United States Department of the Interior

OFFICE OF NATURAL RESOURCES REVENUE
P.O. Box 25165
Denver, Colorado 80225-0165

SEP 13 2016

Dear Reporter:

The Office of Natural Resources Revenue (ONRR) recently published the Consolidated Federal Oil & Gas and Federal & Indian Coal[1] Valuation Reform Final Rule[2] (2017 Rule). This letter provides guidance on changes to Federal oil and gas valuation and reporting as required under the 2017 Rule, which is effective beginning with production occurring January 1, 2017. Specifically, this letter includes information and instructions on:

- General valuation changes
- Changes to Federal oil valuation
- Changes to Federal gas valuation
- Reporting changes
- Changes to up-front system edits

General Valuation Changes
This letter addresses the numerous changes to Federal oil and gas royalty valuation in the 2017 Rule but does not provide a comprehensive account of each change or the reasoning behind it. Please refer to the preamble to the 2017 Rule for further information.

Definitions
ONRR consolidated the definitions that apply to Federal oil and gas and Federal and Indian coal into a single section at 30 CFR § 1206.20. ONRR also added, modified, and deleted several definitions.

Guidance and Determinations
ONRR clarified the differences between valuation guidance and determinations and outlined the information that ONRR requires to issue a valuation determination. Broadly, valuation determinations are requests for ONRR (or Assistant Secretary for Policy, Management and Budget) approval of a proposed valuation method. Alternatively, ONRR also provides non-binding guidance to answer questions regarding the application or interpretation of our governing laws and regulations.[3]

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[1] ONRR will discuss reporting and valuation changes associated with coal production from Federal and Indian leases in a separate letter.
[2] *See* 81 FR 43338 – July 1, 2016
[3] *See* the preamble to the 2017 Rule and 30 CFR § 1206.108 for Federal oil and 30 CFR § 1206.148 for Federal gas.

Exceptions to Allowance Limitations
As we discuss in more detail in the reporting changes section below, you may no longer exceed the 50-percent transportation or 66 $^2/_3$-percent processing allowance limits for Federal oil or gas for production after January 1, 2017.

Default Provision
ONRR clarified the Secretary of Interior's (Secretary's) authority to determine value under a new "default provision" in the 2017 Rule.[4] The default provision addresses valuation situations where we cannot reasonably determine the correct value of production. Cases where ONRR may determine value under the default provision include but are not limited to:

- instances involving failure to provide documents,
- misconduct (as defined in 30 CFR § 1206.20),
- breach of the duty to market, or
- any other situation that significantly compromises the Secretary's ability to reasonably determine the correct value.

Deep Water Gathering
ONRR modified the definition of gathering and added additional language to the transportation allowance sections to clarify that any movement of bulk production from the wellhead to a platform offshore is gathering and not transportation.[5] These changes effectively rescind the May 20, 1999, ''Guidance for Determining Transportation Allowances for Production from Leases in Water Depths Greater Than 200 Meters" (Deep Water Policy). Previously, the Deep Water Policy allowed lessees to deduct certain costs associated with moving bulk production from the seafloor to the first platform.

Rate of Return
As of January 1, 2017, the rate of return is 1.0 times the *Standard & Poor's* BBB bond rate for calculating non-arm's-length Federal oil transportation allowances (30 CFR § 1206.112(i)(3)), Federal gas transportation allowances (30 CFR § 1206.154(i)(3)), and Federal gas processing allowances (30 CFR § 1206.161(h)(3)).

Changes to Federal Oil Valuation

Non-Arm's-Length Oil Valuation
ONRR eliminated the option to value non-arm's-length oil dispositions in the Rocky Mountain Region using an ONRR-approved tendering program.

Transportation Allowances – Pipeline Losses
You may no longer include the value of pipeline losses in your non-arm's-length transportation allowance.

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[4] The default provision for Federal oil is at 30 CFR § 1206.105 and Federal gas is at 30 CFR § 1206.144.
[5] *See* 30 CFR §§ 1206.20, 1206.110(a)(1)(ii), and 1206.152(a)(1)(ii).

Changes to Federal Gas Valuation

ONRR made several significant changes to Federal gas valuation in the 2017 Rule. We outline these changes below.

Non-Arm's-Length Gas Valuation
As of January 1, 2017, you will no longer use the sequential benchmarks to value your non-arm's-length dispositions of Federal gas production. For non-arm's-length transactions, you now have the option to value your gas and natural gas liquids (NGLs) using either a value obtained under your affiliate's first arm's-length contract, or an index-based value. Once you make an election, you must use that valuation method for at least two years from the month of the election. ONRR will publish a list of approved publications and information about excluded index points at www.onrr.gov prior to January 1, 2017. Please see 30 CFR §§ 1206.141 and 142 for additional information on this significant change.

