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Part V

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Minerals Management Service

30 CFR Parts 202 and 206
Gas Royalty Valuation; Proposed Rulemaking

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DEPARTMENT OF THE INTERIOR

Minerals Management Service

30 CFR Parts 202 and 206

Revision of Gas Royalty Valuation Regulations and Related Topics

AGENCY: Minerals Management Service (MMS), Interior.

ACTION: Notice of proposed rulemaking.

SUMMARY: This proposed rulemaking provides for the amendment and clarification of regulations governing valuation of gas for royalty computation purposes. The amended and clarified regulations govern the methods by which value is determined when computing gas royalties and net profit shares under Federal (onshore and Outer Continental Shelf) and Indian (Tribal and allotted) oil and gas leases (except leases on the Osage Indian Reservation, Osage County, Oklahoma).

DATES: Comments must be received on or before May 14, 1987. Hearings are scheduled as follows:

1. April 7 and 8, 1987, 8:30 A.M. to 4:00 P.M., Denver, Colorado.
2. April 21 and 22, 1987, 8:30 A.M. to 4:00 P.M., Houston, Texas.

ADDRESSES: Written comments may be mailed to Minerals Management Service, Royalty Management Program, Rules and Procedures Branch, Denver Federal Center, Building 85, P.O. Box 25165, Mail Stop 660, Denver, Colorado, 80225, *Attention: Dennis C. Whitcomb.*

The hearings will be held at the following locations:

1. Denver—Sheraton Denver Airport Hotel, 3535 Quebec Street, Denver, Colorado.
2. Houston—Houston Airport Hilton Inn, 500 North Belt East, Houston, Texas.

FOR FURTHER INFORMATION CONTACT: Dennis C. Whitcomb, (303) 231-3432, (FTS) 326-3432.

SUPPLEMENTARY INFORMATION: The principal authors of this proposed rulemaking are John L. Price, Scott L. Ellis, Thomas J. Blair, Stanley J. Brown, and William H. Feldmiller, of the Royalty Valuation and Standards Division of the Minerals Management Service; and Peter J. Schaumberg of the Office of the Solicitor, Washington, DC.

I. Introduction

On January 9 and 10, 1986, the first meeting of the Royalty Management Advisory Committee (RMAC) was held in Lakewood, Colorado. (See Notice of Meeting, 50 FR 52385, December 23, 1985). The RMAC, which is composed primarily of representatives from States, Indian Tribes and allottees, and the coal, oil, and gas industry, was charged with the responsibility of advising the Secretary of the Interior about the form and content of changes to Minerals Management Service (MMS) regulations governing the value, for royalty purposes, of coal, oil, and gas production from Federal and Indian leases.

At the first RMAC meeting, the Committee asked the Secretary to withhold promulgation of proposed valuation regulations until the Committee had an opportunity to review the issues and make its recommendations. The Secretary agreed to the request, and in response to the Committee's request, MMS made available to RMAC its latest drafts of regulations governing the valuation of coal, oil, and gas, and those governing transportation and processing allowances. At the same time, MMS made copies of those same draft regulations available to the public (51 FR 4507, Feb. 5, 1986, and 51 FR 7811, March 6, 1986). Public comment on the drafts was requested both in written form and at a public meeting held in Lakewood, Colorado, on March 18 and 19, 1986.

The RMAC formed three working panels to review the draft coal, oil, and gas rules, and the transportation and processing rules related to each product. Between January and October of 1986, the various working panels held several meetings to review the draft rules. The working panel meetings were published in the **Federal Register** and the meetings were open to members of the public, many of whom participated actively.

Each of the three working panels prepared a detailed set of recommendations to RMAC. These were reviewed at the RMAC meeting held July 28–30, 1986, and October 20–22, 1986. The RMAC was unable to approve the reports of both the oil and the gas panels for transmission to the Secretary, which, by the terms of RMAC's charter, required a two-thirds vote of the Committee membership. The RMAC did approve, for submission to the Secretary, a set of recommendations regarding certain of the provisions contained in the coal valuation regulations.

The MMS representatives were present at, and participated in, all meetings of RMAC and the working panels. As a consequence of the extensive discussion between members of the groups representing the States, Indians, and the industries, and the detailed written recommendations prepared by the working panels, MMS's task of drafting proposed valuation regulations was enhanced significantly. In preparing these proposed regulations, MMS carefully considered all of the discussions which occurred at the various meetings, regardless of whether or not they were adopted in any of the three working panel reports or by the full Committee. The MMS also has considered the written and oral comments from the public on the draft rules and the resolution presented to the Secretary by RMAC. The MMS appreciates the hard work and dedication of a large number of people who were willing to work toward the common goal of clarifying and improving the regulations governing the valuation, for royalty purposes, of coal, oil, and gas production from Federal and Indian leases.

The policy of the Department of the Interior is, whenever practicable, to afford the public an opportunity to participate in the rulemaking process. Accordingly, interested persons may submit written comments, suggestions, or objections regarding the proposed rule to the location identified in the ADDRESSES section of this preamble. Comments must be received on or before May 14, 1987. Two public hearings will be held on the dates and at the locations identified in the DATES AND ADDRESSES sections of this preamble.

II. Purpose and Background

The MMS is proposing to revise the current regulations regarding the valuation of gas to accomplish the following:

(1) Clarification and reorganization of the existing regulations at 30 CFR Parts 202 and 206.

(2) Creation of regulations consistent with the present organizational structure of the Department of the Interior.

(3) Placement of the gas royalty valuation regulations in a format compatible with the valuation regulations for all leasable minerals.

(4) Clarification that royalty is to be paid on all considerations received by lessees, less applicable allowances, for production removed or sold from the lease.

(5) Creation of regulations to guide the lessee in the determination of allowable transportation costs for gas to aid in the calculation of proper royalty due the lessor.

Several general provisions which relate to both oil and gas are proposed to be added to Part 202. These provisions are included in the Notice of Proposed Rulemaking to amend the oil valuation regulations recently published

by the Department. (See 52 FR 1858, January 15, 1987.)

These proposed rules would be applied prospectively. They would supersede all existing gas royalty valuation directives contained in numerous Secretarial, MMS, and U.S. Geological Survey Conservation Division (now Bureau of Land Management, Onshore Operations Division) orders, directives, regulations and NTL's (Notice to Lessees) issued over past years. Specific guidelines governing the application of, the gas valuation regulations will be incorporated into the MMS Payor Handbook subsequent to the issuance of final rulemaking in the Federal Register.

MMS believes the proposed valuation methods would yield a reasonable and long-term maximum rate of return for both Federal and Indian leases. The basic premise underlying this methodology is that value is best determined by the interaction of competing market forces—the 7/8ths or 4/5ths owner is going to negotiate the best deal he/she can to further his/her own interests, advancing those of the royalty owner as well. This would add certainty to the marketplace and assure maximum, long-term revenues to all parties concerned. Comments are especially requested on this issue.

The proposed rules in § 206.150 would expressly recognize, however, that where the provisions of any Indian lease, or any statute or treaty affecting Indian leases, are inconsistent with the regulations, then the lease term, statute, or treaty would govern to the extent of the inconsistency. The same principle would apply to Federal leases.

A separate gas definitions section applicable to the royalty valuation of gas is included in this proposed rulemaking in Part 206. All definitions contained under each subpart of Part 206 shall be applicable to the regulations contained in Parts 202, 203, 207, 210, and 241.

III. Section-by-Section Analysis

The MMS is proposing to amend 30 CFR Part 202, Subpart B, Oil, Gas, and OCS Sulphur, General. The changes are included in the recently issued proposed changes to the oil valuation regulations. (See 52 FR 1858, January 15, 1987).

Proposed § 202.150, Royalty on gas, would set forth general policies regarding what gas is subject to royalty. Proposed § 202.150(a) states that royalty must be paid in value unless MMS requires payment in-kind. Proposed § 202.150(b) states that all gas is subject to royalty except gas lost which BLM or MMS, as appropriate, has determined was unavoidably lost, or gas that is used on, or for the benefit of, the lease. Accordingly, royalty would be due on gas avoidably lost or wasted, and gas for which compensatory royalty has been determined to be due as a result of drainage from the leased land, as determined by BLM for onshore oil and gas operations, or by MMS for offshore oil and gas operations. This is consistent with section 308 of the Federal Oil and Gas Management Act of 1982 (30 U.S.C. 1756). Gas used for the benefit of a lease, which is royalty free, includes gas used in lease equipment on communitized areas or unit areas when the lease is committed to a communitization agreement or unitization agreement, and gas used in lease equipment located at any other location when the BLM or MMS, as appropriate, has approved the use of that location prior to the point of royalty settlement. If the provisions of any lease are inconsistent with this section, the lease terms would govern. An example is a lease issued pursuant to section 6 of the OCS Lands Act which requires royalty to be paid on production used on the lease.

Proposed § 202.150(c) would cover those situations where a person other than the lessee of a Federal or Indian lease actually takes the allocated share of Federal or Indian lease production under a unitization or communitization agreement. These situations primarily involve production governed by a Federally approved unitization agreement or communitization agreement. The terms of these agreements require that all production covered by the agreement be allocated, for royalty purposes, to the individual leases comprising the agreement in accordance with the schedule approved by the BLM for onshore leases and by MMS for offshore leases. Many times, the lessee of a particular lease will not take the production attributable to its lease owing to the lack of a sales agreement or owing to the curtailment by the pipeline of deliveries under the existing sales agreement. In these instances, another working interest owner will often take the production attributable to a Federal or Indian lease and sell or dispose of it. As proposed, this section would require that the production attributable to the Federal and Indian lease would be subject to the royalty payment and reporting requirements of Title 30. The production would be valued as if the person actually taking the production were the Federal or Indian lessee. Therefore, as explained in more detail below, if the person actually taking the production attributable to the Federal or Indian lease sold that production under an arm's-length contract, then the value would be the gross proceeds accruing, or which could accrue, to that person under the applicable arm's-length contract. If the sale by that person was other than by an arm's-length contract, the value would be established by applying the criteria set forth in these proposed regulations. In applying those criteria, the information pertinent to the person actually taking the production would be used rather than information pertinent to the lessee of the Federal or Indian lease.

Proposed § 202.151, Royalty on processed gas, would require the payment of royalty on all residue gas and gas plant products resulting from processing gas. Proposed § 202.151(a) would provide that MMS would authorize a processing allowance for the reasonable, actual costs of processing the gas in determining the royalty payment due. The determination of processing allowances is covered by proposed Subpart D of Part 206. Proposed § 202.151(b) would provide for the royalty-free use of a reasonable amount of residue gas for operation of the processing plant, but would not provide for an allowance for boosting residue gas or other expenses incidental to marketing. Proposed § 202.151(c) would provide that royalty would not be due on residue gas or any gas plant product used in a manner to benefit the lease as provided previously for gas (see § 202.150(b)).

Proposed § 202.152, Standards for reporting and paying royalties on gas, would set forth the criteria for reporting the volumes of unprocessed gas, residue gas, and gas plant products on which royalty is due.

Proposed § 206.150, Purpose and scope, is an introductory section stating that Subpart C would be applicable to gas produced from all Federal and Indian leases, except leases on the Osage Indian Reservation. Paragraph (b) would incorporate the principle that if the specific provisions of any lease, statute, or treaty are inconsistent with the regulations, then the lease, statute, or treaty provisions would govern to the extent of the inconsistency. This principle would apply to existing leases as well as leases executed after the effective date of the regulations. Paragraph (d) would require all gas determined by BLM to have been avoidably lost or wasted from an onshore lease, all gas determined by BLM to have been drained from an onshore lease for which compensatory royalty is due, and all gas determined by MMS to have been avoidably lost from

an offshore lease to be valued in accordance with Part 206.

Proposed § 206.151, Definitions, would set forth definitions applicable to the proposed gas valuation regulations. Most definitions applicable to gas are straightforward and self-explanatory. A few of the definitions, however, require further explanation:

"Arm's-length contract" would be defined as a contract or agreement between independent, nonaffiliated persons. The definition would further provide that two persons are affiliated if one person controls, is controlled by, or is under common control with another person, *or* if one person owns an interest (regardless of the amount), either directly or indirectly, in another person. This definition is important to the regulations because, as is explained below, MMS is proposing that the gross proceeds under an arm's-length contract would be accepted as value. Other valuation criteria would apply to non-arm's-length contracts.

The thrust of the proposed arm's-length contract definition is to include within its coverage only those contracts between persons who have no affiliation or interrelationship of any kind that would cause the contract terms to be suspect as to their arm's-length nature. The MMS recognizes that by excluding from the definition those contracts between persons where one party to the contract has any ownership interest in the other, it is narrowing the universe of contracts which would fall within the scope of the definition.

The MMS has proposed a definition for arm's-length contract that excludes references to such matters as "adverse economic interests" or "free and open markets" because the inclusion of such sometimes subjective concepts would make a lessee's determination that its contract was arm's-length subject to uncertainty. The advantage to the proposed definition is that it would be almost purely objective, and lessees and other payors would have assurance that if they pay royalties on the basis of gross proceeds from an arm's-length contract, the royalty valuation would not later be susceptible to redetermination.

MMS would like commenters to address whether a list of items could be developed which could serve to define an arm's-length contract. Specifically, is there a list of questions which a lessee could answer which would lead to an objective determination of whether the contract is arm's-length? Possible questions are: (1) Is there a common equity interest between the parties to the contract; (2) is there common control of the parties to the contract; (3) was there a consolidated tax filing by the parties to the contract. MMS would like commenters to address whether the development of such a list is possible and what questions should be part of the list.

