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Minerals Management Service

30 CFR Parts 202 and 206

Revision of Gas Royalty Valuation Regulations and Related Topics; Final Rule

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: Final rule.

SUMMARY: This 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).

EFFECTIVE DATE: March 1, 1988.

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

SUPPLEMENTARY INFORMATION: The principal authors of this 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 Royalty Management Program (RMP), Minerals Management Service; Donald T. Sant, Deputy Associate Director for Valuation and Audit, Minerals Management Service; and Peter J. Schaumberg of the Office of the Solicitor, Washington, DC.

I. Introduction

On February 13, 1987, 52 FR 4732, MMS issued a notice of proposed rulemaking to amend the regulations governing the valuation of gas from Federal leases onshore and on the Outer Continental Shelf (OCS), and from Indian Tribal and allotted leases. During the public comment period, MMS received almost 100 written comments. In addition, public hearings were held in Lakewood, Colorado, on April 7, 1987, and in Houston, Texas, on April 28, 1987. Sixteen persons made oral presentations at those hearings.

Because of the complexity of the regulations, and in accordance with MMS's understanding with the Congress, MMS issued a further notice of proposed rulemaking on August 17, 1987 (52 FR 30776), which included as an appendix MMS's draft of the final regulations. The purpose of the further notice of proposed rulemaking was to obtain further public comment during a short comment period and then to make any necessary revisions to the final regulations. See Conference Report on H.R. 1827, in the *Congressional Record* of June 27, 1987, pages H5651–H5666.

The public comment period on the first further notice of proposed rulemaking was scheduled to close on September 2, 1987, but was extended to September 11, 1987 (52 FR 33247, Sept. 2, 1987). On September 21, 1987, MMS issued a Notice of Intent to Issue a Second Further Notice of Proposed Rulemaking (52 FR 35451). In that Notice, MMS stated that all comments received on the Further Notice of Proposed Rulemaking and the first draft final rules would be included in the rulemaking record for this rule, even if they were received after September 11.

In addition to receiving written comments on the first draft final rules, MMS held several meetings with representatives from the States, Indian lessors, and industry in an effort to develop a set of regulations which were acceptable generally to all groups, though not a panacea for any one of them. Each of the groups exhibited a commendable willingness to make positive contributions to the process and, where necessary, to reach compromises.

In a further effort to ensure that all of the interested constituencies had a full and fair opportunity to comment upon the gas valuation rules following the several meetings and MMS's review of the written comments, MMS issued a second further notice of proposed rulemaking and second draft final rules (52 FR 39792, October 23, 1987). Public comments were received for 30 days. Over 35 additional comments were submitted in response to the second further notice of proposed rulemaking. Many commenters repeated comments that had been submitted in response to earlier requests for comments. However, MMS did receive additional comments, particularly on sections which were changed. All comments were reviewed and considered in drafting the final rules.

The MMS has considered carefully all of the public comments received during this rulemaking process, which included draft rules and input from the Royalty Management Advisory Committee (RMAC), proposed rules, and further notices of proposed rulemaking with draft final rules. A complete account of the RMAC process is included in the preamble to the proposed regulations issued in February 1987. Based on its review, MMS hereby adopts final regulations governing the valuation of gas from Federal and Indian leases. These regulations will apply prospectively to gas production on or after the effective date specified in the DATES section of this preamble.

II. Purpose and Background

The MMS has revised 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 (DOI).

(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 consideration 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 and processing costs for gas to aid in the calculation of proper royalty due the lessor.

A number of sections have been renumbered and/or moved to a new subpart. In Part 202, existing §§ 202.150, 202.151, and 202.152 of Subpart D, were redesignated as new sections under Subparts B and C and new §§ 202.150, 202.151 and 202.152 were added. Sections 206.150, 206.151, and 206.152 under Part 206, Subpart D, have been revised. In addition, new §§ 206.153, 206.154, 206.155, 206.156, 206.157, 206.158, and 206.159 have been added to Subpart D of Part 206.

Several general provisions which relate to both oil and gas have been added to Part 202. These provisions are included in the final rule to amend the oil valuation regulations also being published by the Department elsewhere in today's **Federal Register.**

This rule applies prospectively to gas production on or after the effective date of this rule. It supersedes all existing gas royalty valuation directives contained in numerous Secretarial, Minerals Management Service, and U.S. Geological Survey Conservation Division (now Bureau of Land Management, Onshore Operations) orders, directives, regulations, and Notices to Lessees (NTL) issued over past years, particularly NTL-5 (42 FR 22610, May 4, 1977, as amended; 51 FR 26759, July 25, 1986). Specific guidelines governing reporting requirements consistent with these new gas valuation regulations will be incorporated into the MMS Payor Handbook.

