THE MARKETABLE CONDITION RULE

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Clicker Question!!

How familiar are you with the marketable condition rule?

A. Very familiar
B. Somewhat familiar
C. I have very little familiarity with this topic
D. This is my first exposure to this topic

Agenda

- Marketable Condition for Gas:
  - What is the Marketable Condition Rule?
  - What are some of the key principles of Marketable Condition Cases?
  - Examples
- Marketable Condition for Oil and Condensate.

What Is The Marketable Condition Rule?

ONRR's Definition of Marketable Condition

Marketable Condition is defined as "lease products which are sufficiently free from impurities and otherwise in a condition that will be accepted by a purchaser under a sales contract typical for the field or area."

- 30 C.F.R. § 1206.151 (Federal gas)
- 30 C.F.R.§ 1206.171 (Indian gas)

Marketable Condition Requirement

The lessee must place gas in marketable condition and market the gas for the mutual benefit of the lessee and the lessor at no cost to the Federal Government.

30 C.F.R. § 1206.152(i) [Federal gas]
30 C.F.R. § 1206.174(h) [Indian gas]

Clicker Question!

ONRR's current procedures regarding marketable condition are based on:

A. ONRR regulations
B. Administrative law (IBLA or IBIA decisions)
C. Case Law (District Court, Court of Appeals, U.S. Supreme Court)
D. All of the above

Common Elements of Marketable Condition

These elements of our marketable condition equation *<u>are</u> defined*

<u>Compression</u>: the process of raising the pressure of the gas

<u>Gathering</u>: the movement of lease production to a central accumulation and/or treatment point on the lease, unit, or communitized area, or to a central accumulation or treatment point off the lease, unit, or communitized area as approved by the BLM or BSEE operations personnel for onshore and OCS leases, respectively

30 C.F.R. 1206.151 [Federal gas]
30 C.F.R. 1206.171 [Indian gas]

Common Elements of Marketable Condition

Marketability generally includes all processes that improve the salability of the product—functions that give the oil or gas its "value"

Dehydration: removing water vapor from the product stream.

- Improves the product
- Protects infrastructure integrity

Sweetening: this step involves the removal or reduction of hydrogen sulfide (H_2S) and/or carbon dioxide (CO_2). These components are sometimes referred to as "acid gas" or "sour gas," and this process encompasses the removal of these items from the product stream

- Not always a waste product
- Can be further processed to yield a valuable product

Is ONRR entitled to the value of the salable byproducts created here?

Major Principles

Principle 1:

The lessee must gather, dehydrate, and compress gas at no cost to the lessor. The lessee must remove sulfur (H_2S) and carbon dioxide (CO_2) at no cost to the lessor.

References:

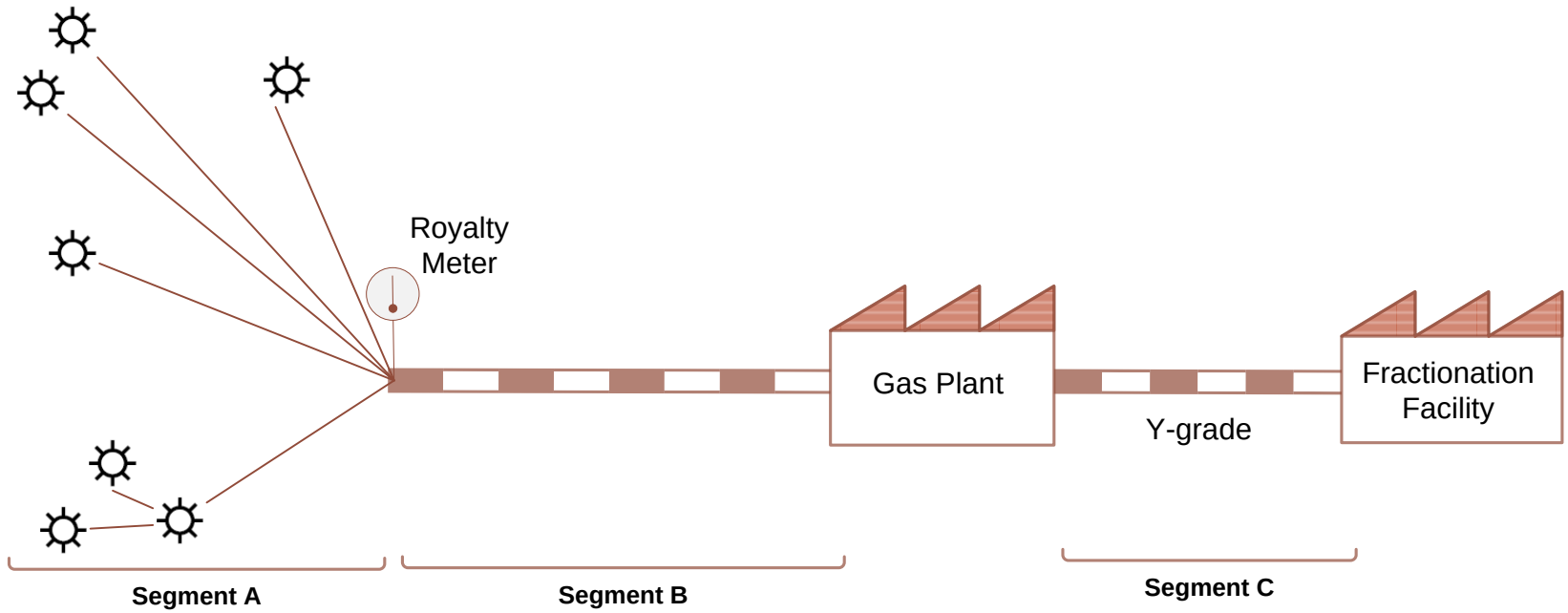
The Texas Co., 64 I.D. 76 (1957); *California Co. v. Udall*, 296 F.2d 384 (D.C. Cir. 1961); *Devon Energy Corporation v. Kempthorne*, 551 F.3d 1030 (D.C. Cir. 2008), cert. denied,130 S. Ct. 86 (2009). *Apache Corp.*,127 IBLA 125 (1993); *Texaco, Inc. v. Quarterman*, No. 96-CV-008J (D. Wyo. Aug. 20, 1996); *Amoco Prod. Co. v. Watson*, 410 F.3d 722, 725 (D.C. Cir. 2005), aff'd sub nom., *BP Amoco Prod. Co. v. Burton*, 549 U.S. 84 (2006).