The MMS is proposing a definition for the term "gas plant products." This term would include all products resulting from the processing of gas, including natural gas liquids, nitrogen, carbon dioxide, and sulfur, but excluding residue gas.

The term "gross proceeds" is another term which is important to the regulations because it would be a common royalty value determinant. Gross proceeds is proposed to be defined as the total money or other consideration paid to an oil and gas lessee, or money or other consideration to which such lessee is entitled, for the disposition of unprocessed gas, residue gas, or gas plant products. Gross proceeds would be defined to include payments to the lessee for certain services such as treating, measuring, and field gathering that the lessee is obligated to perform at no cost to the lessor. Gross proceeds also would be defined to include: payments or credits for advanced prepaid reserve payments, or advanced exploration or development costs, subject to recoupment through reduced prices in later sales; take-or-pay payments; and reimbursements where the purchaser reimburses the seller, or pays any costs on behalf of the seller, for such items as severance taxes.

The definition is intended to be expansive to ensure that it includes all the benefits flowing from the purchaser to, or on behalf of, the seller in anticipation of and/or for the disposition of the unprocessed gas, residue gas, or gas plant products.

"Lessee" would be defined as any person to whom the United States, an Indian Tribe, or an Indian allottee, issues a lease, and any person who has assumed an obligation to make royalty or other payments required by the lease. The MMS is proposing to expressly include in the definition all persons who may have to make royalty payments. This would include all persons who have an interest in a lease as well as an operator or other payor, including in some instances, the purchaser who has assumed a royalty payment responsibility by contract or other agreement with the persons who have the actual lease interests. By using this broad definition for the product valuation regulations, it would not be necessary to use multiple terms such as lessee/payor/operator throughout the rules. This definition is not intended to change any contractual obligations under the lease instrument between the lessor and the current or original lease holder, except as it pertains to royalty valuation.

"Like-quality lease products" would be defined as lease products that have similar chemical, physical, and legal characteristics. This definition is required in order to apply valuation standards at § 206.152 and § 206.153 in non-arm's-length or no-contract situations. In these sections, the use of criteria tied to like-quality lease products is required to determine value. The value of a sweet gas with a high Btu heating value cannot be compared favorably with the value of a sour gas with a low Btu heating value. The legal characteristics primarily refer to the category for which the gas qualifies in accordance with the NGPA of 1978. Also, natural gas liquids have been subject to price regulations. When determining value of gas, MMS would not mix NGPA categories.

"Marketable condition" would be defined as lease products that are sufficiently free from impurities and otherwise in a condition that they will be accepted by a purchaser under a sales contract typical for the field or area. Federal and Indian leases typically require the lessee to pay royalties equal to a specified percentage of the amount or value of production saved, removed, or sold from the leased area. The regulations governing operations require that the lessee place in marketable condition, to the extent economically feasible, all oil, gas, etc., produced from the leased land. See 43 CFR 3162.7-1(a) and 30 CFR 250.42. See also § 206.152(i) and § 206.153(i) of the proposed rules. Court decisions have upheld the principle that the lease operator is obligated to perform necessary field gathering and treatment to develop a product that has been conditioned for market sale (*California Co.* v. *Udall,* 296 F.2d 384 (D.C. Cir. 1961)).

"Gas" is defined as any fluid, either combustible or noncombustible, hydrocarbon or nonhydrocarbon, which is extracted from a reservoir and which has neither independent shape nor form, but tends to expand indefinitely. It is a substance that exists in a gaseous or rarefied state under standard temperature and pressure conditions. The terms "gas" and "gas plant products," discussed above, and the term "residue gas," discussed below, are used either separately or together throughout the proposed gas valuation regulations. Existing valuation regulations were written to deal primarily with hydrocarbon gas streams. This was especially true when dealing

with processed gas. In the last decade, the existing regulations proved difficult to administer when handling gas mixtures of diverse content. Gas plants have been constructed to process gas mixtures where some gas plant products may not be a hydrocarbon. In order to accommodate processing plants that process and sell nonhydrocarbon production, the term "gas" will commonly apply to the total gas mixture as it enters the plant. The term "residue gas", will refer to gas consisting principally of methane resulting from processing gas. The term "gas plant products" will refer to natural gas liquids collectively (ethane, propane, butane, pentane, etc.) and other products also produced by a processing plant (carbon dioxide, sulfur, nitrogen, etc.).

Proposed § 206.152 and § 206.153 would set forth the standards by which MMS would establish values, for royalty purposes, for unprocessed gas and processed gas, respectively.

In both of these proposed sections, references are made to arm's-length contracts that contain a provision reserving to the lessee the right to process gas and arm's-length contracts which provide for the sale of gas prior to processing with the value determined later based upon a percentage of the purchaser's proceeds resulting from processing the gas (so-called percentage of proceeds contracts). The MMS recognizes these features of gas sales agreements and proposes to treat these arm's-length contracts as arm's-length contracts for the sale of residue gas and gas plant products (i.e. processed gas) rather than as unprocessed gas.

Proposed § 206.152, Valuation standards—unprocessed gas, would set forth the valuation standards for all gas from Federal and Indian leases that is not processed, such as so-called "dry gas." It also would apply to gas that is processed but is sold or otherwise disposed of by the lessee pursuant to an arm's-length contract prior to processing. However, if the price established under an arm's-length contract is based upon a percentage of the purchaser's proceeds from the residue gas and gas plant products resulting from the purchaser's processing of the gas (so-called percentage of proceeds contracts), this section would not apply. Therefore, if the gas from a lease is "wet gas" that is ultimately processed, and the lessee sells the gas pursuant to an arm's-length contract before processing at a fixed price per MMBtu, value would be determined based upon that sale and not upon a subsequent sale, or other disposition, at or beyond the tailgate of the processing plant. However, if under the same circumstances, the sale made is non-arm's-length, then value would be determined pursuant to § 206.153, discussed below.

Pursuant to proposed § 206.152, value would be determined differently depending upon whether or not the sales agreement is arm's-length. Subsection (a)(2) would state expressly that the value, for royalty purposes, of unprocessed gas production would be the value of the gas determined pursuant to § 206.152, less applicable allowances for transportation (§§ 206.156 and 206.157). However, as explained below, lessees would not be allowed to report a single net number for the royalty value (i.e. value less allowances), but would be required to report the allowances separately on the Report of Sales and Royalty Remittance, Form MMS-2014. Lessees would not be entitled to deduct transportation allowances in all situations (see discussion below).

In accordance with proposed § 206.152(b)(1), the value of unprocessed gas sold pursuant to an arm's-length contract would be the gross proceeds accruing, or which could accrue, to the lessee. Prior approval by MMS of this value would not be required, but it would be subject to monitoring, review and/or audit. MMS may direct a lessee to pay royalty at a different value if it determines that a lessee has applied the regulations improperly.

Paragraph (b)(2) would provide a specific exception to the arm's-length contract rule for gas sold pursuant to warranty contracts, even if those contracts are arm's-length. For such gas, MMS expressly reserves the right to establish the value, giving due consideration to all the valuation criteria in § 206.152.

If the disposition of unprocessed gas from a Federal or Indian lease is not pursuant to an arm's-length contract, specific criteria must be used to determine the proper royalty value. The valuation process contained in § 206.152(c) would be used when there is no arm's-length contract. In those situations, § 206.152(c) of the proposed regulations would require that the value be determined through application of criteria in a prescribed order. In other words, the second criterion would not be considered unless the first criterion could not reasonably be applied. Likewise, the third and fourth criteria would not be considered unless those preceeding it were inapplicable, etc.

The first criterion is for the lessee to use the gross proceeds accruing, or which could accrue, 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 lessee's 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 area. In evaluating the comparability of arm's-length contracts for the purpose of the proposed regulations, numerous factors must be considered. The pertinent factors are price, time of contract execution, duration of the contract, market or markets served, terms, quality of gas, volume, and any other factors which may be relevant. This method allows the lessee certainty in determining its own value without dependence upon MMS to establish the value. At the same time, it is indicative of the value in the field or area for like-quality gas. The MMS believes this method is preferable to the major portion analysis provided for in existing oil and gas regulations which proved difficult to administer. See existing 30 CFR 206.103.

If the first valuation criterion is inapplicable, the second criterion would apply. This second criterion would be the lessee's gross proceeds accruing, or which could accrue, 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 under comparable arm's-length contracts between other persons for purchases or sales of like-quality gas in the same field or area. In evaluating the comparability of arm's-length contracts, the same factors would be used as under § 206.152(c)(1).

In the first and second benchmarks, MMS is proposing to accept the lessee's gross proceeds as value where the lessee can demonstrate that that is a reasonable value by comparing it to sales under other arm's-length contracts which otherwise are comparable. However, the proposed rules require that there be numerous factors considered before an arm's-length contract could be deemed comparable. The purpose of these factors is to prevent abuses through application of only a few factors such that contracts containing unusually low or high prices could be used. Thus, for a lessee selling a large volume of gas under a non-arm's-length contract, a large volume would be required to be purchased under an arm's-length contract before the arm's-length contract could be used in determining the acceptability of the lessee's gross proceeds under its non-arm's-length contract.

In the event that there are no comparable arm's-length contracts applicable to the field or area within which the gas is produced, the third criterion would provide for the determination of a value after considering all relevant information including gross proceeds under arm's-length contracts for purchases or sales of like-quality gas in other fields or areas, posted prices for gas, prices received in spot sales of gas, and other information as to the particular lease operation or affecting the saleability of the gas.

If a value cannot be determined using any of the valuation procedures previously mentioned, a net-back procedure to value the gas could be used. This last benchmark also would authorize the use of any other reasonable method to determine value.

The MMS particularly solicits comments regarding the proposed ordering of valuation benchmarks.

When a valuation method other than gross proceeds is used for unprocessed gas sold pursuant to a non-arm's-length contract, such as spot prices, the lessee may not be entitled to a transportation allowance. By way of illustration, if the value of unprocessed gas is established under paragraph (c)(3) based upon spot prices in the field where the lease is located, the value would not be reduced by a transportation allowance even if the lessee actually sold the unprocessed gas on a delivered basis at a point remote from the lease and incurred transportation expenses. The allowance would be inapplicable because the spot prices in this example already reflect value of unprocessed gas at the lease. However, pursuant to § 206.152(h), the valuation of the lessee's unprocessed gas based on the spot prices could not be less than the lessee's gross proceeds reduced by the transportation allowance which would be determined considering the costs the lessee actually incurred. Therefore, regardless of the value determined pursuant to the benchmarks, under no circumstances can the value, for royalty purposes, be less than the gross proceeds accruing, or which could accrue, to the lessee, less applicable transportation allowances. This long-standing principle is set forth at § 206.152(h), and is discussed below.

Proposed § 206.152(d) would provide that if the maximum lawful price permitted by Federal law is less than the value determined pursuant to the valuation regulations in Part 206, then MMS would accept such maximum price as the value. This limitation would not be applicable to gas sold pursuant to a warranty contract. Also, gross proceeds still would be a minimum value.

Proposed § 206.152(e)(1) would provide that where the value is determined pursuant to the benchmarks, MMS approval would not be required. The lessee would be required to retain the necessary data to support its benchmark applications for monitoring, review, and/or audit. MMS could direct the lessee to use a different value if it determines that the lessee has improperly applied the regulations.

Proposed § 206.152(f) would expressly provide that if MMS determines that the lessee has not properly determined value, then the lessee would be entitled to a credit, or would be required to pay additional royalty, plus interest. This could occur after an MMS review and/or audit of a value which did not require prior approval.

Proposed § 206.152(g) would give the lessee the option to seek a valuation from the MMS, where such prior approval otherwise would not be required. The lessee would first propose to MMS what that methodology should be and provide all supporting documentation for that proposal. The MMS would then establish a value as soon as possible. The lessee could use its proposed value until MMS issues its determination at which time the lessee would be required to adjust its previous reports in accordance with paragraph (f).

Proposed § 206.152(h) restates the long-standing principle that under no circumstances can the value, for royalty purposes, be less than the gross proceeds accruing, or which could accrue, to the lessee, less applicable transportation allowances. The definition of gross proceeds was discussed earlier. It is worth noting again, however, that the gross proceeds accruing to the lessee includes all costs paid by the purchaser of the gas on behalf of the seller. This principle has been upheld in several cases: *Wheless Drilling Co.*, 80 I.D. 599, 13 IBLA 21 (1973); *Amoco Production Co.*, 29 IBLA 234, 236 (1977); *Hoover & Bracken Energies, Inc.*, 52 IBLA 27, 88 I.D. 7 (1981), *aff'd*, 723 F.2d 1388 (10th Cir. 1983). Thus, if the purchaser reimburses the seller, or pays any costs on behalf of the seller, for such items as severance taxes, gathering, compressing, or measuring, then the seller must include those reimbursed costs as part of the gross proceeds upon which the royalty value is determined.

The proposed rules in paragraph (i) would retain the existing requirement that gas operations such as gathering, treating, measuring, and compressing are costs incurred to place the gas in marketable condition and are to be borne exclusively by the lessee.

Proposed § 206.152(i) also would provide that, where value is based on gross proceeds, the value would be increased to the extent those gross proceeds were 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 gas in marketable condition. By way of illustration, compressing gas to meet pipeline pressure requirements is a cost of making gas marketable that must be borne by the lessee. If the lessee enters into a contract where the purchaser agrees to compress the gas and, hence, the contract price is reduced by 10 cents per mcf, MMS would add the 10 cents per mcf back to the gross proceeds to determine the value.

