

Interim Report of Subcommittee on Oil & Gas Valuation

Royalty Policy Committee Meeting
September 18, 2008

A stylized silhouette of a mountain range in a teal color, located at the bottom right of the slide.

Subcommittee on Royalty Management Report

Recommendation 4-26

- ◆ At January 2008 RPC meeting, the O&G Valuation Subcommittee was directed to take up Recommendation 4-26: By the end of FY 2008 publish proposed revisions to gas valuation regulations and guidelines to address cost-bundling.
- ◆ For *gas valuation rulemaking*, MMS directed to consider the use of market indices for valuation of non-arm's length transactions in lieu of existing benchmarks.
- ◆ For *cost bundling guidance*, while transportation costs and gas processing costs are allowable deductions, service providers do not generally separate deductible costs and non-deductible costs, which greatly confounds MMS review of transportation and processing allowances.
- ◆ RPC O&G Valuation Subcommittee decided to first focus on the bundling of costs by service providers before again addressing gas valuation in advance of a Federal rulemaking effort.

MRM's Perspective

- ◆ Costs associated with transportation and processing are deductible for calculating royalty.
- ◆ Costs associated with placing production into marketable condition, gathering, and marketing are not deductible.
- ◆ However, placing the gas in marketable condition and gathering are situation specific and do not allow a bright line test applicable in all circumstances.

MMS Unbundling Project

- ◆ Apart from the Subcommittee, MMS is undertaking studies on several gas systems that will attempt to break out charges into deductible and nondeductible costs.
- ◆ MMS has been meeting with service providers to discuss obtaining information that would allow cost allocation for services that are consistent with MMS regulations and guidance.
- ◆ Overall, cost unbundling is not currently as difficult offshore because of FERC regulated pipelines; however, auditing of transportation rates to the same level of detail as onshore will begin in FY09.
- ◆ MRM has provided updates to the Subcommittee on its cost unbundling project and the direction its efforts are taking.

Subcommittee on Oil & Gas Valuation Efforts

- ◆ Subcommittee participants include representatives from trade groups, states, industry and the Indian community.
- ◆ Since January, Subcommittee has had 4 meetings, all directed at cost unbundling.
- ◆ While there is general agreement among participants that the complexity and uncertainties of cost unbundling are unsatisfactory, no consensus has yet been reached on a better approach.

Approaches to Cost Unbundling

Three concepts have emerged:

- ◆ **Standard Deduction:** MMS-prescribed amounts for use on each system based on MMS analysis of cost structure of service-related engineering and equipment.
- ◆ **Itemized Deductions:** Case-by-case amounts offered by producers based on templates provided by MMS; could require renegotiation of contracts with service providers to allow cost unbundling.
- ◆ **Percentage of Commodity Price:** Case-by-case amounts offered by producers based on MMS-prescribed percentage; percentage could include min and max limits.

Pros and Cons of Each Approach

Pros

Cons

	Pros	Cons
Standard Deduction	<ul style="list-style-type: none">▪ Certainty▪ Administrative simplicity	<ul style="list-style-type: none">▪ Less precise than actual costs▪ Initial effort by MMS (and service providers) to arrive at amount is significant
Itemized Deductions	<ul style="list-style-type: none">▪ Allows actual costs to be deducted	<ul style="list-style-type: none">▪ No certainty without MMS review▪ Remains administratively burdensome for all
Percentage of Commodity Market Price	<ul style="list-style-type: none">▪ Certainty▪ Administrative simplicity▪ Recognizes that change in value affects costs▪ Initial effort by MMS to establish percentage may be less than standard deduction	<ul style="list-style-type: none">▪ Less precise than actual costs

Unresolved Questions on Standard Deduction Approach

- ◆ Opt-out possible if costs are clearly unbundled?
- ◆ Established on an area-wide or system basis?
- ◆ Are standard deductions equally feasible for transportation and processing?
- ◆ How often would a standard deduction be adjusted?
- ◆ Applicable to arm's length and non-arm's length transactions? Percent of proceeds contracts?

Future Subcommittee Activity

- ◆ With the Bush Administration nearing an end, no rulemaking will begin until 2009.
- ◆ In the meantime, the Subcommittee will continue to work with MRM to explore approaches to the cost-bundling problem.
- ◆ Even if no consensus can be reached, the Subcommittee can assist the MRM by characterizing the cost-unbundling issue, identifying alternatives and isolating relevant factors for decision making.
- ◆ The Subcommittee intends to provide recommendations to the RPC and MRM early in the next Administration, and prior to formation of an MRM gas valuation regulation writing team.