Clicker Question!

Assume the gas is produced in marketable condition with regards to pressure, water content, and acid gases.

Which **pipeline segment(s)** is/are disallowed?

A. Segment A
B. Segment B
C. Segment C
D. A & C
E. None of the above.



Major Principles

Principle 2:

The fact that gas can be sold does not mean that it is in marketable condition. A lessee cannot avoid the marketable condition requirement by selling gas not in marketable condition at a lower price.

References:

California Co. - "almost anything can be sold, if the price is no consideration. In the record before us there is no evidence of a market for the gas in the condition it comes from the wells. The only market, as far as this record shows, was for this gas at certain pressure and certain minimum water and hydrocarbon content"

Amoco and Devon – the fact that the gas was sold untreated at the well head does not mean it was in marketable condition at the wellhead

Major Principles

Principle 3:

A lessee cannot avoid the marketable condition requirement by selling gas not in marketable condition at a lower price, and transferring the cost of conditioning to the purchaser.

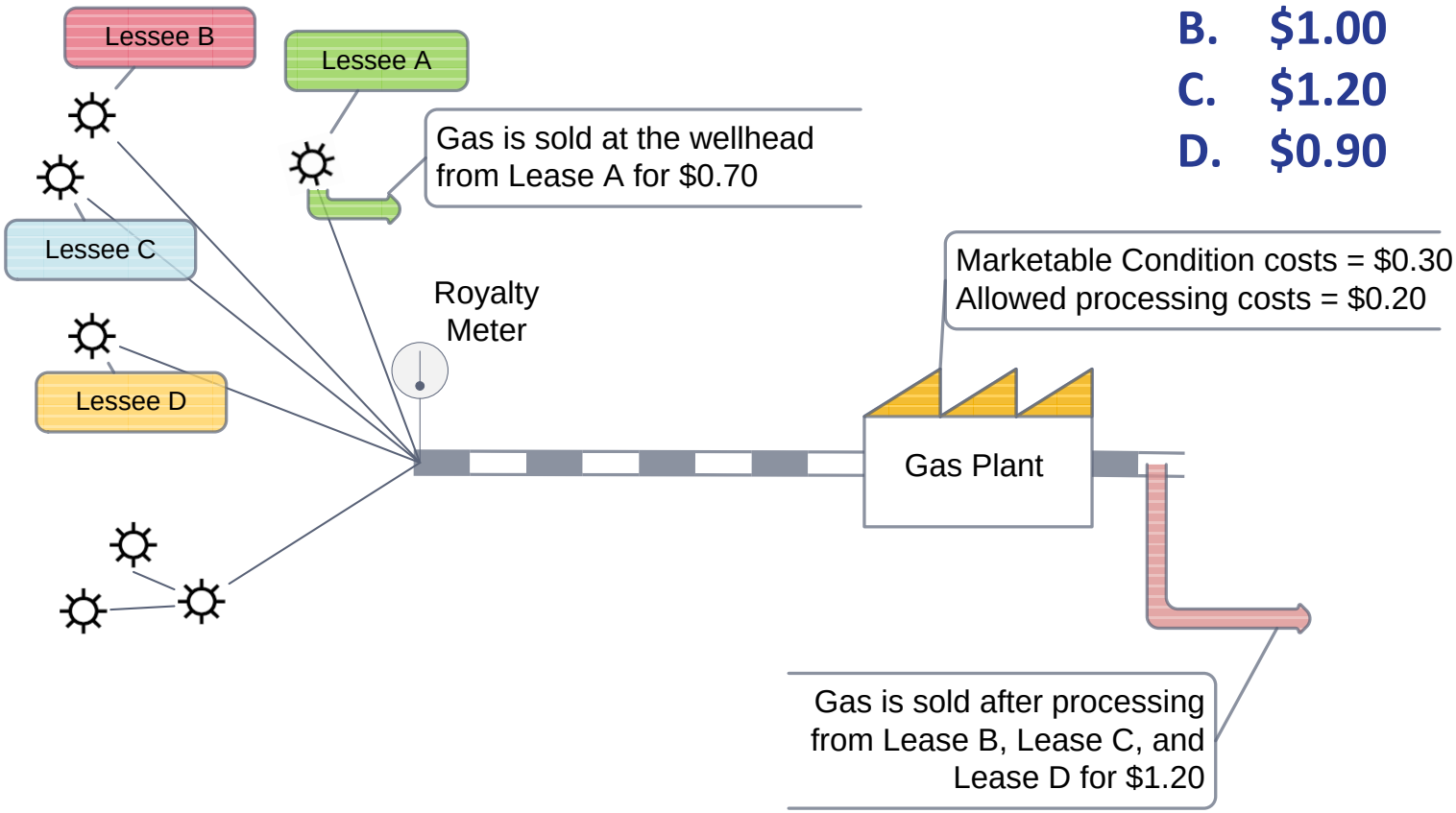
References:

Placid Oil Co., 70 I.D. 438 (1963); *Exxon Co. USA*, 121 IBLA 234 (1991).