Proposed § 206.152(j) would expressly impose a diligence requirement on lessees. For example, if, pursuant to an arm's-length contract, a lessee could charge its purchaser a higher price as of a certain date, and if the lessee fails to take proper and timely action to collect that additional money, it would be liable for royalty on the higher value. However, if the purchaser refuses to pay and the lessee enforces its right, using reasonable, documented measures, it would not be required to pay the additional royalties until the lessee's efforts are successfully concluded. The MMS believes that this regulation reflects the lessee's obligation to operate the lease prudently for the mutual benefit of itself and the lessor.

Proposed § 206.152(j) would not operate to excuse a lessee from paying any royalty if, for example, gas were delivered under a contract and the purchaser failed to pay. In such an event, royalty still would be due on the value of the gas. This section is intended to apply only to the lessee's obligation to pursue price increases to which it may be entitled under its contract.

Proposed § 206.153, Valuation standards—processed gas, applies to all gas production to which the provisions of § 206.152 would not apply. For the most part, § 206.153 mirrors proposed § 206.152. The arm's-length philosophy and mechanism of establishing values are the same, except values are established for all commodities that result from processing gas; i.e., the residue gas and gas plant products. In view of this similarity, a section-by-section analysis will not be repeated. However, this proposed section would provide that the lessee is entitled to an allowance for the reasonable actual costs of processing the gas, as well as an allowance for the reasonable actual costs of transporting the gas to a plant remote from the lease and for

transporting residue gas and gas plant products to a sales point remote from the plant. Regulations governing the determination of allowances, and limitations on allowances, are discussed below.

Proposed § 206.154, Determination of quantities and qualities for computing royalties, paragraph (a)(1), would require that royalty be computed on the basis of the quantity and quality of unprocessed gas in marketable condition at the point of royalty settlement approved by MMS for offshore leases or by BLM for onshore leases. In those instances where the lessee sells unprocessed gas at conditions and/or at locations other than the point of royalty settlement condition and location approved by BLM or MMS, paragraph (a)(2) would require that the value of the unprocessed gas determined pursuant to § 206.152 be adjusted to reflect the quantity and quality of the unprocessed gas at the point of royalty settlement approved by BLM or MMS. Proposed § 206.154(b) would require that royalty be computed on the basis of the quantity and quality of the residue gas and gas plant products produced by a processing plant. Paragraph (b)(2) would require that the value of the residue gas and/or gas plant products be adjusted to reflect the quantity and/or quality of the residue gas and/or gas plant products attributable to a lease. Paragraph (c) would provide the requirements for determining the residue gas and gas plant products attributable to a lease. Paragraph (d) would provide that no credit against the volumes determined pursuant to paragraphs (a) through (c), or the value of those volumes, would be allowed.

Proposed § 206.155, Accounting for comparison, would provide in paragraph (a) that where a lessee, or a person to whom the lessee has transferred gas pursuant to a non-arm's-length contract or no-contract situation, processes the lessee's gas (including where the lessee's arm's-length contract includes a reservation of the right to process the gas), and if 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 value of the residue gas and gas plant products that result from processing the gas determined pursuant to § 206.153 (as adjusted for any approved processing or transportation deductions), plus the value of any condensate recovered downstream of the point of royalty settlement without resorting to processing or (2) the value of the gas prior to processing at the point of royalty settlement, determined in accordance with § 206.152. By this proposal, MMS would be eliminating dual accounting in situations where the value of residue gas is determined by the market pursuant to an arm's-length contract. However, paragraph (b) would remind lessees, particularly lessees of Indian leases, that the comparison of these values is sometimes required by the lease terms and, as previously stated in § 206.150(b), those lease terms shall govern. The MMS particularly solicits comments on whether this proposal for dual accounting should be adopted or whether MMS should maintain the requirement that dual accounting be required whenever gas is processed.

Proposed § 206.156, Transportation allowances—general, would include the general requirements for the determination of transportation allowances for unprocessed gas, residue gas, and gas plant products. Paragraph (a) would provide that where the value of production has been determined pursuant to § 206.152 or § 206.153 at a point remote from the lease, MMS shall allow a deduction for reasonable, actual transportation costs. For both onshore and offshore leases, this would include the transportation costs from the lease to the sales point remote from the lease. It also would include transportation costs from the lease to a processing plant, and from the plant to the sales point remote from the plant.

Proposed § 206.156(b) would impose a limit on the transportation allowance. The allowance could not exceed 50 percent of the value of the unprocessed gas, residue gas, or gas plant product determined pursuant to § 206.152 or § 206.153, as appropriate. This is the same limitation which exists under current MMS onshore procedures. By way of illustration, a lessee sells unprocessed gas with a delivery point remote from the lease. The lessee's gross proceeds under an arm's-length sales contract is $2.00 per mcf, and the lessee pays a third party $1.25 per mcf to transport the gas. Proposed § 206.156(b) would limit the transportation allowance to $1.00 per mcf. Therefore, the lessee would be required to pay royalty based on a value of $1.00 per mcf.

Under the proposed rules, the Director of MMS could approve an allowance greater than the 50 percent limit for transportation costs if the lessee demonstrates that a higher allowance is in the best interests of the lessor. The lessee must provide data to support its request to the Director. Under no circumstances could the Director approve an allowance that would result in zero royalty payments during any given reporting period. As an alternative to approving allowances greater than the 50 percent limit for transportation costs, MMS solicits comments on whether it should allow lessees to roll forward to subsequent months any costs that cannot be deducted by the lessee as a result of the limitation on transportation allowances. MMS particularly solicits comments on what circumstances would justify rolling forward the costs in excess of 50 percent of the value of the product which is the proposed limitation on transportation allowances.

Proposed § 206.156(c) would require that transportation costs be allocated among all the products produced from a lease and transported. Specific regulations on this allocation, and the limitations on the allowance, are discussed in more detail in proposed § 206.157.

Proposed § 206.156(d) would provide that if, after a review and/or audit, MMS determines that the lessee improperly determined a transportation allowance, then the lessee would be required to pay any additional royalties, plus interest, or would be entitled to a credit without any interest.

Proposed § 206.157, Determination of transportation allowances, would provide the procedure for determining the transportation allowance. The allowance would be substantially different depending upon whether the lessee has an arm's-length contract with a third party to provide transportation services, or whether the lessee has a non-arm's-length contract or no contract, such as those situations where the lessee has an interest in the pipeline or other transportation system.

Paragraph (a) would apply to arm's-length transportation contract situations. It would provide that the transportation allowance will be the reasonable, actual costs for transportation incurred by the lessee under that contract. Prior MMS approval would not be required before the lessee could deduct the allowance in computing its royalty payments. However, the contract is subject to monitoring, review, and/or audit. MMS may direct a lessee to use a different allowance if it determines that the lessee has improperly applied the regulations. Before taking an allowance, the lessee would, unless MMS specified a different procedure, be required to submit to MMS a completed page one of Form MMS-4295 the same month the allowance first is reported on Form MMS-2014, Report of Sales and Royalty Remittance. This would be a one-time

filing applicable to all months in the reporting period. The allowance would be denied for any production month for which a Form MMS-4295 is not received by the due date for the Form MMS-2014. Therefore, if a lessee begins incurring transportation costs for January gas production pursuant to an arm's-length contract, and if it did not submit a Form MMS-4295 until April 15, it would be entitled to an allowance only for March and subsequent months' production in the reporting period. No allowance would be permitted for January and February, and the lessee would be required to refund, with interest, any allowance which was taken.

Proposed section 206.157(a)(2) would provide that a transportation allowance determined pursuant to an arm's-length contract would remain effective for a reporting period of 12 months, or until the contract is modified or terminates, whichever is earlier. At that time, the lessee must submit a new page one of Form MMS-4295 in accordance with § 206.157(c).

An arm's-length transportation contract may include more than one gaseous product and may not allocate the costs among the gaseous products. In such an instance, § 206.157(a)(3) would require the lessee to allocate the costs to each gaseous product in the same proportion as the ratio of the volume of each gaseous product to the volume of all gaseous products. Proposed § 206.157(a)(3) would consider all gas transported in determining transportation costs. However, a transportation allowance would not be allowed for lease production which is not royalty-bearing.

Proposed § 206.157(a)(4) would cover those situations where both gaseous and liquid products are transported in the same transportation facility and the costs attributable to each cannot be determined from the arm's-length contract. This section would require that the lessee propose an allocation procedure to MMS. MMS approval of the cost allocation would be required because a volumetric-based allocation method may not be as appropriate as for transportation systems transporting only gaseous products. The lessee would use the gas transportation allowance determined in accordance with its proposed allocation procedure until MMS issues a determination on the transportation allowance. Proposed § 206.157(a)(4) also would provide for the submission of the lessee's proposed allocation within a prescribed time.

In some instances an arm's-length contract for transportation will not require a cash payment by the lessee. Instead, the transporter will be entitled, for example, to retain a percentage of the product. In such an event, § 206.157(a)(5) would require the lessee to determine the dollar value equivalent of those volumes to compute its allowance. Pursuant to § 206.157(a)(6), MMS could require lessees to submit copies of arm's-length transportation contracts and related documents within the time prescribed by MMS.

Proposed § 206.157(b)(1) provides that if the lessee does not have an arm's-length contract for transporting lease products, but has a non-arm's-length contract or no contract because it has an interest in the pipeline or the transportation facility, then the allowance would be based upon the lessee's reasonable, actual costs of transportation.

Paragraph (b)(2) proposes a procedure similar to that previously discussed for allowances for arm's-length situations. The allowance approval for non-arm's-length or no-contract situations is also a two-step process, consisting of a submittal of an estimated transportation allowance for the current 12-month period and a submittal of the actual transportation allowance within 90 days after the end of the 12-month period containing the actual costs incurred during the previous 12-month period. Prior MMS approval is not required before commencing transportation deductions for non-arm's-length or no-contract situations. However, unless MMS specifies differently, a completed page one of Form MMS-4295 with an estimated allowance must be received in the same month the lessee first reports its allowance on Form MMS-2014, Report of Sales and Royalty Remittance, or the allowance will be denied until Form MMS-4295 is filed. This filing would be effective for the entire reporting period. Within 90 days following the end of the 12-month period, the lessee would submit page one of Form MMS-4295 with its actual costs incurred during the previous 12-month period and its estimate for the succeeding reporting period.

Proposed § 206.157(b)(3) would expressly state that a lessee may deduct its transportation allowance without prior MMS approval, subject to monitoring, review, and/or audit by MMS. When necessary or appropriate, MMS could direct a lessee to modify its estimated or actual allowance deduction.

Proposed § 206.157(b)(4) provides that an estimated allowance may be used by lessees for facilities that are in a start-up period.

Proposed § 206.157(b)(5) would specify the types and nature of costs which MMS considers acceptable in determining a transportation allowance for non-arm's-length or no-contract situations. The categories of expenses are operating and maintenance expenses, overhead, depreciation, and a return on undepreciated capital investment or, alternately, a return on the initial capital investment with no allowance for depreciation (see discussion below). Paragraphs (b)(5) (i) and (ii) provide a list of operating and maintenance expense categories which MMS considers typical operating or maintenance expenses. Paragraph (b)(5)(iii) would provide for overhead to be included as a transportation cost, providing that the overhead is directly attributable or allocable to the operation or maintenance of the transportation system.

MMS is proposing two alternatives regarding return on capital investment. Under alternative 1, paragraph (b)(5)(iv) would provide for two financial depreciation methods: *straight-line* depreciation and unit of production depreciation. Accordingly, depreciation would be based on the useful life of the equipment or the life of the reserves the transportation facility services. Also, salvage value must be observed and equipment could not be depreciated below a reasonable salvage value.

The MMS is also proposing that the establishment of a transportation system depreciation schedule would not be altered because of a recapitalization or a change in ownership. A lessee would not be able to depreciate a transportation system using a schedule based on replacement costs or any other basis other than actual costs. Similarly, a change in ownership cannot be a basis for a change in the depreciation schedule for allowance purposes. If, for example, a transportation system has a depreciation schedule of 20 years and has been depreciated for 10 years by the first owner and then sold, the new second owner would be entitled to the remaining 10 years' depreciation based on the original capitalized cost. MMS specifically would like comments on whether or not this no-recapitalization provision should be adopted if alternative 1 is adopted.

As alternative 2, MMS is proposing in subsection (b)(5)(iv) to disallow any cost deduction for depreciation. Instead, each year MMS would allow an amount equal to the initial capital investment in the transportation system multiplied by a *floating rate of return, as discussed* below. Alternative 2, if adopted, would be supplemental to alternative 1 and is proposed to apply only to new transportation systems or newly acquired transportation systems. MMS

would like commenters to address the feasibility of alternative 2.

Paragraph (b)(5)(v) would establish the rate of return to be applied to either the undepreciated capital investment under alternative 1, discussed above, or the initial capital investment under alternative 2, also discussed above. The rate of return is proposed to be determined by the Moody Aaa corporate bond rate as published by Moody's Investors Services, Inc. in *Moody's Bond Record* the first business day of the reporting period for which the allowance becomes applicable. At the beginning of each subsequent 12-month period that follows, the rate would be redetermined.

MMS would like commenters to address whether a specific rate of return for each lessee should be used and how such a rate of return would be calculated.