For the convenience of oil and gas lessees, payors, and the public, the following chart summarizes the effects of these rules.

Regulation changes	Descriptions
I. Redesignations	
Part 202	
Sections 202.150, 202.151 and 202.152 under Subpart D are redesignated as new § 202.100, under Subpart C and new §§ 202.53 and 202.52, under Subpart B, respectively	This administrative action more appropriately locates within Part 202 the information contained in these sections.
II. Removals	
Part 206:	
Sections 206.106 and 206.107 are removed from Subpart C.	These requirements have been incorporated into new §§ 202.150 and 202.151 in Part 202.
III. Additions	
1. *Part 202:*	
New §§ 202.150, 202.151, and 202.152 are added to Subpart D.	These new sections provide gas valuation standards and
2. *Part 206:*	
New §§ 206.10, 206.153, 206.154, 206.155, 206.156, 206.157, 206.158, and 206.159 are added to Subparts A and D	These new sections provide gas valuation standards and procedures and identify allowable costs for transportation and processing to be deducted from gas royalty value

The rules in § 206.150 expressly recognize 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 governs to the extent of the inconsistency. The same principle applies to Federal leases.

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

III. Response to General Comments Received on the Proposed Gas Valuation Regulations and Related Topics

The notice of proposed rulemaking for the amendment and clarification of regulations governing valuation of gas for royalty computation purposes was published in the **Federal Register** on February 13, 1987 (52 FR 4732). This was followed by a Further Notice of Proposed Rulemaking (52 FR 30776, Aug. 17, 1987), and a Second Further Notice of Proposed Rulemaking (52 FR 39792, October 23, 1987). Over 200 comments were received from interested persons including Indian lessors, the States, and industry.

The Indian commenters included tribal groups, a tribal council, and Indian trade groups. Various government agencies, including State entities, Federal agencies, State associations, State Governors, and local governments also commented. Industry commenters included oil and gas companies, individual commenters, and several industry trade groups.

Many commenters made comments on the basic issues and principles underlying the proposed rulemaking without addressing specific sections of the proposed regulations, but addressing the basic premise underlying the proposed valuation methodology. These comments generally were repeated in response to the first and second notices of further proposed rulemaking.

The respondents were generally composed of two groups, with industry generally on one side and States, Indians, and local governments on the other. Industry generally endorsed the basic principles underlying the proposed regulations. Although the industry commenters objected to many of the specific provisions of the proposed and draft rules, they stated generally that a market-oriented approach based on gross proceeds from arm's-length contracts would fulfill MMS's goals of creating royalty certainty, fairness, and long-term revenue maximization. Some industry commenters advocated the adoption, in total, of the Royalty Management Advisory Committee (RMAC) Gas Panel's recommendations as the only proper solution to the valuation issue. States, Indians, and local governments, on the other hand, generally objected to the basic premise of the proposed valuation methodology that gross proceeds from arm's-length contracts represent value. They also objected to other parts of the proposed regulations for a variety of reasons.

The general comments raised by industry, States, and Indians may be categorized similarly to those raised with respect to the oil valuation regulations: (1) Acceptance of gross proceeds under an arm's-length contract, or the benchmarks, as the value for royalty purposes; (2) deduction of transportation costs; (3) legal mandates and responsibilities toward Indians; (4) complexity and obscurity of regulations and definitions; and (5) economic impacts. Because the general issues raised and MMS's responses thereto are so similar, MMS hereby incorporates the discussion in the General Comments portion of Section III of the Preamble to the final oil valuation regulations published elsewhere in today's **Federal Register**, as if fully and completely set forth herein.

The Further Notice of Proposed Rulemaking of August 17, 1987 (52 FR 30776), and the Second Further Notice of Proposed Rulemaking of October 23, 1987 (52 FR 39792), specifically requested comments on certain broad issues. These issues were whether there were additional requirements or approaches which would improve the royalty payment process, the ability of auditors to determine compliance with these regulations and the extent to which these rules were responsive to concerns regarding royalty underpayments identified in the Linowes Commission Report and reports of the Congress, the General Accounting Office, and the Department's Office of Inspector General.