30 C.F.R. § § 1206.152(i) and 1206.153(i) [Federal gas]
30 C.F.R. § 1206.174(h) [Indian gas]

Clicker Question: Lessees A and B produce gas of the same quality/condition and it is <u>not</u> in marketable condition at the lease. What value should Lessee A be paying royalties on?

A. $0.70
B. $1.00
C. $1.20
D. $0.90



Major Principles

Principle 4:

Marketable condition requirements are typically established by the quality specifications necessary to enter the pipeline that transports the gas to market. It is not required that these specifications be written in the sales contract.

References:

Amoco, Devon, R.E. Yarbrough Co., 122 IBLA 217, 221 (1993), Shoshone, The Texas Co., J-W Operating Co.,159 IBLA 1 (2003)

Pipeline Quality Specifications: Example

Wyoming Interstate Company, L.L.C.
FERC Gas Tariff
Third Revised Volume No. 2

Part IV: GT&C
Section 3 - Quality
Version 2.0.0

3. QUALITY

3.1 Freedom from Objectionable Matter. The Gas Tendered:

(a) Shall be commercially free from dust, gums, gum-forming constituents, dirt, impurities, or other solid or liquid matter which might interfere with its merchantability or cause injury to or interference with proper operation of the pipelines, regulators, meters, or other equipment of Transporter;

(b) Shall not contain more than .25 grain of hydrogen sulphide per 100 cubic feet of Gas.

(c) Shall not contain more than 5 grains of total sulphur (including the sulphur in any hydrogen sulphide and mercaptans) per 100 cubic feet;

(d) Shall not at any time have an oxygen content in excess of 10 parts per million by volume, and the Parties hereto shall make every reasonable effort to keep the Gas free of oxygen;

(e) Shall be Delivered at a temperature not in excess of 120 degrees Fahrenheit or less than 20 degrees Fahrenheit;

(f) Shall, before Gas Day March 1, 2013, not contain more than 3.00 percent by volume of carbon dioxide; and beginning Gas Day March 1, 2013, not contain more than 2.00 percent by volume of carbon dioxide in the Gas stream except as provided in GT&C Section 3.8;

(g) Shall not contain water vapor in excess of 5 pounds per million cubic feet of Gas; and

(h) Shall not contain any hydrocarbon fractions which would condense to free liquids in the line at a temperature of 25 degrees Fahrenheit at pressure between 100 p.s.i.a. and the maximum available operating pressures of Transporter's transmission facility, as calculated from the Gas composition. This subsection (h) shall not apply to gathering systems or lateral lines.

Typically, Marketable Condition is determined by the specifications set by the pipeline at the tailgate of a processing facility.

Maximum H_2S accepted in gas stream.

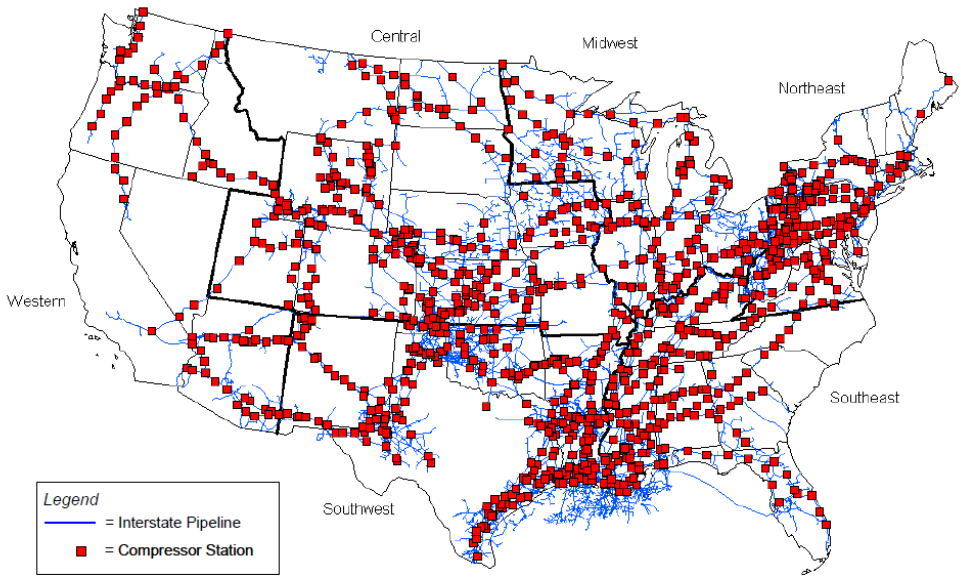
Maximum CO_2 accepted in gas stream.

Maximum H_2O accepted in gas stream.

What Are the Pressure Requirements?

- Pressure varies over the length of an interstate pipeline
- Marketable condition pressure will depend on each producer's delivery point into the pipeline
- Pressure data may be available from plant operators or interstate pipeline company

Figure 1. Interstate Natural Gas System Mainline Compressor Stations, 2006



Note: EIA has determined that publication of this figure does not raise security concerns, based on the application of Federal Geographic Data Committee's *Guidelines for Providing Appropriate Access to Geospatial Data in Response to Security Concerns*.
Source: Energy Information Administration, Natural Gas Division, Natural Gas Transportation Information System, Compressor Station Database.

Major Principles

Principle 5:

If a lessee claims their gas is in marketable condition based on something other than the high-pressure pipeline, the lessee must demonstrate that there is a real and active market for the gas in that condition.