Proposed § 206.157(b)(6) would set forth the requirement that the lessee allocate the transportation costs to each of the lease products transported where more than one lease product is transported through the same pipeline or transportation system. In such instances, § 206.157(b)(6) would require the lessee to allocate the costs to each lease product in the gaseous phase in the same proportion as the ratio of the volume of each lease product in the gaseous phase to the volume of all lease products in the gaseous phase. All gas would be treated the same in determining transportation costs, but a transportation allowance would not be allowed for lease products that are not royalty-bearing.

Proposed § 206.157(b)(7) would cover those non-arm's-length and no-contract situations where both gaseous and liquid products are transported in the same transportation system. Proposed § 206.157(b)(7) would require that the lessee propose an allocation procedure to MMS. MMS approval of the cost allocation would be required because, again, a volumetric-based allocation may not be as appropriate as for transportation systems transporting only gaseous products. The lessee would use the transportation allowance determined in accordance with its proposed allocation procedure until MMS issues a determination on the transportation allowance. Proposed § 206.157(b)(7) also would provide for the submission of the lessee's proposal within a prescribed time.

Proposed § 206.157(b)(8) would authorize MMS to require supporting data for any transportation allowance reported on Form MMS-4295.

Paragraph (c) would set forth the reporting requirements subsequent to the initial reporting period. Paragraph (c)(1) would require page one of Form MMS-4295 to be submitted within 90 days after the end of the previous reporting period for arm's-length contracts, unless MMS approves a longer period. For non-arm's-length or no-contract situations, a completed page one of Form MMS-4295 would be required to be submitted within 90 days following the end of the reporting period, unless MMS approves a longer period. Regardless of whether or not transportation is conducted under arm's-length contract, non-arm's-length contract, or no-contract conditions, if Form MMS-4295 is not timely received, then the new allowance for the succeeding reporting period will not be effective until the first day of the month a proper Form MMS-4295 is received by MMS and will be applicable to any Form MMS-2014 received after that date.

Section 206.157(c)(2) would require that transportation allowances under either arm's-length, non-arm's-length, or no-contract situations be reported on a separate line on Form MMS-2014, Report of Sales and Royalty Remittance. Unless otherwise directed by MMS, lessees are not to report values that are net of transportation allowances.

Proposed § 206.157(c)(3) would authorize MMS to establish reporting requirements different from those specified in the rules. This may be necessary for workload allocation or other reasons.

If the actual costs are different from the estimated costs used to determine the allowance for transportation, proposed § 206.157(d) would set forth the procedure for reporting the adjustments to royalty payments to MMS. The procedure would be different for onshore than for offshore because of the refund procedures of Section 10 of the OCS Lands Act (43 U.S.C. 1801 et seq.). If actual allowances differ from estimated allowances, the lessee would be required to pay additional royalty, with interest, or would be entitled to a credit, without interest.

Proposed § 206.157(e) would provide that, notwithstanding any other provision, no costs that result from payments for actual or theoretical losses would be allowed for gas transportation. Thus, if an arm's-length transportation agreement requires the lessee to pay the transporter for actual or theoretical line losses (either in value or in volume), such costs would be disallowed by MMS. Similarly, even if a transporter's tariff includes a component for actual or theoretical losses, such costs would be disallowed. The valuation regulations for gas in this Part would disallow such actual or theoretical losses in determining royalty volumes and values. The MMS also would disallow any such costs in non-arm's-length contract or no-contract situations.

Paragraph (f) is proposed to allow application of the same administrative or computation procedures contained in § 206.157 to determine other transportation costs when valuing unprocessed gas, residue gas, or gas plant products under a net-back procedure or other valuation procedure contained in Subpart C of Part 206.

It is the intention of MMS to terminate all existing transportation allowances with the issuance of final rulemaking. This termination would require all lessees to follow the new reporting requirements to be eligible for the deduction of transportation costs for production months subsequent to the effective date of the final rules. Procedures for claiming actual allowances for periods prior to the effective date of the final rules will be provided at the time of final rulemaking.

Proposed § 206.158, Processing allowances—general, would include the general requirements for the determination of a processing allowance. Paragraph (a) would allow a deduction for the reasonable actual costs of processing gas where the value for gas is determined pursuant to § 206.153.

Proposed § 206.158(b) would require that processing costs be allocated among all gas plant products, and a processing allowance determined for each gas plant product. A separate allowance would be required to be determined for each gas plant product and processing plant relationship. This provision would not allow the costs of processing a portion of a gas stream in one plant to be deductible from the values of gas plant products not produced by that particular plant. Natural gas liquids (NGL) would be treated as one gas plant product.

Proposed § 206.158(c) would limit the processing allowance to 66⅔ percent of the value of each gas plant product determined pursuant to § 206.153, less any applicable transportation allowances determined pursuant to §§ 206.156 and 206.157. This provision would, in effect, provide for the application of the processing allowance against the value of each gas plant product at the tailgate of the plant. The MMS Director could approve a greater allowance if the lessee demonstrates that the greater allowance is in the best interests of the lessor. As an alternative to approving allowances greater than the 66⅔ percent limit for processing costs, MMS solicits comments on

whether it should allow lessees to roll forward to subsequent months any costs that cannot be deducted by the lessee as a result of the limitation on processing allowances. MMS particularly solicits comments on what circumstances would justify rolling forward the costs in excess of 66⅔ percent of the value of the gas plant products which is the proposed limitation on processing allowances. This section would provide that the processing allowance could not be applied against the value of the residue gas. It further provides that, if there is no residue gas, the lessee would propose, for MMS's approval, a gas plant product against which no allowance could be taken.

Paragraph (d) would set forth the long-established principle that no processing cost deduction would be allowed for the costs of placing lease products in marketable condition. For example, if hydrogen sulfide is removed from a gas stream and flared, no processing cost deduction would be allowed. However, if hydrogen sulfide is removed from gas and then further *processed to obtain sulfur which is then* sold, royalty is due on the value of the sulfur, but an allowance for the processing costs would be allowed in determining the value of the sulfur.

Paragraph (e) would provide that if a lessee improperly determines a processing allowance, the lessee would be liable for any additional royalties, plus interest, or would be entitled to a credit, without interest.

Proposed § 206.159, Determination of processing allowances, would provide the procedure for determining the processing allowance, which is substantially different depending upon whether the lessee has an arm's length contract with a plant operator for its processing, or whether the lessee has a non-arm's-length contract or no-contract situation, such as those situations where the lessee has an interest in the gas plant.

Paragraph (a)(1) would apply to arm's-length situations. It would provide that the processing allowance would be the actual costs for processing incurred by the lessee under that contract. The MMS's approval would not be required before the lessee could deduct the allowance in computing its royalty payments. However, the contract is subject to later monitoring, review, and/or audit. MMS may direct a lessee to use a different allowance if it determines that the lessee has improperly applied the regulations. The proposed rule would further require that before any deduction could be taken, the lessee must submit to MMS a completed page one of Form MMS-4109 the same month the processing allowance first is reported on Form MMS-2014, Report of Sales and Remittance. The deduction would be denied for any production month for which a Form MMS-4109 is not received prior to, or at the same time as, the Form MMS-2014 for that month. Therefore, if a lessee begins incurring processing costs for January gas production pursuant to an arm's-length contract, and if it did not submit a Form MMS-4109 until April 15, it would be entitled to an allowance only for March and subsequent months production in the reporting period. No allowance would be permitted for January and February, and the lessee would be required to refund, with interest, any allowance that was taken.

Paragraph (a)(2) would provide that any allowances determined pursuant to an arm's-length contract would be effective for a reporting period beginning the month that the lessee first is authorized to deduct a processing allowance and would continue for 12 months, or until the applicable contract or rate terminates or is modified or *amended, whichever is earlier.* At the end of the reporting period, the lessee must resubmit page one of Form MMS-4109.

An arm's-length processing contract may include more than one gas plant product and may allocate the costs among the gas plant products. In such an instance, § 206.159(a)(3) would accept the allocation of the costs to each gas plant product in accordance with the contract. A processing allowance for lease products which are not royalty-bearing would not be allowed.

Proposed § 206.159(a)(4) would cover those situations where more than one gas plant product is produced at a plant and the costs attributable to each cannot be determined from the arm's-length contract. This section would require that the lessee propose an allocation procedure to MMS. The lessee would use the processing allowance determined in accordance with its proposed allocation procedure until MMS issues a determination on the processing allowance. Proposed § 206.159(a)(4) also would provide for the submission of the lessee's proposal within a prescribed time. If the approved allowance differs from the proposal, the lessee must correct its reports. The lessee would be required to pay additional royalties, with interest, or would get a credit, without interest.

In some instances, an arm's-length contract for processing will not require a cash payment by the lessee. Instead, the processing plant owner will be entitled, for example, to retain a percentage of the gas plant products. In such an event, § 206.159(a)(5) would require the lessee to determine the dollar value equivalent of those volumes to compute its allowance. Pursuant to § 206.159(a)(6), MMS could require lessees to submit copies of arm's-length processing contracts and related documents within the time prescribed by MMS.

Proposed § 206.159(b)(1) would provide that if the lessee does not have an arm's-length contract for processing gas, but has a non-arm's-length contract or no-contract situation because it has an interest in the processing plant, then the allowance would be based upon the lessee's reasonable, actual costs of processing the gas. This paragraph also provides that allowances are subject to monitoring review, and/or audit, and that for non-arm's-length or no-contract situations, MMS approval is not required.

Paragraph (b)(2) proposes a procedure similar to that previously discussed for allowances for arm's-length situations. The allowance approval for non-arm's-length or no-contract situations is also a twostep process, consisting of a submittal of an estimated processing allowance for the current 12-month period and a submittal of the actual processing allowance within 90 days after the end of the 12-month period, containing the actual costs incurred during the previous 12-month period. The MMS approval is not required prior to commencing processing allowance deductions for non-arm's-length or no-contract situations. The MMS must receive a completed Form MMS-4109 with an estimated allowance in the same month the lessee first reports its allowance on Form MMS-2014, Report of Sales and Royalty Remittance, or the allowance will be denied until Form MMS-4109, completed in its entirety with accompanying schedules, is filed. *This is a one-time filing effective for the* entire reporting period. Within 90 days following the end of the 12-month period, the lessee would submit Form MMS-4109 with its actual costs incurred during the previous 12-month period and its estimate for the succeeding reporting period.

Proposed § 206.159(b)(3) would provide that an estimated allowance may be used by lessees for processing plants systems that are in a start-up period.

Proposed § 206.159(b)(4) would specify the types and nature of costs which MMS considers acceptable in determining a processing allowance for non-arm's-length or no contract situations. The categories of expenses are operating and maintenance expenses, overhead, depreciation, and a

return on undepreciated capital investment or, alternatively, a return on the initial capital investment with no allowance for depreciation—see discussion below. Paragraph (b)(4) (i) and (ii) provide a list of operating and maintenance expense categories which MMS considers typical operating or maintenance expenses. Paragraphs (b)(4)(iii) would provide for overhead to be included as a processing cost, providing the overhead is directly attributable or allocable to the operation or maintenance of the processing plant.

MMS is proposing two alternatives regarding return on capital investment. Under alternative 1, paragraph (b)(4)(iv) would provide for two financial depreciation methods: Straight-line depreciation and unit of production depreciation. Accordingly, depreciation would be based on the useful life of the equipment or the life of the reserves the processing plant services. Also, salvage value must be observed and equipment could not be depreciated below a reasonable salvage value.

The MMS is also proposing that the establishment of a processing plant depreciation schedule would not be altered because of a recapitalization or a change in ownership. A lessee would not be able to depreciate a processing plant using a schedule based on replacement costs or any other basis other than actual costs. Similarly, a change in ownership cannot be a basis for a change in the depreciation schedule for allowance purposes. If, for example, a processing plant has a depreciation schedule of 20 years and has been depreciated for 10 years by the first owner and then sold, the new second owner would be entitled to the remaining 10 years' depreciation based on the original capitalized cost. MMS specifically would like comments on whether or not this no-recapitalization provision should be adopted if alternative 1 is adopted.

As alternative 2, MMS is proposing in subsection (b)(4)(iv) to disallow any cost deduction for depreciation. Instead, each year MMS would allow an amount equal to the initial capital investment in the processing plant multiplied by a floating rate of return, as discussed below. Alternative 2, if adopted, would be supplemental to alternative 1 and is proposed to apply prospectively only to new plants or newly acquired plants. MMS would like commenters to address the feasibility of alternative 2.

Paragraph (b)(4)(v) would establish the rate of return to be applied to either the undepreciated capital investment under alternative 1, discussed above, or the initial capital investment under alternative 2, also discussed above. The rate of return is proposed to be determined by the Moody Aaa corporate bond rate as published by Moody's Investors Services, Inc. in *Moody's Bond Record* the first business day of the reporting period for which the allowance becomes applicable. At the beginning of each subsequent 12-month period that follows, the rate would be redetermined.

MMS would like commenters to address whether or not a specific rate of return for each lessee should be used and how such a rate of return would be calculated.

Proposed § 206.159(b)(5) would set forth the requirement that the lessee allocate the processing costs to each gas plant product. In such instances, § 206.159(b)(5) would require the lessee to allocate the processing costs to each gas plant product based upon generally accepted oil and gas accounting principles.