A number of comments were received on additional requirements or approaches which would improve the royalty payment process. Some of the commenters stated that improvement had been made, but the provisions in the draft final rules attempting to ensure that a lessee had acted prudently had removed some of the certainty of earlier versions. These commenters suggested that MMS recognize that lessees act prudently in contract negotiations and allow royalty to be based on these contracts.

One commenter recommended that regulations must be revised as soon as the requirements of those provisions are identified as creating problems for lessees and MMS. One Indian commenter suggested that MMS establish an Indian audit branch and a special Indian valuation office.

MMS Response: The MMS does believe that the vast majority of lessees act prudently in contract negotiations and that values for royalty purposes will be set by the terms of those contracts. Therefore, the provisions of the final regulations providing MMS with the ability to assure that values are set only by the terms of arm's-length contracts that have been prudently negotiated should not detract from the improvements made over the existing regulations.

The suggestion that timely revisions to regulatory provisions be made to alleviate problems is well received by MMS. Many reports have stated that the area of product valuation was long ignored by the Department. MMS believes that the dialogue with industry, States, and Indians over the last few years has been invaluable in leading to these final rules, and it is anticipated that communication will continue so that necessary revisions to any of the provisions of the final rules adopted today will be timely promulgated.

It is clear from the requirements of the final rules that MMS must become increasingly familiar with the transactions occurring in those areas where Federal and Indian lands are situated. Many of the Indian lands under the Department's jurisdiction are in close proximity to Federal lands and purchasers of production from these areas often are the same. Although MMS expects that the increased awareness of the marketplace and the already high priority given audits of Indian leases will suffice in assuring compliance with these rules, MMS will study the suggestion for separate audit and valuation offices for Indian lands.

Most of the commenters addressing the ability of auditors to determine compliance with these regulations suggested the establishment of guidelines governing audit closure rather than addressing the specific issue. A few commenters stated that clear regulations with timely revisions would enhance the ability of auditors to determine compliance. One commenter stated that the difficulty in determining if any consideration outside of the contract exists, the lack of any provisions for approval of non-arm's-length contracts, the burden on auditors to show control and administer the benchmark system, and the lack of independent cross-checks on values all act as impediments to auditors in determining compliance with the regulations.

MMS Response: The MMS agrees that regulations that are clear and understandable and timely revision of provisions causing problems enhance an auditor's ability to determine compliance with those regulations. The MMS agrees that it is difficult to identify consideration that exists outside of a contract. However, it is no more difficult than determining whether or not the requirement under current regulations that a lessee pay royalties based upon its gross proceeds has been met when part of the consideration received by the lessee is not covered by the sales contract. Similarly, approval of non-arm's-length contracts would not improve an auditor's ability to determine compliance. Approval of non-arm's-length contracts would not assure that the lessee has provided documentation of all consideration to be received in the transaction. Further, the resources that would be necessary to approve all non-arm's-length contracts and any amendments thereto would be overwhelming. The MMS does recognize that demonstrating control will be somewhat burdensome on auditors. However, showing control and the valuation of the gas sold under that contract under the benchmark system does not mean that the gross proceeds under that contract will not be accepted as defining value. Also, there are tests in the final rules that will result in the valuing of the gas under the benchmark system if the value under an arm's-length contract is unreasonable because of misconduct or a breach of the lessee's duty to market the gas for the mutual benefit of the lessee and the lessor. Finally, MMS does not agree that the benchmark system will be difficult to administer or that there will be a lack of cross-checks. As stated above, MMS realizes that it must become increasingly familiar with transactions occurring in the areas where Federal and Indian leases are situated. By becoming more familiar and obtaining sales volume and price information, MMS will be able to identify anomalies that exist and review the circumstances involved in those transactions.

Two commenters stated that the changes in the valuation regulations and other changes implemented by the Department were responsive to the concerns addressed by the Linowes Commission and others. One commenter stated that the regulations were not responsive to the concerns addressed by the Linowes Commission because States' suggestions were ignored, and the regulations were open to interpretation in many areas and lacked independent cross-checks.

