number of people who wish to present information. Parties representing similar interests may be asked to combine information and to choose one member to present that information. Written presentations can be submitted in lieu of oral remarks. Participants will be contacted during the week of August 3 with times of presentations.

Authority: Sec. 1006(e), Pub. L. 101-380.

Dated: May 27, 1992.

Thomas A. Campbell,

General Counsel, National Oceanic and Atmospheric Administration.

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DEPARTMENT OF THE INTERIOR

Minerals Management Service

30 CFR Part 202

RIN 1010-AB57

Valuation of Gas Production Under Unitization or Communitization Agreements

AGENCY: Minerals Management Service (MMS), Interior.

ACTION: Advance notice of proposed rulemaking.

SUMMARY: Pursuant to the Federal Oil and Gas Royalty Management Act of 1982 (30 U.S.C. 1701), the Royalty Management Program (RMP) of the Minerals Management Service (MMS) is considering amendments to its regulations regarding the valuation of gas produced from federal and Indian leases that are committed to a federally approved unitization or communitization agreement. The primary concern is the basis for royalty evaluation in cases where a lessee takes and sells less or in some cases more than its full entitled share of production. An associated issue involves the parties responsible for reporting and paying royalties on a lease, particularly in cases where lessees are taking and selling volumes different than their entitled share of agreement production.

This notice describes seven alternatives for rule changes in these areas and solicits comments on these and any other alternative approaches to valuation and reporting of gas production from unitization or communitization agreements.

DATES: Comments must be received on or before July 16, 1992.

ADDRESSES: Written comments, suggestions, or objections regarding alternative valuation and reporting methods should be mailed to the Minerals Management Service, Royalty Management Program, Rules and Procedures Branch, Mail Stop 3910, P.O. Box 25165, Denver, Colorado 80225-0165, Attention: Dennis C. Whitcomb.

FOR FURTHER INFORMATION CONTACT: Dennis C. Whitcomb, Chief, Rules and Procedures Branch at (303) 231-3432 or (FTS) 326-3423.

SUPPLEMENTARY INFORMATION:

I. Background

Unitization and communitization agreements are entered into for the purpose of exploring and developing oil and gas reservoirs in an orderly and unified manner. These agreements are normally entered into for the conservation of natural resources, the assurance of the maximum recovery of the resource, the prevention of the drilling of unnecessary wells, and the protection of correlative rights. Under these agreements, the costs and benefits of development and production are shared by the working-interest owners. The method of determining each working-interest owner's proportionate share of the costs and benefits is governed by an operating agreement. When Federal or Indian lands are involved, the Department of the Interior must approve the unitization or communitization agreement. The Department does not, however, approve the operating agreement.

One of the most important aspects of the Department's approval of the agreement is the allocation of production for royalty purposes. Allocation of production to the leases committed to the agreement may be based upon surface acreage, net acre-feet of original gas in place, or other criteria. Depending upon the agreement, the allocation may be fixed for the life of the agreement or it may change as the productive area within the agreement expands or contracts. Production from any location in the agreement area is deemed to have been produced proportionally from all of the leases. Thus, each individual lease in the agreement area is allocated a proportionate share of the agreement area's total production regardless of whether production physically occurs on the lease. One reason for this condition is that some individual leases within the agreement may not contain any producing wells, therefore, the volume of production removed from the lease must be determined by a means other than production from wells physically located thereon.

In the early to mid-1980's, market imbalances created situations where many working-interest owners in an agreement were unable or unwilling to sell their proportionate share of agreement production. Although the working-interest owners are generally able to agree among themselves how to balance their interests over the life of the reservoir, the interests of the lessors and other royalty interest owners are interpreted in various ways by the different working-interest owners. For example, some working-interest owners that do not take any production contend that their lessor is not entitled to any royalty for that month. Others that take no production contend that their lessor is entitled to royalty that month, but that the party actually taking the production is responsible for the royalty payment.

MMS has attempted to state clearly its position on reporting, paying, and valuation by addenda and revisions to its Payor Handbook and letters to payors. The MMS also establish specific requirements in gas valuation regulations that were published on January 15, 1988 (53 FR 1230).