Paragraph (c) would set forth the reporting requirements subsequent to the initial reporting period. Paragraph (c)(1) would require that page one of Form MMS-4109 be submitted within 90 days after the end of the previous reporting period for arm's-length contracts, unless MMS approves a longer period. For non-arm's-length or no-contract situations, a Form MMS-4109, completed in its entirety with accompanying schedules, would be required to be submitted within 90 days following the end of the reporting period, unless MMS approves a longer period. Regardless of whether gas processing is conducted under arm's-length contract, non-arm's-length contract, or no-contract conditions, if Form MMS-4109 is not timely received, then the new allowance for the succeeding reporting period will not be effective until the first day of the month a proper Form MMS-4109 is received by MMS and would be applicable to any Form MMS-2014 received after that date. The lessee would be required to refund, with interest, any unauthorized allowance that was taken.

Section 206.159(c)(2) would require that processing allowances under either arm's-length, non-arm's-length or no-contract situations be reported on a separate line on Form MMS-2014, Report of Sales and Royalty Remittance. Unless otherwise directed and approved by MMS, lessees are not to report values that are net of processing allowances.

Proposed § 206.159(c)(3) would authorize MMS to establish reporting requirements different from those specified in the rules. This may be necessary for workload allocation or other reasons.

If the actual costs are different from the estimated costs used to determine the processing allowance, proposed § 206.159(d) would set forth the procedure for reporting the adjustments to royalty payments to the MMS. The procedure would be different for onshore than for offshore because of the refund procedures of Section 10 of the OCS Lands Act (43 U.S.C. 1801 et seq.). If actual allowances differ from estimated allowances, the lessee would be required to pay additional royalty, with interest, or would be entitled to a credit, without interest.

Paragraph (e) would apply the same administrative or computation procedures contained in § 206.159 to determine other gas processing costs when valuing gas under a net-back procedure or other valuation procedure contained in Subpart C of Part 206.

As with transportation allowances, it is the intention of MMS to terminate all existing processing allowances with the issuance of final rulemaking. Again, lessees would be required to follow the new reporting requirements to be eligible to deduct processing costs for product months subsequent to the effective date of the final rulemaking.

The MMS is aware of the extraordinary costs inherent in some offshore operations and also of the extensive facilities needed to process the deep sour gas that is being produced from some leases today. MMS requests comment on whether or not the final regulations should provide that unusual or unconventional post-production costs be allowed as a deduction in determining royalty values regardless of whether those costs are incurred on or off the lease.

The proposed oil valuation regulations (52 FR 1856, January 15, 1987) include proposed revisions to 30 CFR Part 207, governing such matters as contract retention. These provisions would be applicable also to unprocessed gas, residue gas, and gas plant products.

IV. Procedural Matters

Executive Order 12291

The Department of the Interior (DOI) has determined that this document is not a major rule and does not require a regulatory analysis under Executive Order 12291. This proposed rulemaking is to consolidate Federal and Indian gas royalty valuation regulations; to clarify DOI gas royalty valuation policy; and to provide for consistent royalty valuation policy among all leasable minerals.

Regulatory Flexibility Act

Because this rule primarily consolidates and streamlines existing regulations for consistent application,

there are no significant additional requirements or burdens placed upon small business entities as a result of implementation of this proposed rule. Therefore, the DOI has determined that this rulemaking will not have a significant economic effect on a substantial number of small entities and does not require a regulatory flexibility analysis under the Regulatory Flexibility Act (5 U.S.C. 610 et seq.).

Paperwork Reduction Act

The information collection and recordkeeping requirements located at §§ 206.157 and 206.159 of this rule has been submitted to the Office of Management and Budget (OMB) for approval under 44 U.S.C. 3501 et seq. The collection of this information will not be required until it has been approved by OMB.

Lessee reporting requirements will be reduced. All gas sales contracts, transportation agreements and gas processing contracts, as well as any other agreements affecting value, will be required to be retained by the lessee, but will only be required to be submitted upon request rather than routinely, as under the existing regulations.

National Environmental Policy Act of 1969

It is hereby determined that this rulemaking does not constitute a major Federal action significantly affecting the quality of the human environment and a detailed statement pursuant to section 102(2)(C) of the National Environmental Policy Act of 1969 (42 U.S.C. 4332(2)(C)) is not required.

Public Comment Procedures

A. Written Comments

The public is invited to participate in this proceeding by submitting data, views, or arguments with respect to this notice. All comments should be submitted by 4:30 p.m., m.s.t., of the day specified in the "DATES" section to the appropriate address indicated in the "ADDRESSES" section of this preamble and should be identified on the outside envelope and on documents submitted with the designation "Revision of Gas Royalty Valuation Regulations and Related Topics." All comments received by the MMS will be available for public inspection in Room E104, Building 85, Denver Federal Center, Lakewood, Colorado, between the hours of 8:00 a.m. and 4:00 p.m., Monday through Friday.

Any information or data submitted which is considered to be confidential must be so identified and submitted in writing, one copy only. The MMS reserves the right to determine the confidential status of the information or data and to treat it according to its independent determination.

B. Public Hearing

(1) *Procedure for requests to make oral presentations:* The time and place for the hearing are indicated in the "DATES" and "ADDRESSES" sections of the preamble.

Written requests for an opportunity to make an oral presentation should contain a business telephone number and also a telephone number where the presenter may be contacted during the day prior to the hearing. Those selected to be heard at the hearing will be notified. Presenters will be required to submit 50 copies of their statement to MMS at the address indicated in the "ADDRESS" section above.

(2) *Conduct of the hearing:* MMS reserves the right to select the persons to be heard at the hearing (in the event there are more requests to be heard than time allows), to schedule their respective presentations, and to establish the procedures governing the conduct of the hearing. The length of each presentation may be limited, based upon the number of persons requesting to be heard.

A Department of the Interior official will be designated to preside at the hearing. This will not be a judicial-type hearing. Questions may be asked only by those conducting the hearing. At the conclusion of all initial oral statements, each person who has made an oral statement will be given the opportunity, if he or she so desires, to make a rebuttal statement. The rebuttal statements will be given in the order in which the initial statements were made and will be subject to time limitations.

Anyone wishing to ask a question at the hearing may submit the question, in writing, to the presiding officer. The presiding officer will determine whether the question is relevant, and whether time limitations permit it to be presented for answer at the hearing.

Any further procedural rules needed for the proper conduct of the hearing will be announced by the presiding officer at the opening of the hearing.

A transcript of the hearing will be made. The entire record of the hearing, including the transcript, will be retained by the MMS and made available for inspection in Room E104, Building 85, Denver Federal Center, Lakewood, Colorado, between the hours 8:00 a.m. and 4:00 p.m., Monday through Friday. A copy of the transcript may be purchased from the reporter.

List of Subjects

30 CFR Part 202

Continental shelf, Government contracts, Mineral royalties, Oil and gas exploration, Public lands-mineral resources, Reporting and recordkeeping requirements.

30 CFR Part 206

Continental shelf, Geothermal energy, Government contracts, Mineral royalties, Oil and gas exploration, Public lands-Mineral resources.

Dated: January 8, 1987.

J. Steven Griles,

Assistant Secretary, Land and Minerals Management.

SUBCHAPTER A—ROYALTY MANAGEMENT

For the reasons set out in the preamble, the following amendments are proposed to be made to 30 CFR Parts 202 and 206.

PART 202—[AMENDED]

30 CFR Part 202 is amended as follows:

1. The authority citation for Part 202 is revised to read as follows:

Authority: 25 U.S.C. 396 et seq.; 25 U.S.C. 396a et seq.; 25 U.S.C. 2101 et seq.; 30 U.S.C. 181 et seq.; 30 U.S.C. 351 et seq.; 30 U.S.C. 1001 et seq.; 30 U.S.C. 1701 et seq.; 43 U.S.C. 1301 et seq.; 43 U.S.C. 1331 et seq.; and 43 U.S.C. 1801 et seq.

2. The table of contents for Subpart D is revised to read as follows:

Subpart D—Federal and Indian Gas

Sec.

202.150 Royalty on gas.
202.151 Royalty on processed gas.
202.152 Standards for reporting and paying royalties on gas.

3. The heading for Subpart D is revised to read as follows:

Subpart D—Federal and Indian Gas

4. Sections 202.150 and 202.151 of Subpart D are revised to read as follows:

§ 202.150 Royalty on gas.

(a) The royalty on gas, except helium produced from Federal leases, shall be at the rate established by the terms of the lease. Royalty shall be paid in value unless MMS requires payment in-kind.

(b)(1) All gas (except gas unavoidably lost or used on, or for the benefit of, the lease, including that gas used off-lease for the benefit of the lease when such off-lease use is permitted by the appropriate agency) produced from a Federal or Indian lease subject to this Part is subject to royalty.

(2) For a lease which is part of a unitized or communitized area, the volume of royalty free gas used off-lease for the benefit of the lease shall be limited to the volume which is equal to the ratio of lease production to total unitized or communitized area production multiplied by the total volume of gas used off-lease for the benefit of the unitized or communitized area.

(3) Where the terms of any lease are inconsistent with this section, the lease terms shall govern to the extent of that inconsistency.

(c) In those instances where the lessee of any lease committed to a Federally approved unitization or communitization agreement does not actually take the proportionate share of the agreement production attributable to its lease in accordance with the terms of the agreement, that production is subject to the royalty payment and reporting requirements of this Title. The value for royalty purposes of that production will be determined in accordance with Part 206. In applying the requirements of Part 206, the circumstances involved in the actual disposition of the production shall be considered as controlling in arriving at the value for royalty purposes as if the person actually selling or disposing of the production were the lessee of the Federal or Indian lease.

§ 202.151 Royalty on processed gas.

(a) A royalty as provided in the lease shall be paid on the value of the residue gas and all gas plant products resulting from processing the gas produced from a lease subject to this Part. The MMS shall authorize a processing allowance for the reasonable, actual costs of processing the gas produced from Federal and Indian leases. Processing allowances shall be determined in accordance with Subpart D of Part 206 of this Title.

(b) A reasonable amount of residue gas shall be allowed royalty free for operation of the processing plant, but no allowance shall be made for boosting residue gas or other expenses incidental to marketing.

(c) No royalty is due on residue gas or any gas plant product resulting from processing gas which is reinjected into a reservoir within the same lease, unit area, or communitized area, when the reinjection is included in a plan of development or operations and the plan has received BLM or MMS approval for onshore or offshore operations, respectively, until such time as they are finally produced from the reservoir for sale or use off-lease.

5. Section 202.152 is revised to read as follows:

§ 202.152 Standards for reporting and paying royalties on gas.

(a)(1) Gas volumes and Btu heating values, if applicable, shall be determined under the same degree of water saturation. Gas volumes shall be reported in units of one thousand cubic feet (mcf), and Btu heating value shall be reported at a rate of Btu's per cubic foot, at a standard pressure base of 14.73 pounds per square inch absolute (psia) and a standard temperature base of 60 °F; provided, however, that for OCS leases in the Gulf of Mexico, gas volumes and Btu heating values shall be reported at a standard pressure base of 15.025 psia and a standard temperature base of 60 °F. Gas volumes and Btu heating values shall be reported, for royalty purposes, on the same water vapor saturated or unsaturated basis prescribed by Federal Energy Regulatory Commission (FERC) regulation, or on the basis prescribed in the lessee's gas sales contract if the sales are not subject to FERC regulation, or the prescribed basis does not result in a conflict with FERC regulation.

(2) The frequency and method of Btu measurement as set forth in the lessee's contract shall be used for reporting purposes. However, the Btu value shall be measured at least semiannually by recognized standard industry testing methods.

(b)(1) Residue gas and gas plant product volumes shall be reported as specified herein.

(2) Carbon dioxide (CO_2), nitrogen (N_2), helium (He), and residue gas shall be reported using the same standards specified in paragraph (a).

(3) Natural gas liquids (NGL) volumes shall be reported in standard U.S. gallons (231 cubic inches) at 60 °F.

(4) Sulfur (S) volumes shall be reported in long tons (2,240 pounds).

PART 206—[AMENDED]

30 CFR Part 206 is amended as follows:

1. The authority citation for Part 206 is revised to read as follows:

Authority: 25 U.S.C. 396 et seq.; 25 U.S.C. 396a et seq.; 25 U.S.C. 2101 et seq.; 30 U.S.C. 181 et seq.; 30 U.S.C. 351 et seq.; 30 U.S.C. 1001 et seq.; 30 U.S.C. 1701 et seq.; 43 U.S.C. 1301 et seq.; 43 U.S.C. 1331 et seq.; and 43 U.S.C. 1801 et seq.

2. The table of contents for Subpart D is revised to read as follows:

Subpart D—Federal and Indian Gas

Sec.
206.150 Purpose and scope.
206.151 Definitions.
206.152 Valuation standards—unprocessed gas.
206.153 Valuation standards—processed gas.
206.154 Determination of quantities and qualities for computing royalties.
206.155 Accounting for comparison.
206.156 Transportation allowances—general.
206.157 Determination of transportation allowances.
206.158 Processing allowances—general.
206.159 Determination of processing allowances.

3. The heading for Subpart D is revised to read as follows:

Subpart D—Federal and Indian Gas

4. Sections 206.150, 206.151, and 206.152 are revised to read as follows:

§ 206.150 Purpose and scope.

(a) This subpart is applicable to all gas produced from Federal and Indian (Tribal and allotted) oil and gas leases (except leases on the Osage Indian Reservation).

(b) If the specific provisions of any statute or treaty, or any oil and gas lease subject to the requirements of this part, are inconsistent with any regulation in this part, then the lease, statute, or treaty provision shall govern to the extent of that inconsistency.

(c) All royalty payments made to MMS are subject to later audit and adjustment.

