



United States Department of the Interior

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Memorandum

To: Deputy Associate Director for Compliance
Deputy Associate Director for Valuation and Operations

From: Associate Director for Royalty Management *James W. Shaw*

Subject: Valuation Guidance for Auditing Affiliate Sales of Natural Gas

The attached guidance paper replaces the guidance paper dated October 22, 1996. The paper provides guidance for you to follow when auditing royalties for affiliate sales of natural gas produced from Federal and Indian leases under the current regulations. The only difference between the two papers is that the references to the memoranda issued by the Assistant Secretary - Land and Minerals Management on October 14 and December 12, 1988, have been deleted. Address any questions about the policy to the Chief, Valuation and Standards Division.

Attachment

GENERAL VALUATION GUIDANCE FOR AUDITING AFFILIATE SALES OF NATURAL GAS

GUIDANCE:

Arm's-length Contracts

The value of natural gas sold under an arm's-length contract is generally the gross proceeds accruing to the lessee. If the arm's-length contract does not reflect the total consideration for the value of production received by the lessee, then value may be determined under the valuation benchmarks (30 CFR §§ 206.152 (c) and 206.153 (c) (1996)). The lessee's gross proceeds may not be reduced by the costs of placing production in marketable condition.

Non-arm's-length Contracts or No Sale Situations

The value of natural gas sold under a non-arm's-length contract or not sold at all is determined by the criteria set forth in the benchmarks as described in Attachment 1 - Applicable Regulations, Policies, and Case History.

Regardless of the benchmark value determined, under no circumstances shall the value production, for royalty purposes, be less than the gross proceeds accruing to the lessee.

If the resale of production from the affiliate to a third party occurs in the same field or area as the sale from the lessee to its affiliate, the proceeds under the arm's-length resale contract may be used in calculating the applicable benchmark value.

The affiliate's records may be examined in order to determine if the affiliate performed services that are the responsibility of the lessee to perform at no cost to the lessor or whether the affiliate received additional consideration for the value of production that should be part of the lessee's gross proceeds. Specific guidance on determining the lessee's gross proceeds after examining the affiliate's records cannot be detailed here. Such determinations must be made on a case-by-case basis taking into account services necessary to place the production in marketable condition or to market the production, the location of the resale, and other relevant matters.

RATIONALE FOR GUIDANCE:

The concept that royalty value cannot be less than the gross proceeds accruing to the lessee is an underlying principle of the natural gas valuation rules. The recent Shell Interior Board of Land Appeals decision (132 IBLA 354) underscores MMS' right to determine what the lessee's gross proceeds are, even after an interim transfer of production to an affiliate. In its brief before the IBLA in the Shell case (132 IBLA 354, decided May 11, 1995, on reconsideration), MMS argued that nowhere in the 1988 rules or rulemaking history is there any restriction against MMS looking to an affiliate's arm's-length sales of production. The MMS has authority under its regulations, and as confirmed by IBLA in the circumstances present in the Shell case, to compare the value properly determined under the first applicable benchmark to the lessee's gross proceeds and select the higher of the two. Sales by affiliates may provide information concerning gross proceeds to the lessee and the appropriate benchmark value in some situations and thus may be considered in determining royalty value.

PROCEDURES:

Arm's-Length Contracts

As a general practice, gross proceeds under an arms-length contract are determined by the sales contract and revenue accounts representing consideration actually received. Any differences between contract values and amounts actually received may represent additional consideration paid for the value of natural gas production. Royalty value is determined by the total consideration received or accruing under the contract or otherwise, less allowable costs of transportation under MMS regulations. Reviews or audits of natural gas gross proceeds should include a verification of all relevant documents such as revenue account bookings and/or purchaser statements.

Non-arm's-length Contracts

As a general practice, royalty value for a non-arm's-length sale or transfer is determined by application of the benchmarks. The first applicable valuation benchmark is used to determine the royalty value. However, under no circumstances can value be less than gross proceeds accruing to the lessee. Royalty value is determined by the higher of consideration received by the lessee less allowable costs of transportation under MMS regulations, or the applicable benchmark value. Reviews or audits of natural gas gross proceeds may include a verification of all relevant documents of the lessee or its affiliate, as well as records of arm's-length purchasers not affiliated with the lessee. Relevant documents may include revenue account bookings and/or purchaser statements. The guidance provided above applies even if the lessee's affiliate is not a "marketing affiliate". If the lessee's affiliate is a "marketing affiliate", MMS must look directly to the sales by the affiliate to determine gross proceeds.

SPECIFIC GUIDANCE REGARDING GAS COMPARABILITY CRITERIA

Comparability can ultimately only be determined from the unique circumstances uncovered in each audit. Auditor's judgment will prevail. However, it may be useful in certain circumstances

to utilize some screening criteria to help evaluate which contracts might be more appropriate than others.

Eight factors are listed under the first benchmark in the gas valuation regulations at 30 CFR §§ 206.152 and 206.153 (1996). Attachment 2 provides definitions of each of the factors. Several of these factors naturally operate together and, when grouped, can be used as a series of "filters" to determine which contracts are comparable for establishing value. The factors may be grouped as follows:

- Volume and quality
- Markets served
- Duration and time of contract
- Price, terms, and other appropriate factors

The first "filter" used is volume and quality. Evaluate each contract and eliminate those not involving sales of equivalent volumes or like-quality production. Next, "filter" the remaining contracts for market(s) served and eliminate any contracts not serving similar market(s). Third, "filter" the contracts for duration and time of sale and eliminate dissimilar contracts. Last, "filter" on price, terms, and other appropriate factors. The remaining contracts become the comparable contracts used to determine value. For example, in the event of a fixed-price contract, the time of sale may be the most important factor.

