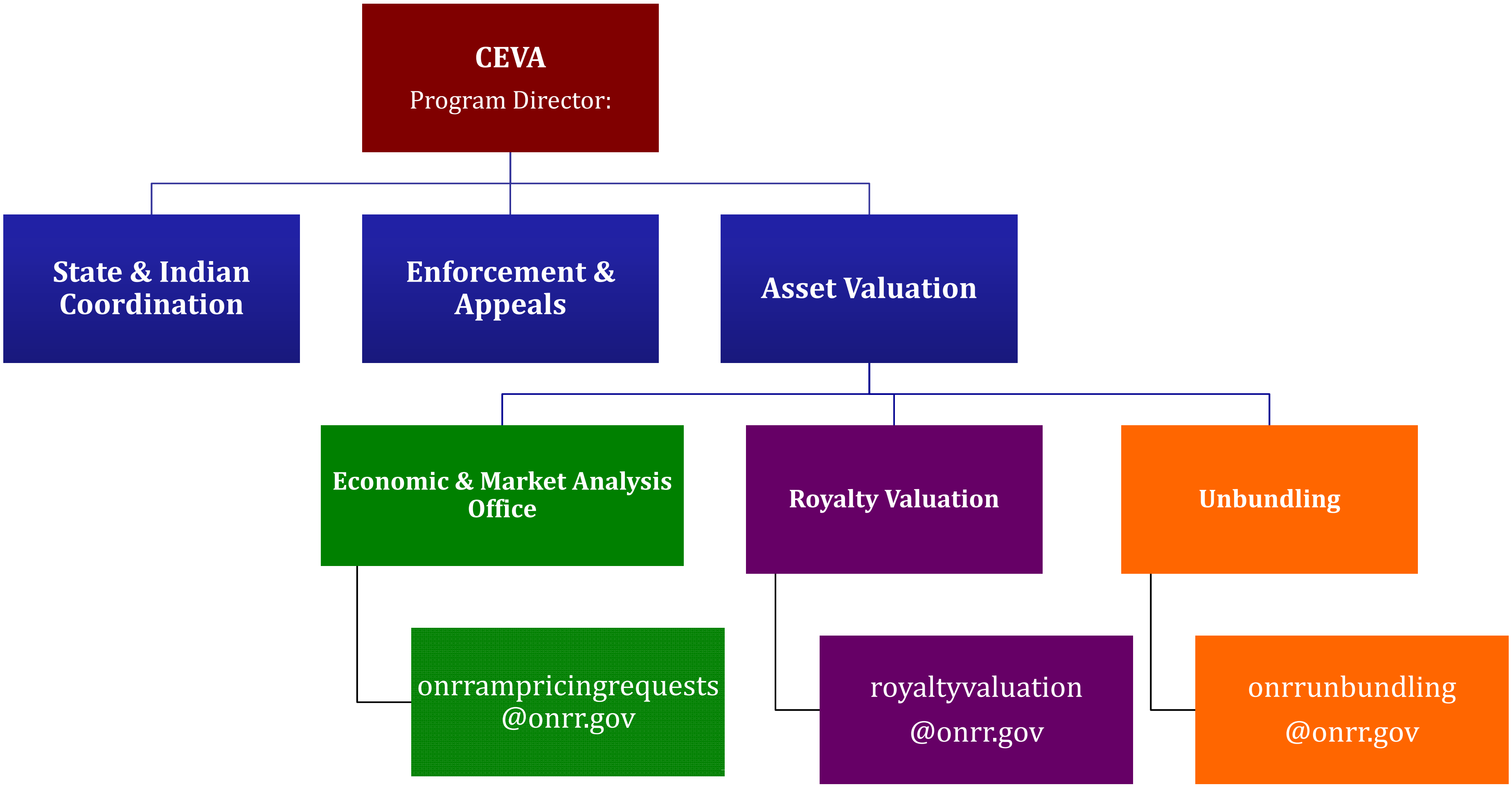
A) 1,000 MMBtu

B) 1,040 MMBtu

C) 1,140 MMBtu

Royalty Reporting	
Prod Code	Sales Volume
03	1,040 MMBtu

CEVA | Coordination, Enforcement, Valuation, & Appeals



Bundled Costs

- A single rate for several services:
  - Gathering
  - Transporting
  - Compressing
  - Treating
  - Processing

- Deductions only allowed for:
  - Cost to transport royalty-bearing gas
  - Cost to process royalty-bearing gas