MMS Response: The MMS believes that the regulations adopted today address most of the concerns of the Linowes Commission and others. Clarity and a great deal of certainty have been added to replace the vague requirements of the existing regulations which were identified as the major contributor to the undervaluing of production. The MMS does not agree that the concerns of States were ignored. Representatives of States have been involved in every step of the long process leading to these final rules and many of the provisions in the final rules directly reflect suggestions made by States. Although MMS does not agree that the final rules are as open to interpretation as suggested by this commenter, MMS intends to supplement these rules with chapters in the MMS Payor Handbook specifically dealing with all areas of valuation. The MMS will be able to identify anomalies in reported values and allowances by monitoring information reported to it and comparing reported information with other reported information and information collected independently by MMS. The MMS believes that such monitoring of reported values and allowances meets the requirement for cross-checks called for by the Linowes Commission.

The Second Further Notice of Proposed Rulemaking also specifically requested comments on certain individual issues. These issues were: (1) The feasibility of a larger scale royalty-in-kind program, particularly including gas; (2) whether or not the oil and gas valuation regulations should be consolidated; (3) whether or not the provisions dealing with extraordinary cost allowances relating to gas production and gas processing should be retained; (4) the practical limit on the term "relative" used in the definition of arm's-length contract; (5) whether or not allowances for certain post-production costs should be added; and (6) the allocation of transportation costs among products.

The comments received regarding a royalty-in-kind program for gas were evenly divided. Half of the commenters recommended that MMS take its gas royalty in-kind, particularly when there is a disagreement over the value of the gas. However, most of these commenters suggested a separate rulemaking to address the complicated issues involved in such a program. The other half of the commenters stated that MMS should not implement a royalty-in-kind program for gas because of the complications of such a program.

MMS Response: The MMS agrees that a royalty-in-kind program for gas is too complicated to be implemented without an in-depth study of all of the issues involved.

The commenters addressing the consolidation of the oil and gas valuation regulations either rejected the idea altogether or suggested deferring any attempt to do so until after the separate regulations are issued as final rules.

MMS Response: The MMS agrees that consolidation could not be accomplished in a timely manner and that experience with the separate rules should be obtained to identify if a need for consolidation exists.

The comments received concerning the remaining four issues will be addressed in later sections of this preamble dealing with the regulatory provisions specifically concerning those issues.

The MMS will monitor the operation and effect of the rules being adopted today. In 3 years, MMS will review the results of its analysis to determine if any significant changes to the regulations are required. In the meantime, technical and minor adjustments to the rules will be made as necessary.

IV. Section-by-Section Analysis and Response to Comments

Comments were not received on every section of the proposed regulations. Therefore, if those sections were not changed significantly from the proposal, there generally is no further discussion in this preamble. The preamble to the proposed regulation (52 FR 4732, Feb. 13, 1987) may be consulted for a full description of the purposes of those sections. For other sections, this preamble will address primarily the extent to which the final rule was changed from the proposal or, in some instances, from the draft final rules. Again, a complete discussion of the applicable sections may be found in the preamble to the proposed regulation.

The mineral leasing laws require that the Secretary receive a royalty on the "value of production" from minerals produced from Federal lands, but value is a word without precise definition. "Men have all but driven themselves mad in an effort to definitize its meaning." *Andrews v. Commissioner of Internal Revenue*, 135 F.2d 314, 317 (2nd Cir. 1943). The word "value" has sometimes been modified by the words "fair market", although the mineral leasing law provisions on "value of production" do not include these words. But, these adjectives do not really clarify the word value. The word "fair" can modify the word value as in "fair value" or it can modify the word market as in "fair market." The term "fair value" may not be interpreted the same as the "fair market" value. The term fair market value, however, has been generally accepted to be the price received by a willing and knowledgeable seller not obligated to sell from a willing and knowledgeable buyer not obligated to buy. Willing, knowledgeable, and obligated are again adjectives which are not terms of precise definition. These general concepts, however, were still the general principles which were followed in drafting these regulations on valuation of production for the purposes of calculating royalties. The general presumption is that persons buying or selling products from Federal and Indian leases are willing, knowledgeable, and not obligated to buy or sell. Because the U.S. economy is built upon a system in which individuals are provided the opportunity to advance their individual self interest, this seems to be a reasonable presumption. This system and its reliance on self-motivated individuals to engage in transactions which are to their own best interest, therefore, is a cornerstone of the regulations.