(d) If BLM determines that gas was avoidably lost or wasted from an onshore lease, or gas was drained from an onshore lease upon which compensatory royalty is due, or MMS determines that gas was avoidably lost or wasted from an offshore lease, then the value of the gas shall be determined in accordance with this part.

(e) If a lessee receives compensation through insurance coverage or other arrangements for gas unavoidably lost, royalties at the rate specified in the lease are to be paid on the amount of compensation received.

§ 206.151 Definitions.

(a) *Alaska Native Corporation* means any of the twelve Alaska Native Regional Corporations formed pursuant to the Alaska Native Claims Settlement Act (ANCSA), 43 U.S.C. 1606, and which, by virtue of the acquisition of land pursuant to ANCSA, as amended and supplemented, owns all or part of the lessor's interest in a lease or is entitled to distribution of a portion of the revenues derived from a lease.

(b) *Allowance* means an authorized or an MMS-accepted or -approved deduction in determining value for royalty purposes. "Processing allowance" means an allowance for the

reasonable, actual costs incurred by the lessee for processing gas, or an MMS-accepted or -approved deduction for costs of such processing.

"Transportation allowance" means an allowance for the reasonable, actual costs incurred by the lessee for moving unprocessed gas, residue gas, or gas plant products to a point of sale or point of delivery remote from the lease, unit area, communitized area, or processing plant or an MMS-accepted or -approved deduction for costs of such transportation, determined pursuant to this subpart.

(c) *Area* means a geographic region at least as large as the defined limits of an oil and/or gas field, in which oil and/or gas lease products have similar quality and economic characteristics.

(d) *Arm's-length contract* means a contract or agreement between independent, nonaffiliated persons. For purposes of this subpart, two persons are affiliated if one person controls, is controlled by, or is under common control with another person, or if one person owns an interest (regardless of how small), either directly or indirectly, in another person.

(e) *Audit* means a review, conducted in accord with generally accepted accounting and auditing standards, of royalty payment compliance activities of lessees or other interest holders who pay royalties, rents, or bonuses on Federal and Indian leases. The term audit includes, but is not limited to, audit activities related to Federal leases located within the boundaries of any State which has entered into a cooperative agreement with MMS under the provisions of sections 202 or 205 of the Federal Oil and Gas Royalty Management Act of 1982 (30 U.S.C. 1732 or 1735), audit activities related to leases located on Indian lands, and the review and resolution of exceptions processed by the official royalty and production accounting systems maintained by the MMS. Audits may also be conducted in response to irregularities identified by BLM or MMS, BIA, or a State or Indian Tribe in the performance of production verification.

(f) *BIA* means the Bureau of Indian Affairs of the Department of the Interior.

(g) *BLM* means the Bureau of Land Management of the Department of the Interior.

(h) *Compression* means the process of raising the pressure of gas.

(i) *Contract* means any oral or written agreement, including amendments or revisions thereto, between two or more persons and enforceable by law that with due consideration creates an obligation.

(j) *Field* means a geographic region situated over one or more subsurface gas and/or oil reservoirs encompassing at least the outermost boundaries of all gas and/or oil accumulations known to be within those reservoirs vertically projected to the land surface. Onshore fields are usually given names and their official boundaries are often designated by oil and gas regulatory agencies in the respective States in which the fields are located. Outer Continental Shelf (OCS) fields are named and their boundaries are designated by MMS.

(k) *Gas* means any fluid, either combustible or noncombustible, hydrocarbon or nonhydrocarbon, which is extracted from a reservoir and which has neither independent shape nor volume, but tends to expand indefinitely. It is a substance that exists in a gaseous or rarefied state under standard temperature and pressure conditions.

(l) *Gas plant products* means separate marketable elements, compounds or mixtures, whether in liquid, gaseous, or solid form, resulting from processing gas, excluding residue gas.

(m) *Gross proceeds* (for royalty payment purposes) means the total monies and other consideration paid to an oil and gas lessee, or monies and other consideration to which such lessee is entitled for the disposition of unprocessed gas, residue gas, or gas plant products. Gross proceeds includes, but is not limited to, payments to the lessee for certain services such as compression, dehydration, measurement, and/or field gathering to the extent that the lessee is obligated to perform them at no cost to the Federal Government or Indian lessor, and payments for gas processing rights. Gross proceeds, as applied to gas also includes: Payments or credits for advanced prepaid reserve payments subject to recoupment through reduced prices in later sales; advanced exploration or development costs that are subject to recoupment through reduced prices in later sales; take-or-pay payments; reimbursements for severance taxes; and other reimbursements. Tax reimbursements are part of the gross proceeds accruing to a lessee even though the Federal or Indian royalty interest may be exempt from taxation.

(n) *Indian allottee* means any Indian for whom land or an interest in land is held in trust by the United States or who holds title subject to Federal restriction against alienation.

(o) *Indian Tribe* means any Indian Tribe, band, nation, pueblo, community, rancheria, colony, or other group of Indians for which any land or interest in land is held by the United States in trust or which is subject to Federal restriction against alienation.

(p) *Lease* means any contract, profit-share arrangement, joint venture, or other agreement issued or approved by the United States under a mineral leasing law that authorizes exploration for, development or extraction of, or removal of lease products—or the land area covered by that authorization, whichever is required by the context.

(q) *Lease products* means any minerals attributable to, originating from, or allocated to Outer Continental Shelf or onshore Federal or Indian leases.

(r) *Lessee* means any person to whom the United States, an Indian Tribe, or an Indian allottee issues a lease, and any person who has assumed an obligation to make royalty or other payments required by the lease. This includes all persons who have an interest in a lease as well as an operator or payor who has no interest in the lease but who has assumed the royalty payment responsibility.

(s) *Like-quality lease products* means lease products which have similar chemical, physical, and legal characteristics.

(t) *Marketable condition* means lease products which are sufficiently free from impurities and otherwise in a condition that they will be accepted by a purchaser under a sales contract typical for the field or area.

(u) *Minimum royalty* means that minimum amount of annual royalty that the lessee must pay as specified in the lease or in applicable leasing regulations.

(v) *Net-back method* means a procedure for valuing unprocessed gas, residue gas, or gas products at the lease, unit area, communitized area, or processing plant when the first sale, transfer, or use has taken place downstream from the lease, unit area, communitized area, or processing plant. The procedure involves working back from the initial sales point, or first alternate point which can be used for value determination, to arrive at the value at the point of settlement for royalty purposes or the processing plant, as applicable.

(w) *Net output* means the quantity of residue gas and each gas plant product that a processing plant produces.

(x) *Net profit share* (for applicable Federal and Indian lessees) means the specified share of the net profit from production of oil and gas as provided in the agreement.

(y) *Outer Continental Shelf (OCS)* means all submerged lands lying

seaward and outside of the area of land beneath navigable waters as defined in section 2 of the Submerged Lands Act (43 U.S.C. 1301) and of which the subsoil and seabed appertain to the United States and are subject to its jurisdiction and control.

(z) *Person* means any individual, firm, corporation, association, partnership, consortium, or joint venture.

(aa) *Posted price* means the price in the field, net of all deductions, as specified in a publicly available posted price bulletin, that a buyer is willing to pay for quantities of unprocessed gas, residue gas, or gas plant products of marketable quality, free of contaminants not normally associated with such gas or gas plant products.

(bb) *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 are not considered processing.

(cc) *Residue gas* means that hydrocarbon gas consisting principally of methane resulting from processing gas.

(dd) *Selling arrangement* means a unique level of subaccounting required by MMS's Auditing and Financial System (AFS).

(ee) *Spot sales agreement* means a contract wherein a seller agrees to sell to a buyer a specified amount of unprocessed gas, residue gas, or gas plant products at a specified price over a fixed period, usually of short duration, which does not require a cancellation notice to terminate, and which does not contain an obligation, nor imply an intent, to continue in subsequent periods.

(ff) *Take-or-pay payment* means any payment received by the lessee under a "take-or-pay" clause in its sales contracts. Such clauses normally require the purchaser to take or, failing to take, to pay for a minimum contracted volume or other measure of lease products. Under such a clause, the purchaser usually has the right to take lease products paid for (but undelivered) in succeeding years.

(gg) *Warranty contract* means a contract for the sale of gas wherein the producer agrees to sell a specific amount of gas and the gas delivered in satisfaction of this obligation may come from fields or sources outside of the designated fields. *Shell Oil Co.* v. *Federal Power Commission* 531 F.2d 1324 at note 6 (5th Cir. 1976).

§ 206.152 Valuation standards—unprocessed/gas.

(a)(1) This section applies to the valuation of gas that is not processed and all gas that is processed but is sold or otherwise disposed of by the lessee pursuant to an arm's-length contract prior to processing. Where the lessee's contract includes a reservation of the right to process the gas and the lessee exercises that right, or where the lessee's contract for the sale of gas prior to processing provides for the value to be determined based upon a percentage of the purchaser's proceeds resulting from processing the gas, § 206.153 shall apply instead of this section.

(2) The value, for royalty purposes, of gas subject to this section shall be the value of gas determined pursuant to this section less applicable transportation allowances determined pursuant to this subpart.

(b)(1) The value of gas which is sold pursuant to an arm's-length contract shall be the gross proceeds accruing, or which could accrue, to the lessee. Prior MMS approval of this value is not required, although it is subject to monitoring, review, and/or audit. MMS may direct a lessee to pay royalty upon a different value if it determines that the lessee's reported value is inconsistent with the requirements of these regulations.

(2) Notwithstanding the provisions of paragraph (b)(1) of this section, the value of gas sold pursuant to a warranty contract shall be determined by MMS and due consideration will be given to all valuation criteria specified in this section.

(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 subsections:

(1) The gross proceeds accruing, or which could accrue, 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 lessee's 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 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;

(2) The gross proceeds accruing, or which could accrue, 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 under comparable arm's-length contracts between other persons for purchases, sales, or other dispositions of like-quality gas in the same field or area. Comparability shall be determined using the same criteria as specified in paragraph (c)(1) of this section;

(3) 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 other fields or areas, posted prices for gas, prices received in spot sales of gas, other reliable public sources of price or market information, and other information as to the particular lease operation or affecting the saleability of the gas; or

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

(d) 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 the MMS shall accept such maximum price as the value. This limitation shall not apply to gas sold pursuant to a warranty contract and valued pursuant to paragraph (b)(2) of this section.

(e)(1) Where the value is determined pursuant to paragraph (c) of this section, that value does not require prior approval by MMS. However, the lessee shall retain all available data to support its determination of value. Such data shall be subject to monitoring, review, and/or audit by MMS. MMS may direct a lessee to pay royalty at a different value if it determines, upon review or audit, that the reported value is inconsistent with the requirements of the regulations.

(e)(2) A lessee shall notify MMS if it has determined value pursuant to paragraph (c)(3) or (c)(4) of this section. The notification shall be by letter to the Associate Director for Royalty Management or his designee. The letter shall identify which valuation method is being used and contain a brief description of the procedure being used.

(f) If MMS determines that a lessee has not properly determined value, the lessee shall be liable for 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 be liable for interest 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 what the value should be, and the lessee may use that value for royalty purposes until MMS issues a value determination. The lessee shall submit available data to support its proposal. The MMS shall expeditiously determine the value based upon the lessee's proposal and any additional information MMS deems necessary. 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, for royalty purposes, be less than the gross proceeds accruing, or which could accrue, to the lessee for gas removed or sold from the lease, less applicable allowances determined pursuant to this subpart.

(i) The lessee is required to place gas in marketable condition at no cost to the Federal Government or Indian lessor. Where the value established pursuant to 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 gas in marketable condition.

(j) Value shall be based on the highest price a prudent operator can receive 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, and may be retroactive. If the lessee makes timely application for a price increase 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 until monies or consideration resulting from the price increase are received. This paragraph applies to price increments only and 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, for a quantity of gas removed or sold from a lease.

(k) Certain information submitted to MMS to support valuation proposals, including transportation and/or processing allowances, is exempted from disclosure by the Freedom of Information Act, 5 U.S.C. 522. Any data specified by the Act to be privileged, confidential, or otherwise exempt, will be maintained in a confidential manner in accordance with applicable law 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.

5. Sections 206.153 through 206.159 are added to read as follows:

§ 206.153 Valuation standards—processed gas.

(a)(1) This section applies to the valuation of all gas that is processed by the lessee and any other gas not subject to the valuation provisions of § 206.152. This section applies where the lessee's contract includes a reservation of the right to process the gas and the lessee exercises that right, and where the lessee's contract for the sale of gas prior to processing provides for the value to be determined based upon a percentage of the purchaser's proceeds resulting from processing the gas.

(2) The value, for royalty purposes, of gas subject to this section shall be the combined value of the residue gas and all gas plant products determined pursuant to this section, less applicable transportation and processing allowances determined pursuant to this subpart.

(b)(1) The value of the residue gas or any gas plant product which is sold pursuant to an arm's-length contract shall be the gross proceeds accruing, or which could accrue, to the lessee. Prior MMS approval of this value is not required, although it is subject to monitoring, review, and/or audit. MMS may direct a lessee to pay royalty upon a different value if it determines that the lessee's reported value is inconsistent with the requirements of these regulations.

(2) Notwithstanding the provisions of paragraph (b)(1) of this section, the value of residue gas sold pursuant to a warranty contract shall be determined by MMS and due consideration will be given to all valuation criteria specified in this section.