The January 1988 regulations specified that when the lessee of any lease committed to a federally approved unitization or communitization agreement does not actually take the proportionate share of the production attributable to its Federal or Indian lease under the terms of the agreement, the full share of production attributable to the lease under the terms of the agreement is still subject to the royalty payment and reporting requirements of the regulations. This rule is consistent with previous practice. The value for royalty purposes of this production must be determined in accordance with the standard valuation rules found at 30 CFR part 206. The circumstances involved in the actual disposition of that part of the production to which the lessee was entitled, whether or not taken, control the determination of the value for royalty purposes of that volume of production from the unit. For example, production taken and sold by parties other than the lessee would be valued on the basis of gross proceeds accruing to those other parties if the production was sold under an arm's-length contract (see 30 CFR 206.152(b)(1)(1)). The January 1988 regulations addressed only the issue of the value of the production for royalty purposes. The regulations did not address which party was responsible for paying and reporting royalties.

The January 1988 regulations also outlined which parties would be viewed as taking the part of production to which the federal or Indian lessee was entitled but did not take (30 CFR 202.150(e)(3)). A provision of these requirements

specified that the value determined by the value of the production sold by parties other than the lessee, and the royalties paid thereon, would not be affected if the lessee subsequently took more than its proportionate share to balance its account or was paid a sum of money by the other agreement participants to balance its account. The method of determining value based on the dispositions of the volume determined to be taken from Federal or Indian leases became known as the "tracing method."

In response to public comments on the proposed rulemaking for valuation of gas production (see 52 FR 4732, February 13, 1987), two provisions were included in the final rulemaking (see 53 FR 1230, January 15, 1988) to allow a lessee to request MMS approval of an alternative valuation method. One provision allows an individual lessee to request an alternate valuation method for that part of the production to which it was entitled but did not take (30 CFR 202.150(e)(2)). The other provision allows for alternate valuation methods for all production attributable to Federal or Indian lands in an agreement (30 CFR 202.150(f)). Approval of an alternate method under both of these provisions is subject to limitations.

II. Experience Under the Current Regulations

Since the issuance of the current valuation regulations in January 1988, many lessees have expressed concerns over the royalty valuation and reporting requirements for agreements which may contain many leases and involve hundreds of working-interest owners. One often-expressed view is that many lessees have difficulty complying with the "tracing method" because many sellers are reluctant to share pricing information claiming concern that they may thereby violate antitrust laws and/ or damage their own competitive position. Another concern is that the time involved in following the tracing method prevents accurate and timely remittance of royalties.

It is common for agreement production to be sold under several contracts by several sellers with the volume of production sold under any given contract varying from month to month. The production sold under a given contract may or may not be identified in the contract as originating from any particular lease; therefore, it is difficult to determine from which lease(s) each selling party delivered gas until the final allocation to each seller is received from transporting pipeline(s) and the purchasers.

The provisions of the current rule which allow lessees to submit an alternative valuation proposal (30 CFR 202.150(e)(2) and (f)) have been satisfied only in isolated cases. The only alternative valuation proposals so far approved by MMS have involved Outer Continental Shelf leases with the same royalty rate and funds distribution and onshore leases within one field in Wyoming.

Most lessees are not able to comply with one or both of the provisions of these rules. Specifically, under 30 CFR 202.150 (e)(2), most proposals involve jointly held leases and do not assure that royalties for a lease will be paid based on a value that is not less than the gross proceeds accruing to the lessee. This stems from MMS viewing the term "lessee" as collectively including all working interest owners in the lease. Under 30 CFR 202.150 (f), the alternative proposal must: (1) Give all persons, to the extent practical, with an interest in the agreement the opportunity to comment on the proposal; and (2) have the consent of all persons, to the extent practical, with committed Federal or Indian lease interests in the agreement. The MMS has been advised by lessees that obtaining the cooperation of all pertinent interest owners is very burdensome for lessees where large or complicated agreements are involved.