The purpose of the regulations is to define the value of production, for royalty purposes, for production from Federal and Indian lands. Value can be determined in different ways, and these rules explain how value is to be established in different circumstances. Value in these regulations generally is determined by prices set by individuals of opposing economic interests transacting business between themselves. Prices received for the sale of products from Federal and Indian leases pursuant to arm's-length contracts are often accepted as value for royalty purposes. However, even for some arm's-length contracts, contract prices may not be used for value purposes if the lease terms provide for other measures of value (such as Indian leases) or when there is a reason to suspect the bona fide nature of a particular transaction. Even the alternative valuation methods, however, are determined by reference to prices received by individuals buying or selling like-quality products in the same general area who have opposing economic interests. Also, in no instance can value be less than the amount received by a lessee in a particular transaction.

Section 202.150 Royalty on gas.

Indian commenters recommended that paragraph (a) should provide specifically that Indian lessors, as well as MMS, have the right to require payment in-kind for royalties due on production.

MMS Response: Most Indian lessors have the authority to require payment in-kind for royalties due on production. To the extent the lease terms so provide, the lessor may take its royalty-in-kind. However, because requests to take royalty-in-kind may involve operational difficulties for the lessee, as well as a change in accounting and reporting procedures necessary for MMS to properly monitor royalty obligations, MMS will continue to administer such requests. Therefore, if an Indian lessor wants royalty-in-kind, he or she must contract MMS. The MMS then will make arrangements with the lessee for the in-kind payment.

The MMS also has added a provision clarifying that when royalties are paid in value, the royalties due are equal to the value, for royalty purposes, multiplied by the royalty rate.

Section 202.150(b).

The MMS received many industry comments stating that unavoidably flared gas should be exempt from royalty requirements. Commenters stated that the definition of the term "unavoidably lost" should be incorporated in § 206.151, Definitions. The commenters also recommended that this paragraph address the procedures for obtaining permission to use gas off-lease for the benefit of the lease.

One industry commenter recommended deletion of the phrase "when such off-lease use is permitted by the appropriate agency." The commenter recommended that legal interpretations affecting the inclusion of any on-lease or off-lease use could be more appropriately covered in the MMS Payor Handbook.

Industry commenters also stated that on-lease or off-lease royalty-free gas use should also include gas used in post-production operations, including boosting residue gas delivery pressure and other operations incidental to marketing, because this gas is used for the benefit of the lease.

One industry commenter recommended the inclusion of the following language: "Gas used for the benefit of the lease in royalty free, which includes gas used in lease equipment located on a platform or in a central facility serving multiple leases. Such platform or central facility may be located on a lease other than the one physically providing gas used."

One industry commenter did not agree that the standard for royalty liability detailed in this paragraph is consistent with section 308 of the Federal Oil and Gas Royalty Management Act of 1982 (FOGRMA), 30 U.S.C. 1756, which limits royalty liability to loss or waste owing to negligence or noncompliance with operational requirements.

Two industry commenters proposed that MMS consider expansion of the clause to include all gas used "on or off a lease as long as it is for the benefit of the lease."

Industry commenters endorsed MMS's decision that gas used off-lease for the benefit of the lease is royalty-free when such use is permitted by the appropriate agency.

Some Indian commenters also recommended that any royalty-free use of gas be subject to prior approval to ensure that production from Indian leases is not disproportionately used in royalty-free operations.

MMS Response: The determination of whether or not gas has been unavoidably or avoidably lost and whether or not gas used is royalty-free (whether used off-lease or on-lease) are operational matters covered by the appropriate regulations of the Bureau of Land Management (BLM) and MMS for onshore and offshore operations, respectively. The BLM's requirements are governed by the provisions of 43 CFR Part 3160 and Notice of Lessees and Operators No. 4A. The MMS's requirements are governed by the provisions of 30 CFR Part 250. Therefore, although these comments raised many substantive issues, they are not properly addressed in this rulemaking. The MMS does not believe that prior approval for royalty-free use of gas is warranted because most leases, by their specific terms, allow royalty-free use of gas and it is a matter which will be reviewed during audits to prevent abuse.

Proposed § 202.150(b)(2), which addressed royalty-free use of gas for leases committed to unit or communitization agreements, has been expanded in the final rules to also cover production facilities handling production from more than one lease with the approval of the appropriate agency. Although MMS is satisfied that this issue is an operational matter governed sufficiently by the appropriate operation of the unit agreement or communitization agreement and BLM's and MMS's regulations, the number of comments received regarding this issue led MMS to believe that reiterating these operational requirements was advisable. This regulation simply provides that a disproportionate share of the fuel consumed at a production facility serving mutliple leases may not be allocated to an individual lease without incurring a royalty obligation on a portion of the fuel.

