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United States Department of the Interior

MINERALS MANAGEMENT SERVICE

Royalty Management Program

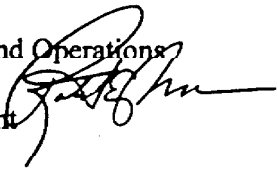
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Memorandum

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

From: ¹⁰⁰⁻¹⁰³ Associate Director for Royalty Management 

Subject: Valuation Guidance for Auditing Crude Oil Premiums

Attached is a guidance paper for you to follow when auditing royalties paid on crude oil produced from Federal and Indian leases under the current regulations. Address any questions about the policy to the Chief, Valuation and Standards Division.

Attachment

GENERAL VALUATION GUIDANCE FOR AUDITING CRUDE OIL

GUIDANCE:

Arm's-length Contracts

The value of oil sold under an arm's-length contract is generally the gross proceeds accruing to the lessee. Premiums¹ received by a lessee represent a portion of gross proceeds to the lessee and should therefore represent part of royalty value. 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. The lessee's gross proceeds may not be reduced by the costs of placing crude oil in marketable condition.

Non-arm's-length Contracts

The value of oil sold under a non-arm's-length contract or not sold at all is determined by the first applicable of five benchmarks as described in Attachment 1 - Applicable Regulations, Policies, and Case History.

Regardless of the benchmark value chosen, under no circumstances shall the value of production, for royalty purposes, be less than the gross proceeds accruing to the lessee. If the lessee or its affiliate receives a premium above posted price, then MMS would normally consider that premium to be part of the gross proceeds to the lessee and would include that premium as part of royalty value, less a transportation allowance, if applicable.

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

¹ A premium can be an explicit dollar per barrel amount paid over and above the posted price. Premiums can also be implicit; for example, an incremental value embedded in a location differential or an exchange agreement price differential that doesn't reflect the apparent value of the respective crudes.

to the lessor or whether the affiliate received premiums 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.

Exchange Agreements

Crude oil produced from Federal leases is frequently disposed of under exchange agreements (e.g.; buy/sell agreements) in which the lessee exchanges oil at one location for oil at another location. Title to the crude oil may transfer at the initial exchange point and a price may be specified in the agreement. However, when the agreement is conditioned upon the lessee's purchase of crude oil at a subsequent exchange point, the value specified in the exchange agreement does not necessarily reflect the total consideration received for the crude oil. Value at the initial exchange point must be determined based on the total consideration received for the crude oil, including any premiums received for the resale of the crude oil at the subsequent exchange point, less any allowable costs or location differentials specified in the exchange agreement.

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 oil 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 process 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 posted prices or contract values and amounts actually received may represent premiums paid for the value of crude oil 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 crude oil 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. The first benchmark relies on the lessee's (or its affiliate's) contemporaneous posted prices or oil sales contract prices in the field or area when: 1) those prices are used to purchase significant quantities of crude oil under arm's-length conditions and 2) those prices are comparable to other purchasers' contemporaneous posted prices or oil sales contract prices used to purchase significant quantities of oil under arm's-length conditions. Benchmarks 2-4 also rely on prices actually paid under arm's-length conditions. In evaluating those other arm's-length sales, the total consideration (including any premiums) received must be determined. It may be necessary to examine the records of purchasers other than those affiliated with the lessee, to determine the proper value under the benchmarks.

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 crude oil gross proceeds may include a verification of all relevant documents of the lessee or its affiliate, as well 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.

TIME PERIODS:

Decisions about how far back MMS would assess royalties for crude oil undervaluation under the current regulations would be subject to the Director's July 14, 1995, guidelines regarding audit timing and resource allocation.

APPLICABLE REGULATIONS, POLICIES, AND CASE HISTORY:

The regulations at 30 CFR 206.102 (h) state,

"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 determined pursuant to this subpart."

The regulations at 206.102 (c) state,

"The value of oil production from leases 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 paragraphs:

(1) The lessee's contemporaneous posted prices or oil sales contract prices used in arm's-length transactions for purchases or sales of significant quantities of like-quality oil in the same field (or, if necessary to obtain a reasonable sample, from the same area); provided, however, that those posted prices or oil sales contract prices are comparable to other contemporaneous posted prices or oil sales contract prices used in arm's-length transactions for purchases or sales of significant quantities of like-quality oil in the same field

(2) The arithmetic average of contemporaneous posted prices used in arm's-length transactions by persons other than the lessee for purchases or sales of significant quantities of like-quality oil in the same field...

(3) The arithmetic average of other contemporaneous arm's-length contract prices for purchases or sales of significant quantities of like-quality oil...

(4) Prices received for arm's-length spot sales of significant quantities of like-quality oil from the same field..., and other relevant matters....

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

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."

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 (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."