A group of 13 major oil and gas companies with common concerns submitted an alternative valuation method to MMS in May 1989 for the valuation of all of their onshore and offshore agreement production. These companies proposed that each lessee would report and pay royalties on the basis of the full amount of production to which each was entitled. Each lessee would pay royalties for the part of production taken, up to its entitled share for the lease, and the value would be based on the actual disposition of that part. The proposal differs from the current rule for the part of production not taken by the lessee. In the proposal, the value of that part would be based on an option that "best represents comparable value at the lease." Using this method, the lessee would be able to choose any one of the following options: (1) The lessee's own weighted-average sales price based on gross proceeds received for sale of production from the same agreement; (2) the lessee's own weighted-average price based on gross proceeds received from sales under comparable contract(s) in the same field/area, adjusted for applicable allowances; or (3) representative published spot-market prices (Clearinghouse, Natural Gas Week, etc.), adjusted for location and applicable allowances. Regardless of how or by whom the production was disposed, royalties would always be paid on the volume of production each lessee was entitled to take from the lease at one of these values.

This proposal could lead to an inconsistency with the current valuation regulations, which required that value for royalty purposes must at least be equal to the gross proceeds accruing to the lessee.

Assume that one Federal lease, with two interest owners, "A and B," was committed to an agreement. One of the interest owners in the Federal lease, "A," takes less than its entitled share of unit production and the other owner, "B," takes more than its share of unit production. However, the total taken by both equals the portion of unit production attributable to the lease based on the approved allocation schedule. Payment of royalties by "A" using its contract price could lead to royalties calculated on less than the gross proceeds accruing to the lessee if the value was less than the actual sales price of "B." Although this proposal would solve a number of the previously described problems for the lessees under current regulations, it is in violation of gross proceeds requirement of the current regulations. Industry's proposal did, however, suggest to MMS that regulatory changes should be considered.

III. Discussion

The MMS is considering proposing an amendment to the procedure for valuing all agreement production. The MMS believes that a preferred valuation methodology for agreement production must be: (1) Consistent in spirit with the long-standing principle that royalties are paid on not less than gross proceeds; (2) based upon criteria that apply in priority order; (3) reflective of market value; (4) able to produce a royalty payment stream consistent with the agreement terms; (5) based on information available to the lessee; and (6) flexible enough to accommodate unique situations or situations where the interest owners may agree to an alternative more appropriate to their circumstances. Lessees are mainly concerned that the methodology used is practical. Both lessees and lessors are concerned that the methodology results in a value that equals or closely reflects actual revenues received from the sale of agreement production.

Several alternatives for solving the above described problems with the

current rules have been considered by MMS. The MMS is providing a description of these alternatives in this notice for the purpose of inviting specific comments on the viability of each alternative. None of the alternative fully meet the above criteria which are desired for valuation purposes. The MMS wishes to emphasize, however, that the alternatives for consideration are not to be limited to the methods listed herein. Therefore, MMS solicits comments that include any other possible valuation and reporting methodologies.

In November 1989, the aforementioned industry group resubmitted a revised alternative valuation proposal to MMS. This revised proposal, which is now supported by 18 large oil and gas companies, has been incorporated, in part, into the alternatives described in this notice.

IV. Description of Alternatives

The MMS invites specific comments on the following seven alternatives that MMS is currently considering for regulation of valuation and reporting of gas produced and sold from federally approved unitization and communitization agreements:

1. Benchmarked Entitlements

Under this method, each lessee's entitled share of monthly agreement production would be equal to its ownership interest in the tract times the tract allocation percentage under the agreement. The value of the lessee's entitled share would be determined in accordance with 30 CFR part 206 of that part, or all, of the lessee's entitled share actually disposed of by the lessee.

For any part to which the lessee was entitled but did not take, the value for royalty purposes would be determined in accordance with the first applicable of the following:

—If the lessee disposes of production from the same lease, the weighted average of the values determined under 30 CFR part 206 for those dispositions.

—If the lessee does not take any of its entitled share from the lease, but the lessee disposes of production attributable to other leases in the agreement, then the value would be the weighted average of values determined by applying 30 CFR part 206 valuation methods to each disposition of like-quality production sold by the lessee from the same agreement (including non-Federal/Indian lease production).

—If the lessee does not dispose of production attributable to other leases in the agreement, then the value would be equivalent to the weighted-average value determined by applying the requirements of 30 CFR part 206 to each disposition of like-quality production by the lessee under comparable contracts in the same field or area; or

—A value determined by consideration of representative published spot-market prices, adjusted for location and applicable allowances.