Processed and Unprocessed Gas Valuation
Beginning on January 1, 2017, if your contract provides for payment based on products resulting from processing your gas, you must base your royalty payment on those constituent products regardless of sales point.[6] This includes gas sold under an arm's-length percentage-of-proceeds contract. See the reporting section below for associated reporting changes.

Accounting for Comparison (Dual Accounting)
The 2017 Rule eliminated the requirement to perform accounting for comparison under previous 30 CFR § 1206.155 for gas produced from Federal leases. However, if your lease terms require dual accounting, you must perform dual accounting.

Transportation Allowances – Pipeline Losses
You may no longer include the value of pipeline losses in your non-arm's-length transportation allowance.

Transportation Allowances – Requests to use a Federal Energy Regulatory Commission (FERC) or State Regulatory Agency Tariff in Lieu of Actual Costs
ONRR also removed the provision by which lessees could request to calculate their Federal gas transportation allowance using a FERC or state-regulatory-agency-approved tariff in lieu of using actual non-arm's-length transportation costs.

Reporting Changes
Gas Sales Value Based on Processed Products
As of January 1, 2017, if the contract under which you sell your Federal gas provides for payment based on products resulting from processing your gas, you must base your royalty payment on those constituent products. Under the previous rules, when you sold your gas before processing, you reported product code 04 on the Form ONRR-2014. Under the 2017 Rule, if the value is based on products resulting from processing (even if

[6] *See* 30 CFR §§ 1206.141 and 142.

the sale occurs before processing), you should report the volume and value of pipeline fuel, drip condensate, residue gas, and any gas plant products that are recovered using the appropriate product codes (usually 03, 05, 07, and 15).

Percentage-of-Proceeds Contracts
The 2017 Rule effectively eliminated the prior provision that required lessees with arm's-length percentage-of-proceeds contracts to report the higher of the value of 100 percent of the residue gas or the lessee's gross proceeds using product code 04 and sales type code APOP. If you are currently reporting using APOP and product code 04, you will need to change your reporting to sales type code ARMS and report processed gas product codes (usually 03, 05, 07, and 15). If you sell your gas under a non-arm's-length percentage of proceeds contract, you will also need to elect to pay on either your affiliate's gross proceeds under its first arm's-length contract, or the new index-based valuation option at 30 CFR § 1206.142, and use either NARM or OINX, respectively.

ONRR adjusted our guidance regarding APOP sales type code reporting and will adjust our up-front edits to account for this change – please see the table in the sales type code section below for additional details.

Transportation Factors
Under the 2017 Rule, you must report your transportation costs separately on the Form ONRR-2014. Previously, ONRR allowed lessees to net transportation costs from their gross proceeds when the lessees' arm's-length contract reduced the price of the oil, gas, or gas plant products by actual costs of transportation. Now, regardless of contract terms, you should report all transportation costs as a separate entry on the Form ONRR-2014.

Transportation Allowances – Allowance Limitations
Under the 2017 Rule, ONRR limits your allowable costs of transportation to 50 percent of the value of your oil, gas, or gas plant products. For production prior to January 1, 2017, subject to the statute of limitations, you may still request to exceed the 50-percent limitation as long as you demonstrate that your reasonable, actual, allowable costs of transportation exceeded 50 percent of the value of your oil, gas, or gas plant products.

Processing Allowances – Allowance Limitations
Under the 2017 Rule, ONRR also limits your allowable costs of processing to $66^2/_3$ percent of the value of your gas plant products. For production prior to January 1, 2017, subject to the statute of limitations, you may still request to exceed the $66^2/_3$-percent limitation as long as you demonstrate that your reasonable, actual, allowable costs of processing exceeded $66^2/_3$ percent of the value of your gas plant products.

Processing Allowances – Extraordinary Processing Cost Allowances
Under the 2017 Rule, ONRR eliminated the provision that allowed lessees to request an extraordinary processing cost allowance and terminated existing approvals.[7] Lessees

[7] The 2017 Rule preamble describes the changes to extraordinary processing cost allowance approvals at 81 FR 43353. The regulations at 30 CFR §§ 1206.160 and 161 limit processing allowances to $66^2/_3$ percent of the value of any gas plant products.

with extraordinary processing cost approvals under the previous regulations are now limited to $66^2/_3$ percent of the value of any gas plant products and may no longer take a processing allowance against their residue gas.