References:

Gas may be in marketable condition at the wellhead if there is a market at the wellhead evidenced by competing offers from multiple purchasers, the sales price is the same as that for gas that is compressed, and the pressure of the gas at the wellhead is adequate to gain access to the pipeline market

Xeno, Inc., 134 IBLA 172 (1995)

Major Principles

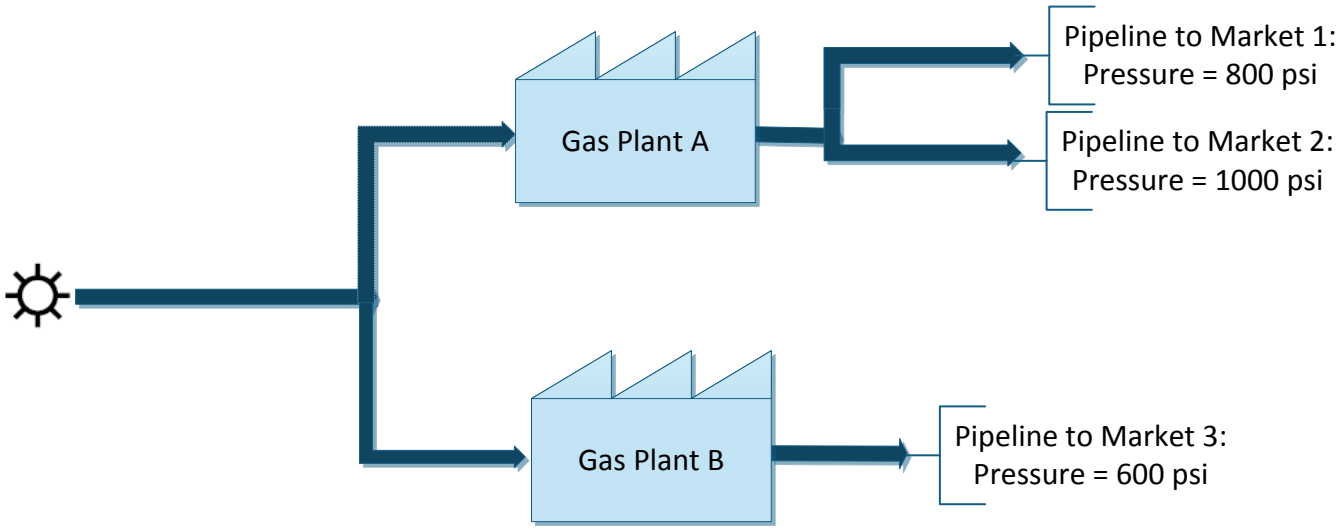
Principle 6:

There may be multiple markets for gas produced from a particular area that may call for different degrees of conditioning. The gas must be placed into the marketable condition required for the market it actually serves.

References:

Amoco, Devon, Encana, and Beartooth Oil and Gas Co. v. Lujan, No. CV 92-99-BLG (D. Mont. Sept. 22, 1993)

Principle 6: Example



The lessee can sell its gas in 3 different markets. They process 50% at Gas Plant A, and 50 % at Gas Plant B. Can they use the 600 psi requirement for 100% of their gas?

Major Principles

Principle 7:

The fact that a conditioning function makes gas transportable or prepares the gas for processing does not mean that the cost is a transportation or processing cost.

References:

Shoshone & Arapaho Tribes v. Hodel, 903 F.3d 784 (10th Cir. 1990)

Summary of Shoshone & Arapahoe Case

ARCO Challenged the MMS's disallowances for the cost of gas compression required both to manufacture <u>AND</u> market the gas

- "Lease provision 3(c) provides that ARCO will pay a royalty based on the value of gas produced from the leased land. In determining the value of the gas produced, ARCO is permitted "a reasonable allowance **<u>for the cost of manufacture</u>**...." The Secretary has also promulgated regulations allowing for such a deduction. 30 C.F.R. § 206.106(b) (1987). That regulation also provides that "no allowance shall be made for boosting residue gas, ***<u>or other expenses incidental to marketing</u>***.""

ARCO challenged the MMS disallowance of a flat 10% of its allowable processing deductions to cover administrative overhead costs.

- "The MMS audit concluded that the overhead deduction can be as high as ten percent of the other permissible operating and maintenance costs, **<u>but that the overhead costs required verification</u>**. ARCO contends that this interpretation is in error because ARCO should be permitted to deduct the ten percent overhead allowance regardless of its ability to verify the costs.

Major Principles

Principle 8:

Each marketable condition requirement is viewed independently of the others. For example, the gas may be in marketable condition with regard to water content, but not for pressure.

References:

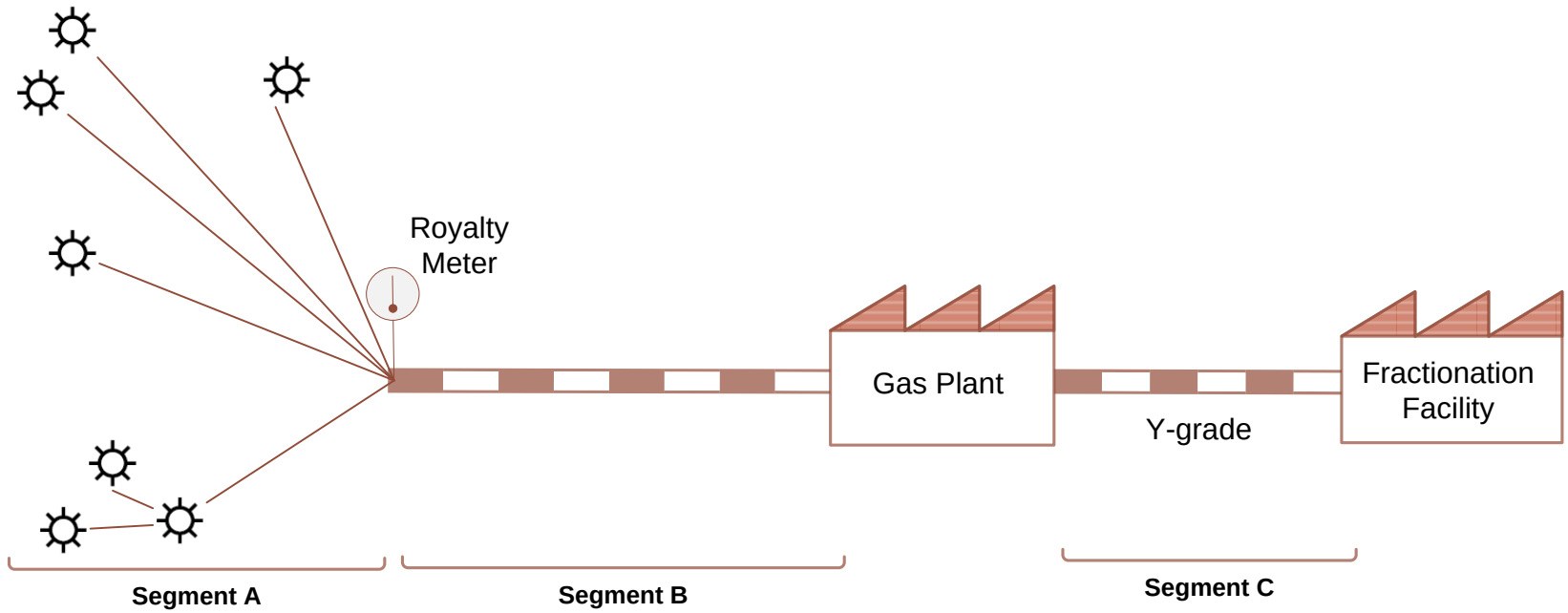
Devon, and Nexen Petroleum USA Inc. v. Norton,
No. 02-3543, 2004 U.S. Dist. LEXIS 5471 (E.D. La. 2004)

Clicker Question!

Assume the produced gas is **not** in marketable condition with regards to pressure, water content, and acid gases.

Which **pipeline segment(s)** is/are allowed?

A. Segment A
B. Segment B
C. Segment C
D. B & C
E. None of the above.



Major Principles

Principle 9:

A lessee is not required to put production into marketable condition more than once or condition production beyond pipeline requirements at its own expense.

References:

Regulation 30 C.F.R 1206.157(f)(9): Supplemental costs for compression, dehydration, and treatment of gas. ONRR allows these costs only if such services are required for transportation and exceed the services necessary to place production into marketable condition required under §§1206.152(i) and 1206.153(i)

Also referenced in Devon

Major Principles

Principle 10:

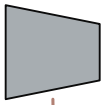
The burden rests properly on the lessee to demonstrate that a cost is allowable for transportation or processing, and not for placing the gas in marketable condition.

References:

Burlington Resources Oil & Gas Co., 183 IBLA 333, 352 (2013); *Citation Oil & Gas v U.S. DOI*, 448 Fed. Appx. 441, 445 (5th Cir. 2011) ("MMS is not required to 'comb a lessee's records to determine if that lessee is entitled to a transportation allowance.'")

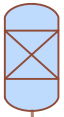
Common Equipment Used to Reach Marketable Condition:

For Pressure:



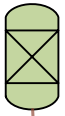
Compressors increase the pressure of the gas stream. They should be reviewed for marketable condition.

For Water Content:



Dehydrators remove water vapor from the gas stream. Commonly seen as glycol or mol sieve dehydration.

For H_2S, CO_2, other impurities:



Treating the gas removes impurities. Commonly seen as **amine treaters** or **sweetening units**, but equipment can vary.

These processes may be allowed when they go beyond Marketable Condition .

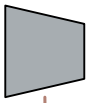
Gathering and Boosting are not allowed, regardless of marketable condition specs.

Gathering:

Central Accumulation Point

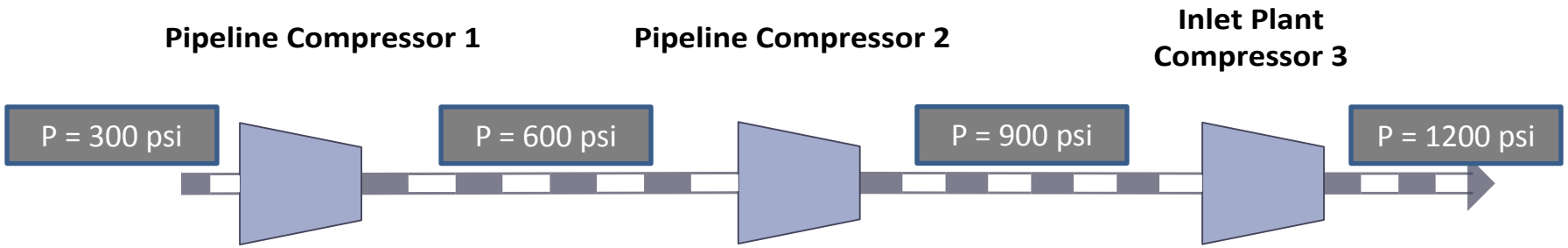
Upstream of the central accumulation point is considered gathering. Transportation doesn't start until after this point.