Based on the particular circumstances unique to each audit, not all criteria are required. Auditor judgment will prevail.

TIME PERIODS:

Decisions about how far back MMS would assess royalties for natural gas undervaluation under the current regulations would be subject to the Director's July 14, 1995, guidelines regarding audit timing and resource allocation. Section 4 of the Federal Oil and Gas Royalty Simplification and Fairness Act of 1996, paragraph (b)(1) provides that actions to assess additional royalties shall be commenced within 7 years from the date on which the obligation becomes due.

APPLICABLE REGULATIONS, POLICIES, AND CASE HISTORY:

REGULATIONS:

The regulations at 30 CFR §§ 206.152 (h) and 206.153 (h) (1996) state, in part,

Notwithstanding any other provision of this section, under no circumstances shall the value of production, for royalty purposes, be less than the gross proceeds accruing to the lessee for lease production, less applicable allowances.

The regulations are 30 §§ CFR 206.152 (c) and 206.153 (c) (1996) state,

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 methods:

(1) The gross proceeds accruing 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 derived from, or paid under, comparable arm's-length contracts for purchases, sales, or other dispositions of like-quality gas in the same field

(2) 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 the same field or nearby fields or areas, posted prices for gas, prices received in arm's-length spot sales of gas, other reliable public sources of price or market information, and other information as to the particular lease operation or the salability of the gas.

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

POLICIES AND DIRECTIVES:

The October 14, 1993, policy paper *Valuation of Sales to Affiliates* states that:

When applying the benchmarks, it is necessary to consider the gross proceeds requirement discussed previously. Gross proceeds may not be reduced by costs to place the product in marketable condition or marketing costs

If the resale from the affiliate to a third party occurs in the same field as the first sale from the lessee to the affiliate and if the affiliate is

performing services other than transportation or processing (i.e., marketing services), the resale price would represent the minimum value for royalty purposes under the gross proceeds requirement.

ADMINISTRATIVE AND COURT DECISIONS:

In Santa Fe Energy Products Co., 127 IBLA 265, 268 (1993), the Board affirmed MMS'

. . . authority [under the Federal Oil and Gas Royalty Management Act (FOGRMA)] to obtain records from any affected person involved in purchasing or selling oil, and that MMS is not limited to dealing exclusively with the signatory lessee concerned. . . . [Therefore,] . . . the obligation to report 'gross proceeds accruing to the lessee' cannot be avoided by an inter-affiliate transfer made in contemplation of later sale to third parties.

In Santa Fe Energy Products Company, No. 95-1221, Tenth Circuit, April 10, 1996, the Court of Appeals stated:

Under the gross proceeds rule, the MMS could reasonably require information relating to Products' sales in order to ascertain the oil's fair market value and to determine the gross proceeds accruing to Energy The MMS' determination that the first arm's-length sale of oil produced under a federal lease was covered by the "other relevant matters" language of its regulations was not arbitrary, capricious, or contrary to law Products is a wholly owned affiliate of Energy. Accordingly, Products sales were relevant to determining gross proceeds accruing to Energy.

In Shell Oil Co. (on reconsideration) 132 IBLA 354, the IBLA ruled that

Consequently, no matter what regulatory benchmark is used to determine royalty, MMS must compare the result obtained thereby against a gross proceeds analysis in any case

Upon reconsideration of the question whether MMS had authority to require disclosure of information regarding the transfer of production to Shell in this case, therefore, we find that the marketing affiliate distinction, upon which the Shell decision turned, had no relevance to the question whether the gross proceeds rule must first be applied

Contrary to the argument advanced by Shell, therefore, the policy paper also indicated that there is an obligation and an expectation that MMS will look beyond the inter-affiliate transfer to determine whether other factors affect

product value. As suggested in Santa Fe [127 IBLA 265, 1993], affiliates participating in a transfer of Federal lease production in contemplation of sales to a third party should expect MMS to scrutinize an inter-affiliate transfer and all subsequent affiliate sales.

The IBLA goes on to say at 132 IBLA 357

The term lessee, however, is specific and cannot be expanded to include an affiliate of the lessee. (30 CFR § 206.101 (1996) [lessee].)

In Xeno, Inc. 134 IBLA 172 (November 14, 1995), the IBLA ruled that

The sale price received by an affiliate of the lessee in the first arm's-length transaction is properly considered in determining the value of produced gas under the gross proceeds rule.

DEFINITION OF FACTORS

PRICE: All components of the contract price (transportation factors, marketing fees, etc.).

TIME OF EXECUTION: Effective date of the contract (not the signed date).

DURATION OF CONTRACT: The stated period of time the contract is in effect.

MARKET OR MARKETS SERVED: Based on the point of sale established in the contract, including sales at the wellhead, gas processing plant inlet, mainline interconnect, or LDC or industrial user.

TERMS: Contract factors not related to price, volume, quality, duration, etc. (Example: Percentage-of-Proceeds v. Conventional Contract)

QUALITY (Gas stream components): Includes, but is not limited to:

- Methane content (mole percent)
- NGL content (GPM - gallons per Mcf)
- Non-hydrocarbon gas content
 - hydrogen sulfide
 - helium
 - nitrogen
 - CO₂

VOLUME: The delivered volume measured in Mcf.

OTHER FACTORS: Any factors that are unique to a particular audit situation, auditor judgement, or a cost/benefit analysis.