The valuation provisions of this alternative are structured to allow the lessee(s) to determine royalties due without knowledge of other lessee's prices. Because the royalties are still due on actual unit volumes, the lessee must still know the volume taken by all members of the unit. The main disadvantage of this alternative is that it does not base royalties on gross proceeds actually accruing for the sale of the production.

With respect to the responsibility for royalty reporting/payment, MMS requests comments on whether the working interest owners in a Federal or Indian lease committed to an agreement should be required to designate one or, at most, two parties to be responsible for the payment of royalties on the proportionate share of the agreement production attributable to that lease.

2. Advanced Minimum Payments

Each lessee's entitled share of agreement production would be equal to its ownership interest in the tract times the tract allocation percentage under the agreement. The value of all of the lessee's entitled share would be determined in accordance with 30 CFR part 206, whether actually disposed of by the lessee or other party.

—Lessees that take more than their entitled share would report/pay royalties only on their entitled share.

—Lessees that do not take production or take less than their entitled share would be required to pay a minimum "advance" royalty based on the entitled amount. Value would either be estimated or be the lowest price of any of the lessee's contracts on the lease or unit or the lowest published comparable price in the region. When the gas is later taken (made up), or the lessee is otherwise compensated, that "advance" royalty payment would be credited to the lessee and, if the actual gross proceeds accruing to the lessee were greater than the amount of advance royalty paid, the lessee would be required to pay additional royalties on the difference. Late payment interest would not be required.

Similar to the "benchmarked entitlements" alternative, the valuation provisions of this alternative are structured to allow the lessee(s) to determine royalties due without knowledge of other lessee's prices. However, with respect to the responsibility of royalty reporting/payment, MMS requests comments on whether the working-interest owners in a Federal or Indian lease committed to an agreement should be required to designate one or, at most, two parties to be responsible for the payment of royalties on the proportionate share of the agreement production attributable to the lease.

3. Pure Takes

A pure takes royalty system would have each lessee, or its agent, paying only when the lessee removes or sells production on its own account, or when some other party that has removed or sold production to which the lessee was entitled settles with the lessee by transferring money or other consideration to the lessee. Working-interest owners would report and pay royalties only on their own leases. Value would be determined as provided in 30 CFR part 206. Under this method, each lessee's ownership share would equal its taken share.

For onshore leases, this alternative may include a requirement for agreement production—and associated royalties—to be balanced annually for royalty purposes among all involved leases so that outstanding royalty liabilities could be periodically met. The MMS recognizes that a change to a pure takes royalty system basis for onshore leases may change the timing of royalty payments, so that a lessor may not receive royalty on its share of the production when the gas is removed from the unit.

4. Operator as Single Payor

All parties to the agreement would designate the operator as the party responsible for all reporting and paying. The operator would be required to submit Payor Information Forms (Form MMS-4025) and Reports of sales and Royalty Remittance—Oil and Gas (Form MMS-2014) for each transaction for each working-interest owner. For this alternative, the current valuation rules would be coupled with the requirement that the taking party, whether or not a Federal or Indian lessee, provide information to the operator to enable the operator to correctly pay and report information to MMS. This alternative, therefore, would not require any deviation from the gross-proceeds

requirement. However, the operator would be responsible for valuing the production correctly under the requirements of 30 CFR part 206.

5. Modified Takes

Each working-interest owner would be required to submit a Payor Information Form for each Federal and Indian lease in agreement. When a working-interest owner sells more production from the agreement than it is entitled to, and the overtaken volume is attributed to particular Federal or Indian leases, that working-interest owner would report and pay royalties on that lease at that lease's royal rate. Because the overtaken volume would still be determined in the manner required under 30 CFR part 206, this method would not alleviate the necessity of tracing to determine overtaken and undertaken volumes. The advantage of this method would be that the working-interest owner would not be required to obtain sales price information from other parties. The disadvantage of this method is that it requires non-Federal lessees to pay royalties to the Federal or Indian lessor when they have no privity of contract.