Boosting Compression



Compression of residue gas (boosting compression), is to place the gas into marketable condition. The final compression at the tailgate of a processing plant

Which Compressors Meet Marketable Condition?

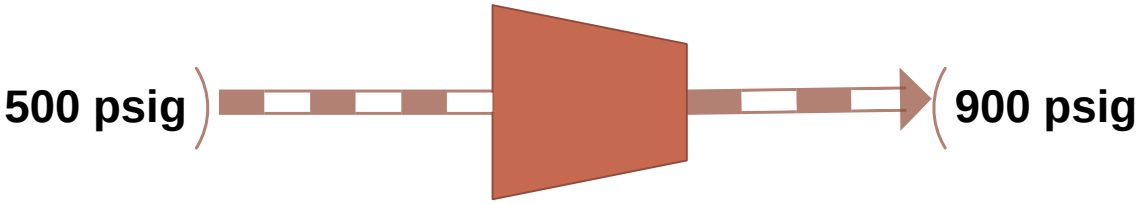


Marketable Condition Pressure = 900 psi

Compressor	Is the Compressor Allowed? A. Yes B. No C. Partially
Pipeline Compressor 1	
Pipeline Compressor 2	
Inlet Plant Compressor 3	

Is This Compressor Allowed?

Pipeline Compressor

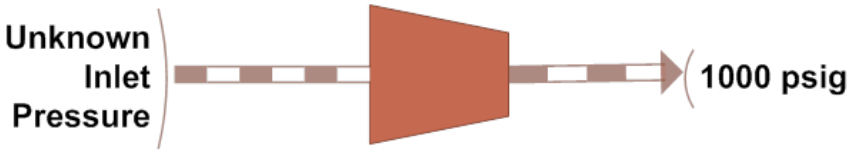


Marketable Condition Pressure = 800 psig

Compressor	Is the Compressor Allowed? A. Yes B. No C. Partially
Pipeline Compressor	

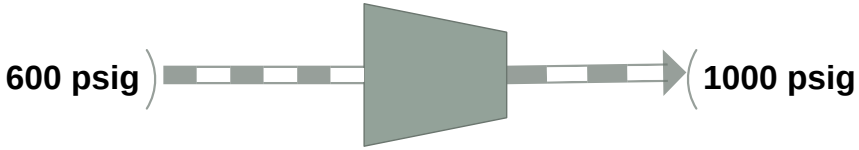
Calculating Partially Allowed Compression?

Pipeline Compressor - Example 1



Marketable Condition Pressure = 800 psig

Pipeline Compressor - Example 2

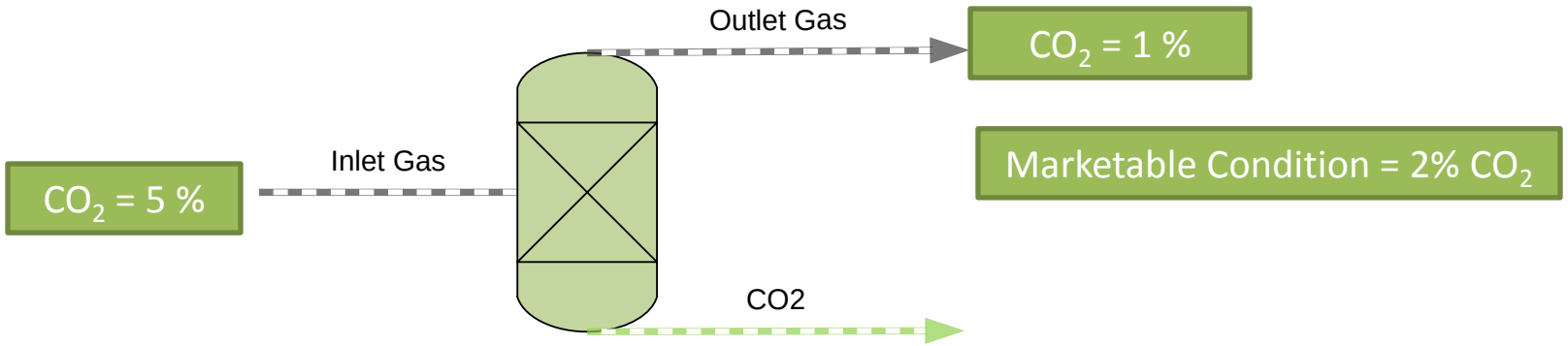


Marketable Condition Pressure = 800 psig

Example 1 (Unknown Inlet Pressure)	*New* Example 2 (Known Inlet Pressure)

Is Gas Treatment Allowed?

Carbon Dioxide Gas Treatment



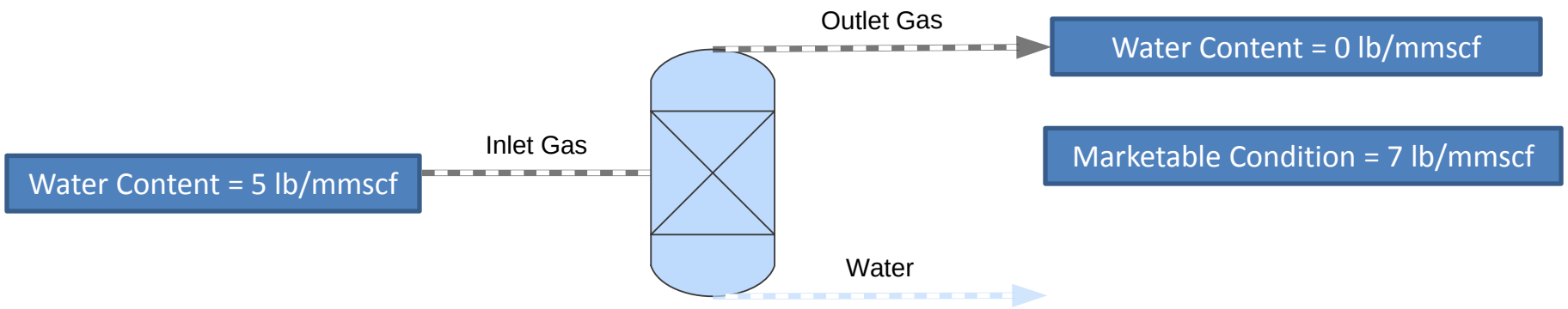
Clicker Question:
Is this Gas Treatment Allowed?