Sales Type Codes

The sales type code you report on the Form ONRR-2014 describes how you are valuing your Federal oil or gas production for royalty purposes. The 2017 Rule changes the options you have for valuing your Federal oil and gas production. Below, we describe the correct use of each sales type code.

Sales Type Code	**Sales Type Name**	**Description**
ARMS	Arm's-length	Use ARMS when the **first disposition** of your Federal oil or gas production is an arm's-length sale.[8]
NARM	Non-arm's-length	Use NARM when you value your Federal oil or gas production based on your **affiliate's gross proceeds** under its first arm's-length sale.[9] Do not use NARM when you are valuing your production under an index-based option.
OINX	Index	Use OINX when you value your Federal oil, gas, or NGL production using an **index-based option**.[10]
POOL	Pooled sales	When you aggregate production **from multiple properties** and then sell or exchange your oil, gas, or gas plant products under **multiple contracts**, you should use POOL. In a pooling situation, you will determine value by computing a weighted average of the prices for all arm's-length sales at all downstream sales outlets.[11]
APOP	Arm's-length percentage-of-proceeds	This sales type code is no longer in use for Federal production.
NPOP	Non-arm's-length percentage-of-proceeds	This sales type code is no longer in use for Federal production.
AG(X)	Hold for Default Provision	If ONRR values your production using the default method, ONRR will assign you an AG sales type code.

[8] *See* 30 CFR § 1206.101, or 30 CFR §§ 1206.141 and 142.
[9] *See* 30 CFR § 1206.102, or 30 CFR §§ 1206.141 and 142.
[10] *See* 30 CFR § 1206.102, or 30 CFR §§ 1206.141 and 142.
[11] *See* 30 CFR § 1206.101(b), or 30 CFR §§ 1206.141(b)(3) and 142(c)(3).

Changes to Up-Front System Edits
ONRR intends to update our up-front edits to account for the changes required by the 2017 Rule. We explain the changes in the chart below.

Edit Number	Edit Message	Warning Status	Change From 2016
9750	APOP Sales Type Code is only allowed for Federal leases with Product Code 04	Fatal	This edit will only be in place for sales months before 01/01/2017.
9751	Allowance exceeds regulation limit	Fatal	After 01/01/2017, there will no longer be exceptions to the 50-percent transportation allowance limit or the $66^2/_3$-percent processing allowance limit. This edit also applies to extraordinary processing cost allowance approvals.
New Edit TBA	Separate Transportation and/or Processing Allowances are not permitted for this sales type/product code combination	Initially a Warning, then Fatal	When you value your Federal gas production using the index-based option under 30 CFR §§ 1206.141 or 142, you may not take a separate transportation or processing allowance.
New Edit TBA	Tentative: Please use ARMS, NARM, or OINX	Initially a Warning, then Fatal	You will no longer be able to use APOP and NPOP for Federal gas. After 01/01/2017, lessees must report arm's-length percentage of proceeds contracts as ARMS and non-arm's-length percentage-of-proceeds contracts as either NARM or OINX.

Guidance Information
This letter does not require you to perform any type of restructured accounting or require you to recalculate and pay royalties. It is valuation guidance and general information for reporting and paying royalties on oil and gas produced from Federal properties. This Letter is not an appealable decision, order, Notice of Noncompliance, or Civil Penalty Notice under 30 CFR Part 1290 Subpart B (2016) or 30 CFR Part 1241 (2016).

If ONRR issues you an order, Notice of Noncompliance, or Civil Penalty Notice at a later date in accordance with the matters addressed in this letter, we will provide your appeal rights at that time.

Summary

This letter addresses the reporting changes you should make once the 2017 Rule is effective January 1, 2017. However, please assess your individual situation in light of the discussion provided in the preamble to the 2017 Rule to ensure that you are valuing, reporting, and paying correctly, especially if you are producing gas from a Federal property. The 2017 Rule is available on the ONRR website at http://www.onrr.gov/Laws_R_D/FRNotices/PDFDocs/43338.pdf.

ONRR is providing valuation training on the changes in the 2017 Rule in October and November 2016. The Dear Reporter letter outlining that training is available at http://www.onrr.gov/DearRep.htm. As always, if you have any questions regarding the changes outlined below, or any questions regarding valuation of your Federal or Indian production, please contact ONRR Royalty Valuation at royaltyvaluation@onrr.gov.

Sincerely,

James D. Steward
Deputy Director