6. Entitlements With MMS Billing

Under this alternative, the working-interest owner taking more than an entitled share would report sales information to MMS and MMS would bill the appropriate party for royalties due. In other words, MMS would be responsible for tracing the volumes and values of overtaken production. The MMS is interested in comments on any system where working-interest owners and taking parties would report sufficient informtion timely to enable MMS to bill for appropriate royalties. The MMS understands that this system requires non-Federal or Indian lessees that are joint unit owners with a Federal or Indian lessee to report price and quantity and selling arrangement information to the MMS.

7. Weighted-Average Price Received for All Agreement Production.

This method would use a weighted-average price for all unit production which would require knowledge of all sales volumes and prices by all payors. Although this is one of the drawbacks to the current rules, this method would not require tracing of the volumes to individual leases. One variation of the weighted-average method is the so-called "Unit Allocation Method." Although this method results in royalties equal to the weighted-average method, each selling party pays royalty for each Federal and Indian lease in the agreement. The royalty paid for each lease is determined by multiplying the tract allocation factor by the royalty rate of the lease, and then applying this result to the value of the production actually sold by each selling party. With each selling party remitting royalties for every lease, sharing of pricing information is avoided. However, the acceptability of the values received must be determined under the requirements of 30 CFR partg 206.

V. Request for Public Comments

The potential regulatory changes in the alternatives discussed above will affect the royalties reported to MMS on about 66 percent of the gas revenue sources reported on MMS's Auditing and Financial System. The MMS is considering these changes with the intention of making the administration of the data collection, reporting and payment, and auditing of mineral royalties easier for both MMS and industry, while assuring Indian tribal and allotted lessors as well as States sharing in Federal lease receipts, that values reflect sales prices actually being paid in the area of production at the time of production. Because the alternatives would apply to a large portion of the royalties collected, MMS specifically requests commenters to address the impact of the new procedure on both royalty valuation and royalty revenue and the associated administrative costs. Commenters should also consider the extent of MMS's responsibilities to promptly report and pay royalties to Indian lessors and how each alternative affects that responsibility.

Since the current valuation regulations on gas valuation (see 53 FR 1230, January 15, 1988) were effective March 1, 1988, MMS requests coments on whether any amendment should be made effective retroactive to that date.

The MMS also requests that commenters consider combinations of alternatives that would be applied for different land categories. For example, an alternative that included "pure takes" for offshore and onshore Federal leases and "modified takes" for onshore Federal and Indian leases may be preferred by some commenterrs. The MMS seeks comments on how alternative valuation and reporting scenarios could be designed for agreement production associated with the following categories:

1. Offshore leases;
2. Offshore 8(g) leases;
3. Onshore Federal leases;
4. Indian leases; and
5. Indian leases in agreements with Federal leases.

There are also several procedural matters on which MMS seeks public comment. The MMS specifically requests comments on whether the use of the terminology "field or area" shoulld be replaced by "field or nearby field" to better establish which of the lessee's transactions would be used in valuing the lessee's undertakes. The MMS requests specific comments on any difficulties that may be as resulting from application of these rules when the values to be used are based upon gas that is processed, or when the lessee has dispositions involving both processed and unprocessed gas. It is requested that commenters address whether a particular pricing publication should be identified and if any requirements can be set to govern the adjustment of spot prices for location and applicable allowances. Finally, MMS would like comments on what financial and administrative effects the proposed changes may have on lessees, particularly smaller independents. Commenters are requested to provide specific suggestions for proposed changes to existing regulatory language.

The MMS recognizes that some of the alternatives could be viewed as a deviation from the Department's historical practice of using gross proceeds as the minimum requirement for value. In order to evaluate the significance of this deviation, MMS is also seeking specific comments on whether it could achieve a solution to the problem that exists under the existing rules by an approach other than modifying the gas valuation regulations.

The MMS is not requesting comments on alternative regulatory language governing the valuation of oil at this time because it has not observed any need for a change. The MMS does, however, solicit comments on whether such a need does exist.

The policy of the Department is, whenever practicable, to give the public an opportunity to participate in the rulemaking process. Accordingly, interested persons may submit written comments, suggestions, or objections regarding this notice to the location identified in the ADDRESSES section of this preamble. Comments must be received on or before the date identified in the DATES section of this preamble.

Dated: January 24, 1992.

Thomas Gernhofer,

Acting Director, Minerals Management Service.

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