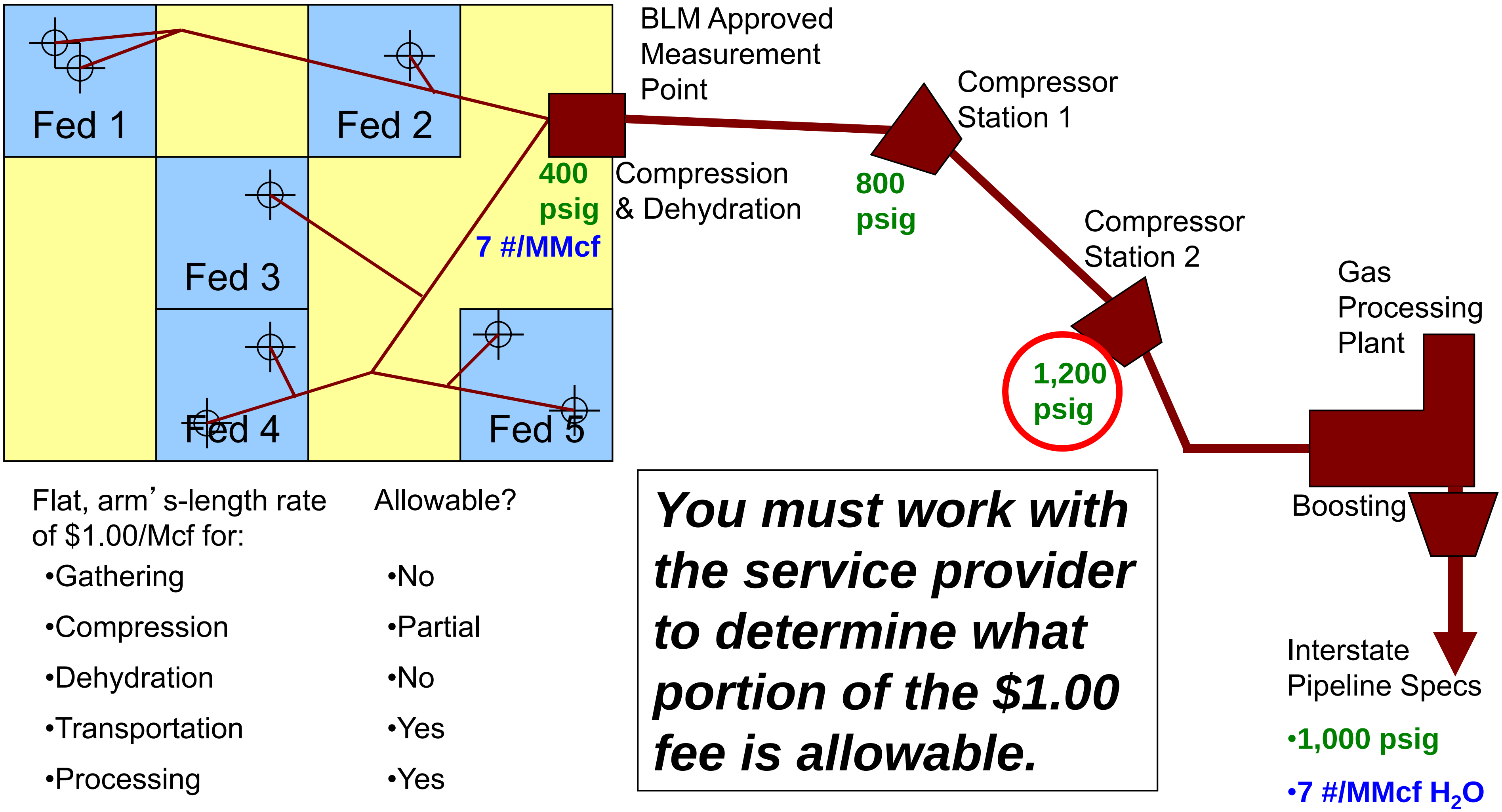
- What is not allowed? – Devon Decision
  - Gathering – movement from the wellhead to the approved royalty settlement point
  - Treating to reach marketable condition
  - Compression to reach marketable condition
  - Costs to remove non-royalty-bearing substances

Unbundling Costs

How do I un-bundle fees?

- Determine what costs are allowable for processing and/or transportation
- Follow the gas as it moves through the pipe
  - Gathering: wellhead to the approved measurement point – not deductible
  - Allowable transportation costs: pipe, maintenance, operation, and compression to <u>maintain</u> pressure
  - Allowable processing costs: extraction royalty-bearing products - usually NGLs (CO_2 only if marketed)

Unbundling Example



Flat, arm's-length rate of $1.00/Mcf for:	Allowable?
•Gathering	•No
•Compression	•Partial
•Dehydration	•No
•Transportation	•Yes
•Processing	•Yes

You must work with the service provider to determine what portion of the $1.00 fee is allowable.

Unbundling Costs

- ONRR is working to make unbundling information available to payors
- Oct 6, 2010 Dear Reporter Letter
  - Good discussion on unbundling
  - Outlines how we determine allowable costs
- Unbundling website
  - http://www.onrr.gov/Unbundling/default.htm
  - Allowable percentages
  - Example calculations

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