One industry commenter was strongly in agreement with § 202.150(b)(3) of the proposed rules, which recognizes the provisions of Indian leases that are inconsistent with the regulations.

One Indian commenter stated that this paragraph may not act to the benefit of Indian lessees unless MMS makes a specific requirement by instruction, manual releases, or notices to lessees with respect to the specific valuation guidelines to be applied.

MMS Response: The provisions of proposed § 202.150(b)(3) were adopted in the final rules. In most instances, the valuation regulations will apply equally to both Federal and Indian leases. This section covers any leases which may be inconsistent with the regulations. The final regulations recognize the primacy of statutes, treaties, and oil and gas leases and provide a means for dealing with special valuation requirements for both Indian and Federal leases. In many instances, lease terms are modified by unitization or communitization agreements. The reference to "leases" in the regulations means the lease terms as modified by any such agreement, where appropriate.

Section 202.150(c).

Section 202.150(c) was proposed as § 206.150(d). It provides that if the BLM (for onshore leases) or MMS (for offshore leases) determines that gas was avoidably lost or wasted, then the value of that gas will be determined in accordance with Part 206. This section also applies to gas drained from onshore leases for which BLM determines that compensatory royalty is due.

One industry commenter stated that the term "avoidable" indicates that such losses could have been anticipated and eliminated and that serious charges like these should be documented and proven, not merely assumed after the loss has been reported. Therefore, the commenter takes exception to this regulation.

MMS Response: Avoidably lost determinations are handled by personnel responsible for lease management operations, BLM onshore and MMS offshore, and are not a valuation issue. Any operator or lessee that BLM or MMS notifies of an avoidable loss determination has the right to appeal the determination if it is believed to be unjust or unfair.

One Indian commenter stated that payment should be due for the entire value, and not just the royalty portion of gas that is determined to have been avoidably lost or wasted from Indian leases.

One industry commenter stated that it should be made clear in this provision that the amount due for avoidably lost gas should be a royalty value and not the total value (100 percent).

MMS Response: The MMS policy for offshore leases is to assess only royalty for gas determined to have been avoidably lost. This also is BLM's policy for onshore leases for gas avoidably lost on and after October 22, 1984. This date is the effective date of BLM's revised regulations at 43 CFR 3162.7-1(d) (49 FR 37356, September 21, 1984), which included the provision for royalty on avoidably lost gas in accordance with Section 308 of FOGRMA, 30 U.S.C. 1756. The MMS and the BLM believe that collection of royalty provides an effective deterrent to wasting gas.

Section 202.150(d).

Section 202.150(d) was proposed as § 206.150(e) and requires royalties to be paid on insurance compensation for unavoidably lost gas.

Several industry commenters stated that to require a lessee to pay royalties on any compensation received "through insurance coverage or other arrangements for gas unavoidably lost is unfair." They stated that insurance proceeds are not received for the sale of production and should not be subject to sharing with the lessor. They believe, however, that if MMS insists on collecting a portion of such proceeds, the cost of such insurance coverage should be allowed as a deduction from royalty.

The MMS removed the insurance compensation section from the first draft final rule. Many Indian and State commenters thought this change was unfair, stating that if the lessee was compensated for the production, the lessor should than receive its royalty share.

MMS Response: The MMS has reinstated this provision in the final rules. However, royalties are due only if the lessee receives insurance compensation from a third person. No royalty is due where the lessee self insures.

Section 202.150(e).

Several industry commenters opposed § 202.150(e), which was proposed as § 202.150(c). They questioned the authority to require other non-Federal/ Indian lessees to pay royalties on leases on which they are not the lessee. According to the commenters, this could present gas balancing problems where production taken by a lessee falls below that lessee's production entitlement. These commenters suggested that proposed § 202.150(c) fails to recognize the marketing aspects of production. Although MMS attempted to clarify the purpose and scope of this section in the draft final rules, many additional comments were received. Many industry commenters commented that a requirement to pay royalties based upon what other unit participants receive for the gas raises many problems of information gathering making timely and accurate reporting of royalties extremely difficult. These commenters suggested alternatives such as allowing a lessee to pay royalties based upon its own contract price or allowing a lessee to pay royalties based upon the volume of production it actually sold.