(c) The value of residue gas or of 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 subsections:

(1) The gross proceeds accruing, or which could accrue, 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 lessee's 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. 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 product, volume, and such other factors as may be appropriate to reflect the value of the residue gas or gas plant product;

(2) The gross proceeds accruing, or which could accrue, 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 under comparable arm's-length contracts between other persons for purchases, sales, or other dispositions of like-quality residue gas or gas plant products from the same processing plant. Comparability shall be determined using the same criteria as specified in paragraph (c)(1) of this section;

(3) 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 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 affecting the saleability of such residue gas or gas plant products; or

(4) The use of a net-back method or any other reasonable method to determine value.

(d) Notwithstanding any other provisions 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. This

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

(e)(1) Where the value is determined pursuant to paragraph (c) of this section, that value does not require approval by MMS. However, the lessee shall retain all available data to support its determination of value. Such data shall be subject to review and/or audit by MMS. MMS may direct a lessee to pay royalty at a different value if it determines upon review or audit that the reported value is inconsistent with the requirements of these regulations.

(2) A lessee shall notify MMS if it has determined any value pursuant to paragraph (c)(3) or (c)(4) of this section. The notification shall be by letter to the Associate Director for Royalty Management or his designee. The letter shall identify which valuation method is being used and contain a brief description of the procedure being used.

(f) If MMS determines that a lessee has not properly determined value, the lessee shall be liable for 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 be liable for interest 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 what the value should be, and the lessee may use that value for royalty purposes until MMS issues its determination. The lessee shall submit available data to support its proposal. The MMS shall expeditiously determine the value based upon the lessee's proposal and any additional information MMS deems necessary. 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, for royalty purposes, be less than the gross proceeds accruing, or which could accrue, to the lessee for residue gas and/or any gas plant products, less applicable transportation and processing allowances determined pursuant to this subpart.

(i) The lessee is required to place residue gas and gas plant products in marketable condition at no cost to the Federal Government or Indian lessor. Where the value established pursuant to 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 residue gas or gas plant product in marketable condition.

(j) Value shall be based on the highest price a prudent operator can receive 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, and may be retroactive. If the lessee makes timely application for a price increase 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 until monies or consideration resulting from the price increase are received. This paragraph applies to price increments only and 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, for a quantity of residue gas or gas plant product.

(k) Certain information submitted to MMS to support valuation proposals, including transportation and/or processing allowances, is exempted from disclosure by the Freedom of Information Act, 5 U.S.C. 522. Any data specified by the Act to be privileged, confidential, or otherwise exempt, will be maintained in a confidential manner in accordance with applicable law 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.

§ 206.154 Determination of quantities and qualities for computing royalties.

(a)(1) Royalties shall be computed on the basis of the quantity and quality of unprocessed gas in marketable condition at the point of royalty settlement approved by BLM or MMS for onshore and offshore leases, respectively.

(2) If the value of gas determined pursuant to § 206.152 is based upon a quantity and/or quality that is different from the quantity and/or quality at the point of royalty settlement, as approved by BLM or MMS, that value shall be adjusted for the differences in quantity and/or quality.

(b)(1) For residue gas and gas plant products, the quantity basis for computing royalties due is the monthly net output of the plant even though residue gas and/or gas plant products may be in temporary storage.

(2) If the value of residue gas and/or gas plant products determined pursuant to § 206.153 is based upon a quantity and/or quality of residue gas and/or gas plant products that is different from that which is attributable to a lease determined in accordance with this section, that value shall be adjusted for the differences in quantity and/or quality.

(c) The quantity of the residue gas and gas plant products attributable to a lease shall be determined according to the following procedure:

(1) When the net output of the processing plant is derived from gas obtained from only one lease, the quantity of the residue gas and gas plant products on which computations of royalty are based is net output of the plant.

(2) When the net output of a processing plant is derived from gas obtained from more than one lease, the quantity of residue gas and gas plant products allocable to each lease shall be determined by the lessee in accordance with a generally accepted lease allocation method.

(d)(1) No deductions may be made from the royalty volume or royalty value for actual or theoretical losses. Any actual loss of unprocessed gas that may be sustained prior to the point of royalty settlement approved by BLM or MMS will not be subject to royalty provided that such loss is determined to have been unavoidable by BLM or MMS, as appropriate.

(2) Royalties are due on 100 percent of the volume determined in accordance with paragraphs (a) through (c) of this section. There can be no reduction in that determined volume for actual losses after the quantity basis has been determined or for theoretical losses that are claimed to have taken place. Royalties are due on 100 percent of the value of the unprocessed gas, residue gas and/or gas plant products as provided in this Part, less applicable allowances. There can be no deduction from the value of the unprocessed gas, residue gas, and/or gas plant products to compensate for actual losses after the quantity basis has been determined or for theoretical losses that are claimed to have taken place.

§ 206.155 Accounting for comparison.

(a) Where the lessee, or a person to whom the lessee has transferred gas pursuant to a non-arm's-length contract or no-contract situation, processes the lessee's gas (including where the lessee's arm's-length contract includes a reservation of the right to process the 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 value of the residue gas and gas plant products resulting from processing the gas determined pursuant to § 206.153 (adjusted for any approved processing and/or transportation allowances), plus the value of any condensate recovered downstream of the point of royalty settlement without resorting to processing, or

(2) The value of the gas prior to processing, determined pursuant to § 206.152.

(b) Notwithstanding the provisions of paragraph (a) of this section, the requirement for accounting for comparison contained in the terms of leases, particularly Indian leases, will govern as provided in § 206.150(b).

§ 206.156 Transportation allowances—general.

(a) Where the value of gas has been determined pursuant to § 206.152 or § 206.153 at a point remote from the lease, MMS shall allow a deduction for the reasonable actual costs incurred to transport unprocessed gas, residue gas, and gas plant products from a lease to a *sales point remote from the lease* including, if appropriate, transportation from the lease to a gas processing plant remote from the lease and from the plant to a sales point remote from the plant.

(b)(1) The transportation allowance shall not exceed 50 percent of the value of the unprocessed gas, residue gas, or gas plant product as determined pursuant to § 206.152 or § 206.153 and shall be determined on a selling arrangement basis.

(2) The MMS Director may approve an allowance in excess of the limitation contained in paragraph (b)(1) of this section if the lessee demonstrates that a higher allowance is in the best interests of the lessor. An application for exception shall contain all relevant and supporting data necessary for the Director to make a determination. Under no circumstances shall the Director allow the royalty payment under any selling arrangement to be reduced to zero.

(c) Transportation costs must be allocated among all lease products produced and transported. However, no transportation deduction shall be allowed for lease products that are not royalty-bearing.

(d) If after a review and/or audit it is determined a lessee has improperly determined a transportation allowance authorized by this subpart, then the lessee shall be liable for any additional royalties, plus interest, determined in accordance with 30 CFR § 218.54, or shall be entitled to a credit, without interest.

§ 206.157 Determination of transportation allowances.

(a)(1) *Arm's-length contracts.* For transportation costs incurred by a lessee pursuant to an arm's-length contract, the transportation allowance shall be the reasonable, actual costs incurred by the lessee for transporting the unprocessed gas, residue gas and/or gas plant product under that contract, subject to monitoring, review, audit, and/or adjustment. Such allowances shall be subject to the provisions of paragraph (e) of this section. The MMS's approval is not required before a lessee may deduct costs incurred under an arm's-length contract. However, before any deduction may be taken, the lessee must submit a completed page one of the Form MMS-4295 the same month the transportation allowance first is reported on Form MMS-2014, Report of Sales and Royalty Remittance. This is a one-time filing effective for the entire annual reporting period. The allowance will be denied for any production month for which a Form MMS-4295 is not received prior to, or at the same time as, the Form MMS-2014 for that month.

(2) The transportation allowance determined pursuant to an arm's-length contract shall be effective for a reporting period beginning the month that the lessee is first authorized to deduct a transportation allowance pursuant to paragraph (a)(1) of this section and shall continue for 12 months, or until the applicable contract or rate terminates or is modified or amended, whichever is earlier. At that time, the lessee must resubmit page one of Form MMS-4295 in accordance with paragraph (c) of this section.

(3) If an arm's-length transportation contract includes more than one lease product in a gaseous phase and the transportation costs attributable to each product cannot be determined from the contract, then the total transportation costs shall be allocated in a consistent and equitable manner to each of those transported lease products in the same proportion as the ratio of the volume of each product (including water vapor) to the volume of all lease products in the gaseous phase. The MMS will not give an allowance for transporting any lease product which is not royalty-bearing.

(4) If an arm's-length transportation contract includes lease products in both gaseous and liquid phases, and the transportation costs attributable to each cannot be determined from the contract, the lessee shall propose an allocation procedure to MMS. The lessee may use its proposed allocation procedure until MMS issues its determination on the acceptability of the cost allocation. The lessee shall submit all available data to support its proposal. The initial proposal must be submitted by *[insert 60 days after effective date of final rule]* or within 60 days after the lessee begins the transportation, whichever is later (unless MMS approves a longer period). The MMS shall then determine the transportation allowance based upon the lessee's proposal and any additional information MMS deems necessary. The lessee shall be required to adjust its royalty reports to the extent the approved allowance is different from the proposal. The lessee shall be required either to pay additional royalties, plus interest, or shall be entitled to a credit without interest.

(5) Where the lessee's payments for transportation under an arm's-length contract are not based on a dollar basis, the lessee shall convert whatever consideration is paid to a dollar value equivalent.

(6) MMS may require that a lessee submit arm's-length transportation contracts and related documents. Documents shall be submitted within a reasonable time, as determined by MMS.

(b)(1) *Non-arm's-length contract or no contract.* If a lessee has a non-arm's-length contract or has no contract, including those situations where the lessee performs transportation services for itself, the transportation allowance will be based upon the lessee's reasonable, actual costs as determined by this subpart. All transportation allowances deducted under a non-arm's-length or no-contract situation are subject to future monitoring, review, and/or audit. For non-arm's-length contract or no-contract situations, prior MMS approval of transportation allowances is not required. The MMS will monitor, review, and/or audit the allowance deductions to ensure that deductions are reasonable and allowable. The MMS may direct a lessee to adjust its allowance when necessary or appropriate.

(2) A transportation allowance for unprocessed gas, residue gas, or gas plant products determined pursuant to a non-arm's-length contract or a no-

contract situation shall be effective for a reporting period beginning the month that the lessee first is authorized to deduct a transportation allowance and shall continue for 12 months, or until the non-arm's-length contract terminates or the no-contract transportation terminates, whichever is earlier. The lessee shall submit a completed page one of Form MMS-4295 the same month the transportation allowance first is reported on Form MMS-2014, Report of Sales and Royalty Remittance. This is a one-time filing effective for the entire annual reporting period. The allowance will be denied for any production month for which a Form MMS-4295 is not received prior to, or at the same time as, the Form MMS-2014 for that month. As provided in § 206.157(c), at the end of the 12-month period, or after the non-arm's-length contract or no-contract transportation terminates, the lessee shall submit a completed page one of Form MMS-4295 containing the actual costs for the previous reporting period. If unprocessed gas, residue gas, or gas plant product transportation is continuing, the lessee shall include on page one of Form MMS-4295 its estimated costs for the next reporting period.

(3) For unprocessed gas, residue gas or gas plant product transportation allowances authorized by this paragraph, a lessee may deduct the transportation allowance that it has determined, subject to review and audit by MMS.

(4) For new transportation facilities, the lessee's initial page one of Form MMS-4295 shall include estimates of the allowable costs for the applicable period. Cost estimates shall be based upon the most recently available operations data for the transportation facility or, if such data are not available, the lessee shall use estimates based upon industry data for similar transportation systems.

(5) The transportation allowance for non-arm's-length or no-contract situations shall be based upon the lessee's actual costs for transportation, including operating and maintenance expenses, overhead, [depreciation], and a return on [undepreciated] capital investment. The transportation allowance shall be based upon actual costs incurred during the 12-month reporting period.

(i) Allowable operating expenses include: Operations supervision and engineering; operations labor; fuel; utilities; materials; ad valorem property taxes; rent; supplies; and any other directly allocable and attributable operating expense which the lessee can document.

(ii) Allowable maintenance expenses include: Maintenance of the transportation system; maintenance of equipment; maintenance labor; and other directly allocable and attributable maintenance expenses which the lessee can document.

(iii) Overhead directly attributable and allocable to the operation and maintenance of the transportation system is an allowable expense. State and Federal income taxes and severance taxes and other fees, including royalties, are not allowable expenses.

Alternative 1

(iv) To compute depreciation, the lessee may elect to use either a straight-line depreciation method or a unit of production method based on the life of equipment or the life of the reserves which the transportation system services. After an election is made, the lessee may not change methods without MMS approval. A change in ownership of a transportation system shall not alter the depreciation schedule established by the original transporter/lessee for purposes of the allowance calculation. With or without a change in ownership a transportation system shall be depreciated only once. Equipment shall not be depreciated below a reasonable salvage value.

Alternative 2

(iv) MMS shall allow as a cost an amount equal to the initial capital investment in the transportation system multiplied by a rate of return determined pursuant to paragraph (b)(5)(v) of this section. No allowance shall be provided for depreciation.

(v) The rate of return on [undepreciated] capital investment shall be the Moody Aaa corporate bond rate as published by Moody's Investors Service, Inc. in *Moody's Bond Record* on the first business day of the reporting period for which the allowance is applicable. This rate will be effective during the entire reporting period. The rate shall be redetermined at the beginning of each subsequent reporting period.