A. Yes
B. No
C. Partially

Calculating Allowed Treatment of Gas:

Is Dehydration Allowed?

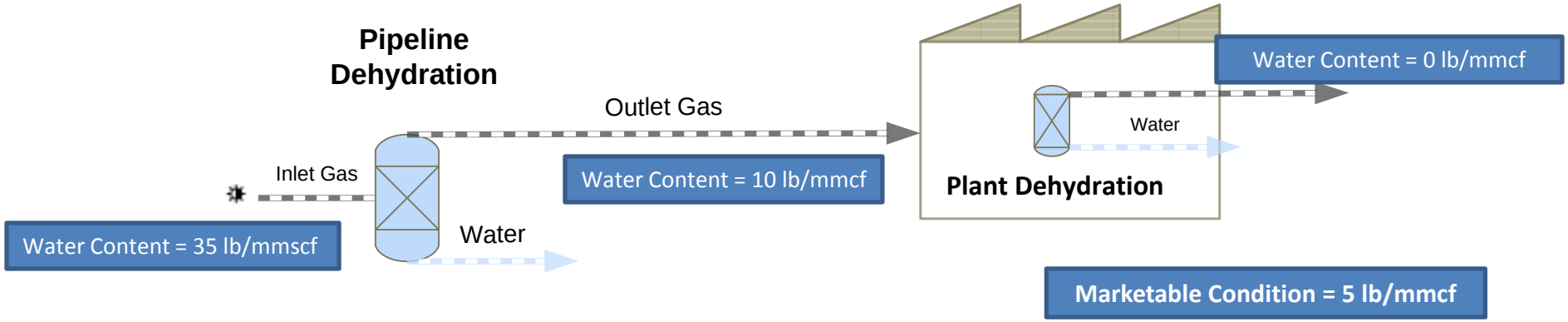
Dehydration



Clicker Question:
Is this Dehydrator Allowed?

A. Yes
B. No
C. Partially

Is Dehydration Allowed?



Pipeline Dehydration:		Plant Dehydration:	
Is it Allowed?		Is it Allowed?	

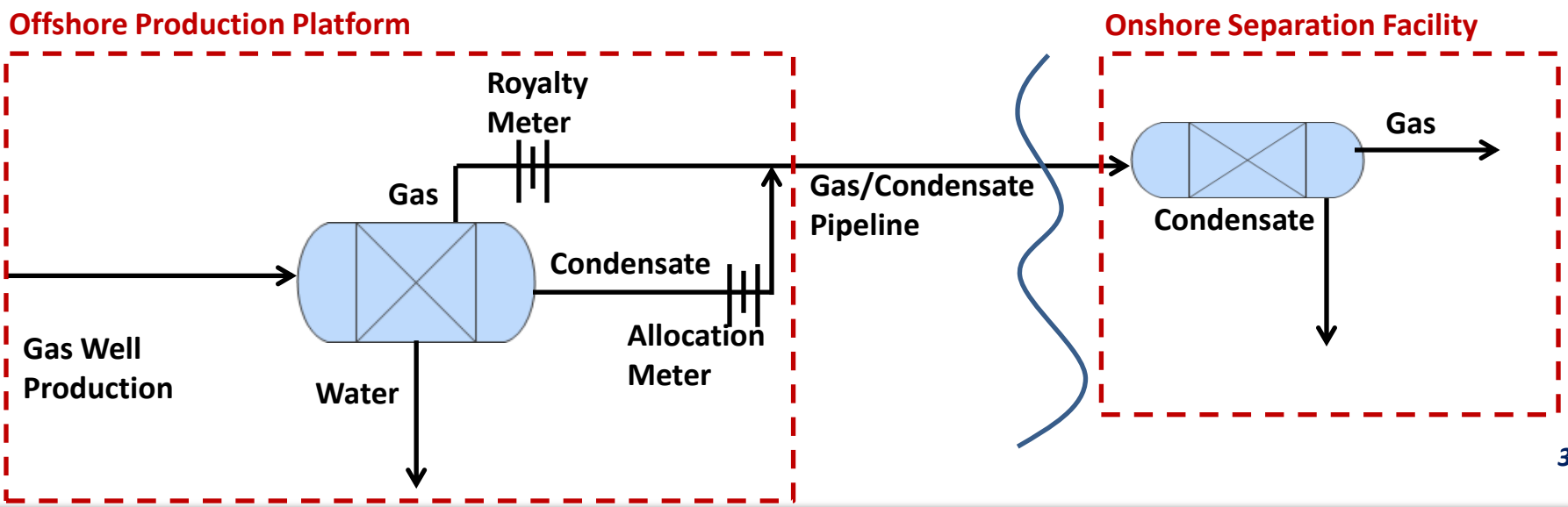
Oil / Condensate

Marketable condition requirements:

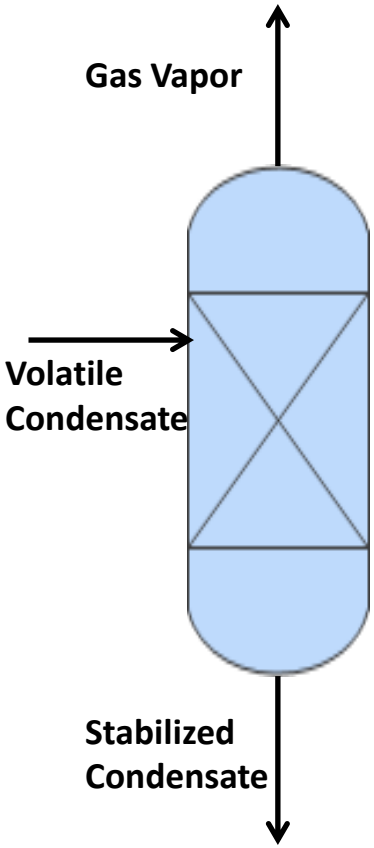
- Gathering
- Separation
- Free of impurities (BS&W limit)
- Condensate stabilization

Gas / Condensate Re-separation

Initial separation (on the production platform) is required for placing the gas and condensate into marketable condition. The re-separation at the onshore facility is allowed.



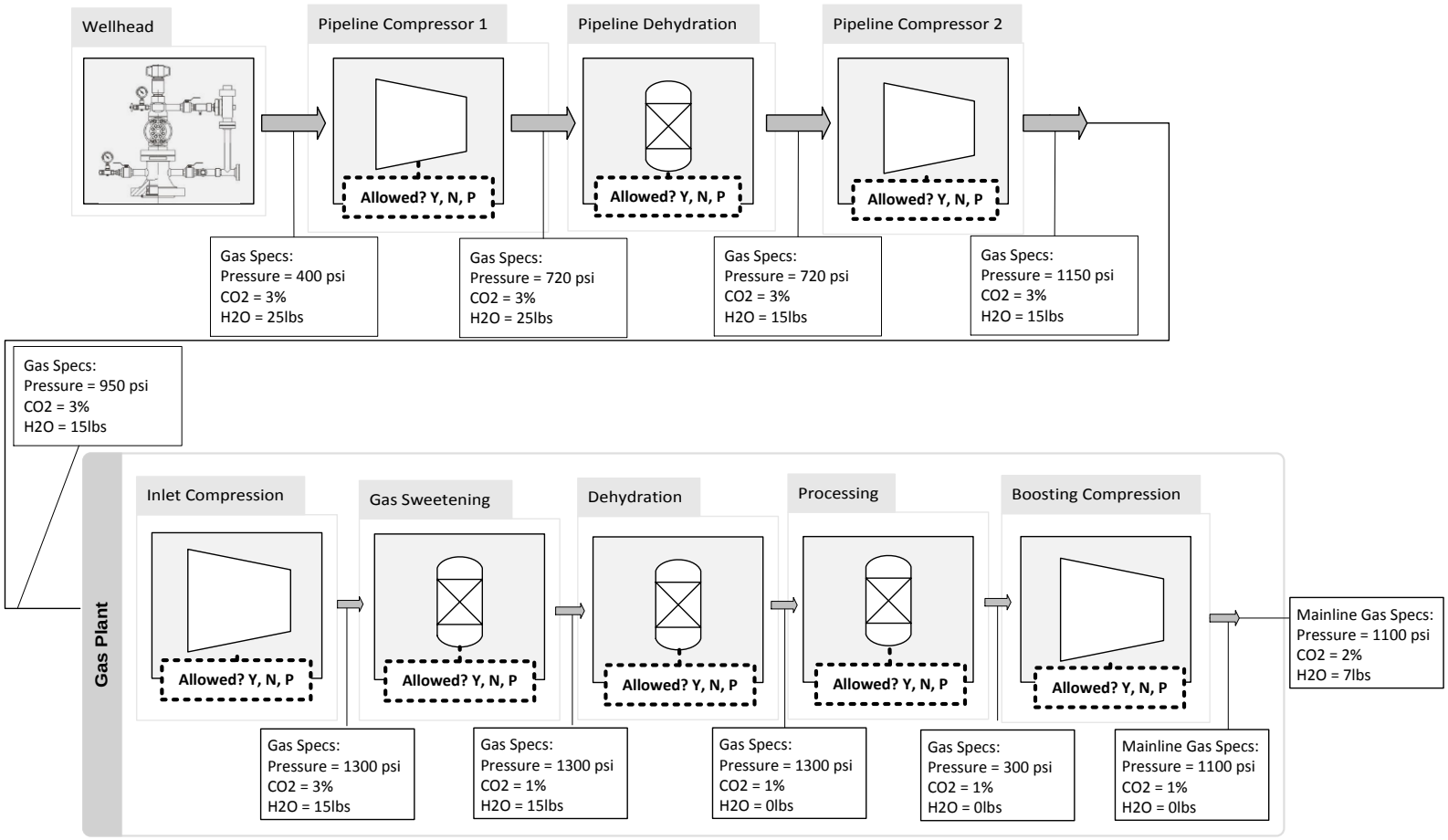
Condensate Stabilization



Condensate must be stabilized to meet the Reid Vapor Pressure (RVP) specs of a condensate pipeline or truck. This is a cost of placing the condensate into marketable condition, and is also not deductible as a cost of processing.

Worksheet Walk Through

Marketable Condition Analysis - Circle the Correct Answer
Is the Equipment Allowed? Yes (Y), No (N), or Partially (P)



QUESTIONS?

Email: royaltyvaluation@onrr.gov