(6) The deduction for transportation costs shall be determined based upon the lessee's cost of transporting each lease product through each transportation system. Where more than one lease product in a gaseous phase is transported, then the total transportation costs shall be allocated in a consistent and equitable manner to each of those lease products in the same proportion as the ratio of the volume of each product (including water vapor) to the volume of all lease products in the gaseous phase. The MMS will not give an allowance for transporting a lease product which is not royalty-bearing.

(7) Where both gaseous and liquid products are transported through the same transportation system, the lessee shall propose a cost allocation procedure to MMS. The lessee may use the transportation allowance determined in accordance with its proposed allocation procedure until MMS issues its determination on the acceptability of the cost allocation. The lessee shall submit all available data to support its proposal. The initial proposal must be submitted within [*insert 60 days after effective date of final rule*] or within 60 days after the lessee begins the transportation, whichever is later (unless MMS approves a longer period). The MMS shall then determine the transportation allowance based upon the lessee's proposal and any additional information MMS deems necessary. If the allowance determined by MMS is different from the proposed allowance, the lessee shall be required to pay any additional royalty, plus interest, or shall be entitled to a credit, without interest.

(8) Upon request by MMS, the lessee shall submit all data used by the lessee to prepare its Form MMS-4295, including estimates and actuals. The data shall be provided within a reasonable period of time, as determined by MMS.

(c)(1) Reporting requirements. After the initial reporting period, for succeeding reporting periods, lessees shall submit page one of Form MMS-4295 on an annual basis. Form MMS-4295 must be received by MMS within 90 days after the end of the previous reporting period unless MMS approves a longer period. If page one of Form MMS-4295 is not received timely, then the allowance requested will not be effective until the first day of the month in which the Form MMS-4295 is received, and will be applicable only to any Form MMS-2014, Report of Sales and Royalty Remittance, received after that date. The lessee will be required to refund, with interest, any unauthorized allowance which it has taken.

(2) Each individual transportation allowance must be reported as a separate line on the Report of Sales and Royalty Remittance, Form MMS-2014.

(3) MMS may establish reporting dates for individual leases different from those specified in this subpart in order to provide more effective administration. Lessees will be notified of any change in their reporting period.

(d)(1) Adjustments. If the actual transportation allowance is less than the amount the lessee has estimated and

taken during the reporting period, the lessee shall be required to pay additional royalties due plus interest computed pursuant to 30 CFR 218.54, retroactive to the first month the lessee is authorized to deduct a transportation allowance. If the actual transportation allowance is greater than the amount the lessee has estimated and taken during the reporting period, the lessee shall be entitled to a credit without interest.

(2) For lessees transporting production from onshore Federal and Indian leases, the lessee must submit a corrected Form MMS-2014, together with any payment, in accordance with instructions by MMS to reflect actual costs.

(3) For lessees transporting production from leases on the OCS, if the lessee's estimated costs were more than the actual costs, the lessee must submit a corrected Form MMS-2014, together with its payment, in accordance with instructions provided by MMS to reflect actual costs. If the lessee's estimated costs were less than its actual costs, the lessee must submit a written request for refund in accordance with *section 10 of the Outer Continental Shelf* Lands Act, as amended, 43 U.S.C. 1339(a).

(e) Notwithstanding any other provisions of this subpart, no cost shall be allowed for unprocessed gas, residue gas or gas plant product transportation which results from payments for actual or theoretical losses.

(f) Other transportation cost determinations. The provisions of this section shall apply to determine transportation costs when establishing value using a net back valuation procedure or any other procedure that requires deduction of transportation costs.

§ 206.158 Processing allowances—general.

(a) When the value of gas is determined pursuant to § 206.153, a deduction shall be allowed for the reasonable actual costs of processing.

(b) Processing costs must be allocated among the gas plant products. A separate processing allowance must be determined for each gas plant product and processing plant relationship. NGL's shall be considered as one product.

(c)(1) The processing allowance shall not exceed 66⅔ percent of the value of each of the gas plant products as determined pursuant to § 206.153, less any applicable transportation allowances determined pursuant to §§ 206.156 and 206.157. Where there are multiple selling arrangements for any individual gas plant product, the transportation allowance reduced values (values at the tailgate of the plant) for each selling arrangement shall be summed for the purposes of applying the 66⅔ percent processing allowance limitation. The processing allowance shall not be applied against the value of the residue gas. Where there is no residue gas, the lessee shall propose, for MMS approval, an appropriate gas plant product against which no allowance may be applied.

(2) The MMS Director may approve an allowance in excess of the limitation contained in paragraph (c)(1) of this section if the lessee demonstrates that a higher allowance is in the best interests of the lessor. An application for exception shall contain all relevant and supporting data necessary for the Director to make a determination. Under no circumstances shall the Director permit the processing allowance for any gas plant product to exceed the value of such product determined pursuant to § 206.153, less any applicable transportation allowance determined pursuant to §§ 206.156 and 206.157.

(d) No processing cost deduction shall be allowed for the costs of placing lease products in marketable condition, including dehydration, separation, compression, or storage, even if those functions are performed off the lease or at a processing plant. Where gas is processed for the removal of acid gases, commonly referred to as "sweetening," no processing cost deduction shall be allowed for such costs unless the acid gases removed are further processed into a gas plant product and ultimately sold. In such event, the lessee shall be eligible for a processing allowance as determined in accordance with this subpart.

(e) If MMS determines that a lessee has improperly determined a processing allowance authorized by this subpart, then the lessee shall be liable for any additional royalties, plus interest, determined in accordance with 30 CFR 218.54, or shall be entitled to a credit, without interest.

§ 206.159 Determination of processing allowances.

(a)(1) *Arm's-Length contracts.* For processing costs incurred by a lessee pursuant to an arm's-length contract, the processing allowance shall be the reasonable actual costs incurred by the lessee for processing the gas under that contract, subject to monitoring, review, and/or audit and adjustment. Prior MMS approval is not required before a lessee may deduct costs incurred under an arm's-length contract. However, before any deduction may be taken, the lessee must submit a completed page one of Form MMS-4109 the same month the processing allowance first is reported on Form MMS-2014, Report of Sales and Royalty Remittance. This is a one-time filing effective for the entire reporting period. The allowance will be denied for any production month for which a form MMS-4109 is not received prior to, or at the same time as, the Form MMS-2014 for that month.

(2) The processing allowance determined pursuant to an arm's-length contract shall be effective for a reporting period beginning the month that the lessee is first authorized to deduct a processing allowance pursuant to paragraph (a)(1) of this section and shall continue for 12 months, or until the applicable contract terminates or is modified or amended, whichever is earlier. At that time, the lessee must resubmit page one of Form MMS-4109 in accordance with paragraph (c) of this section.

(3) If an arm's-length processing contract includes more than one gas plant product, and if the processing costs attributable to each product can be determined from the contract, then the processing costs for each gas plant product shall be determined in accordance with the contract. The MMS will not grant an allowance for processing lease products which are not royalty-bearing.

(4) If an arm's-length processing contract includes more than one gas plant product and the processing costs attributable to each product cannot be *determined from the contract, the lessee* shall propose an allocation procedure to MMS. The lessee may use its proposed allocation procedure until MMS issues its determination. The lessee shall submit all available data to support its proposal. The initial proposal must be submitted by [*insert 60 days after effective date of final rule*] or within 60 days after the lessee begins the processing, whichever is later (unless MMS approves a longer period). The MMS shall then determine the processing allowance based upon the lessee's proposal and any additional information MMS deems necessary. The lessee shall be required to adjust its royalty reports to the extent the approved allowance differs from the proposal. The lessee shall be required to pay any additional royalties, plus interest, or shall be entitled to a refund, without interest.

(5) Where the lessee's payments for processing under an arm's-length contract are not based on a dollar basis, the lessee shall convert whatever consideration is received to a dollar value equivalent.

(8) MMS may require that a lessee submit arm's-length processing contracts and related documents. Documents shall be submitted within a reasonable time, as specified by MMS.

(b)(1) *Non-arm's-length or no contract.* If a lessee has a non-arm's- length contract or has no contract, including those situations where the lessee performs processing for itself, the processing allowance will be based upon the lessee's reasonable, actual costs. For all processing allowances deducted under non-arm's-length or no-contract situations, MMS approval of processing allowances is not required. All processing allowances deducted under a non-arm's-length or no-contract situation are subject to future review and audit. The MMS will review and/or audit the allowance deductions to ensure that deductions are reasonable and allowable. The MMS may direct a lessee to adjust its allowance when necessary or appropriate.

(2) A gas processing allowance determined pursuant to a non-arm's-length contract or a no-contract situation shall be effective for a reporting period beginning the month that the lessee first is authorized to deduct a processing allowance and shall continue for 12 months, or until the non-arm's-length contract or the no-contract processing terminates, whichever is earlier. The lessee shall submit a completed Form MMS-4109 the same month the processing allowance first is reported on Form MMS-2014. This is a one-time filing, effective for the entire reporting period. The allowance will be denied for any production month for which a Form MMS-4109 is not received prior to, or at the same time as, the Form MMS-2014 for that month. As provided in § 206.159(c), at the end of the 12-month period, or after the non-arm's-length contract or no-contract processing terminates, the lessee shall submit a Form MMS-4109 completed in its entirety with accompanying schedules containing the actual costs for the previous reporting period. If gas processing is continuing, the lessee shall include on Form MMS-4109 its estimated costs for the next reporting period.

(3) For new processing plants, the lessee's initial Form MMS-4109 shall include estimates of the allowable processing costs for the applicable period. Cost estimates shall be based upon the most recently available operations data for the processing plant, or if such data are not available, the lessee shall use estimates based upon industry data for similar processing plants.

(4) The processing allowance for non-arm's-length or no-contract situations shall be based upon the lessee's actual costs for processing, including operating and maintenance expenses, overhead, [depreciation], and a return on [undepreciated] capital investment. The processing allowance shall be based upon actual costs incurred during the 12-month reporting period.

(i) Allowable operating expenses include: Operations supervision and engineering; operations labor; fuel; utilities; materials; ad valorem property taxes; rent; supplies; and any other directly allocable and attributable operating expense which the lessee can document.

(ii) Allowable maintenance expenses include: Maintenance of the processing plant; maintenance of equipment; maintenance labor; and other directly allocable and attributable maintenance expenses which the lessee can document.

(iii) Overhead directly attributable and allocable to the operation and maintenance of the processing plant is an allowable expense. State and Federal income taxes and severance taxes, including royalties, are not allowable expenses.

Alternative 1

(iv) To compute depreciation, the lessee may elect to use either a straight-line depreciation method or a unit of production method based on the life of equipment or the life of the reserves which the processing plant services. After an election is made, the lessee may not change methods without MMS approval. A change in ownership of a processing plant shall not alter the depreciation schedule established by the original processor/lessee for purposes of the allowance calculation. With or without a change in ownership, a processing plant shall be depreciated only once. Equipment shall not be depreciated below a reasonable salvage value.

Alternative 2

(iv) MMS shall allow as a cost an amount equal to the initial capital investment in the processing plant multiplied by a rate of return determined pursuant to paragraph (b)(4)(v) of this section. No allowance shall be provided for depreciation.

(v) The rate of return on [undepreciated] capital investment shall be the Moody Aaa corporate bond rate as published by Moody's Investors Service, Inc. in *Moody's Bond Record* on the first business day of the reporting period for which the allowance is applicable. This rate shall be effective during the reporting period. The rate shall be redetermined at the beginning of each subsequent reporting period.

(5) The processing allowance for each gas plant product shall be determined based on the lessee's reasonable and actual cost of processing the gas. Allocation of costs to each gas plant product shall be based upon generally accepted accounting principles.

(c)(1) *Reporting requirements.* After the initial reporting period, for succeeding reporting periods, lessees shall submit Form MMS-4109 completed in its entirety with accompanying schedules (or page one of Form MMS-4109 for arm's-length contracts) on an annual basis. Form MMS-4109 must be received by MMS within 90 days after the end of the previous reporting period, unless MMS approves a longer period. If the Form MMS-4109 is not received timely, then the processing allowance requested will not be effective until the first day of the month in which the Form MMS-4109 is received, and will be applicable only to any Form MMS-2014 received after that date. The lessee will be required to refund, with interest, any unauthorized allowance which it has taken.

(2) Each individual processing allowance must be reported as a separate line on the Report of Sales and Royalty Remittance, Form MMS 2014.

(3) MMS may establish reporting dates for individual leases different from those specified in this subpart in order to provide more effective administration. Lessees will be notified of any change in their reporting period.

(d) *Adjustments.* (1) If the actual processing allowance is less than the amount the lessee has estimated and taken during the reporting period, the lessee shall be required to pay additional royalties due, plus interest, computed pursuant to 30 CFR 218.54, retroactive to the first month the lessee is authorized to deduct a processing allowance. If the actual processing allowance is greater than the amount the lessee has estimated and taken during the reporting period, the lessee shall be entitled to a credit without interest.

(2) For lessees processing production from onshore Federal and Indian leases, the lessee must submit a corrected Form MMS-2014, together with any payment, in accordance with instructions provided by MMS, to reflect actual costs.

(3) For lessees processing production from OCS leases, if the lessee's estimated costs were more than the actual costs, the lessee must submit a corrected Form MMS-2014, together

with its payment, in accordance with instructions provided by MMS, to reflect actual costs. If the lessee's estimated costs were less than its actual costs, the lessee must submit a written request for refund in accordance with section 10 of the Outer Continental Shelf Lands Act, as amended, 43 U.S.C. 1339(a).

(e) *Other processing cost deductions.* The provision of this section shall apply to determine processing costs when establishing value using a net-back procedure or any other procedure that requires deduction of processing costs.

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