MMS Response: Section 202.150(e) of the final rules states that all production attributable to a Federal or Indian lease under the terms of the agreement is subject to the royalty payment and reporting requirements of Title 30 of the Code of Federal Regulations even if an agreement participant actually taking the production is not the lessee of the Federal or Indian lease. Only a few concerns were expressed about this requirement and many commenters supported it. Most important, however, § 202.150(e) requires generally that the value, for royalty purposes, of this production be determined in accordance with 30 CFR Part 206 under the circumstances involved in the actual disposition of the production. As an example, if a Federal lessee does not sell or otherwise dispose of its allocable share of unit production, it will be sold or otherwise disposed of by other unit participants. If one of the unit participants other than the Federal lessee transports unprocessed gas to a sales point off the unit area under an arm's-length transportation agreement and then sells the gas under an arm's-length sales contract, the value, for royalty purposes, will be that participant's gross proceeds less the costs of transportation incurred under the arm's-length transportation agreement. This provision does not address the issue of what participant must report and pay the royalties; it only addresses the issue of valuation.

These rules do not require non-Federal and non-Indian lessees to conform to these regulations for valuing production. The MMS merely has required that the lessee must determine its royalty liability in accordance with the other interest owners' contracts or proceeds as long as those royalties comply with these value regulations. Any gas balancing problem that may exist because of interest owners taking more than their entitlement is a matter to be settled by the agreement members.

The MMS has added a new paragraph (3) to the final rules to clarify that all agreement participants actually taking volumes in excess of their allocated share of production in any month are deemed to have taken ratably from all persons taking less than their proportionate share. The MMS decided that such a provision was required to provide certainty as to which unit participants' dispositions the lessee must consider to satisfy the requirements of this provision, especially where there is no balancing agreement among the unit participants.

Two industry commenters also stated that the foreseeable results of this paragraph includes: "* * * (1) chronic late payments of royalties; (2) inconsistent AFS and PAAS reporting; (3) difficulty in determining proper royalty values where the overproduced working interest owners dispose of production pursuant to non-arm's-length transactions; and (4) excessive accounting and administrative costs for MMS and all working interest owners."

MMS Response: The MMS believes that lessees generally will be able to comply with the requirements of the regulations. However, MMS has added a new paragraph (2) which authorizes MMS to approve a royalty valuation method different from that prescribed by paragraph (1) to value any volumes of agreement production allocated to a lessee but which the lessee does not take. The lessee must request the exception and MMS may approve it only if it is consistent with the purposes of the regulations. For example, under a unit agreement a Federal lessee may be entitled to 100,000 mcf of production. The lessee is required to pay royalty on that volume. However, the lessee is able to sell only 75,000 mcf under its arm's-length contract that month. The lessee could request that MMS allow it to pay royalty on the remaining 25,000 mcf at its contract price.

The MMS recognizes that under most balancing agreements, a lessee who has undertaken at some point will overtake to balance its account. Because the lessee was required to pay royalties on the value of its allocated share when it undertook, the lessee is not required to pay additional royalties for prior periods for that lease when it subsequently over takes. Again, royalties are due only on the allocated share of agreement production even when the lessee takes and sells a greater volume. The MMS has added a new paragraph (4) to clarify this issue.

Some industry commenters recommended that paying and reporting royalties be accomplished solely on the basis of sales. According to these comments, because royalties will have been paid on total sales from the leases, there should be no decrease in royalty payments due over the life of the lease through the use of the sales approach.

MMS Response: Paying and reporting royalty solely on the basis of sales would not conform to the requirements of the federally approved agreement or the terms of the lease. It also could cause a hardship for Indian lessors who rely on a steady stream of revenues when there is production from their leases. Therefore, it is not an acceptable procedure.

In response to comments that the valuation method for production from unitization and communitization agreements required by the proposed and draft rules could cause royalty calculation and reporting problems for lessees, MMS is including in the final rules in subsection (f) an exception authority for valuing production from Federal and Indian leases committed to agreements. The authority is discretionary and may be exercised where the lessee requests an alternative method, the proposal is consistent with applicable statutes, lease terms and agreement terms, to the extent practical, persons with an interest in the agreement are notified and given an opportunity to comment, and, to the extent practical, all persons with an interest in a Federal or Indian lease committed to the agreement agree to use the proposed method.

Section 202.151 Royalty on processed gas.

Section 202.151(a).

Some commenters recommended deleting the word "reasonable" before the words "actual costs" in paragraph (a) because the lessee should be able to deduct actual costs from the processed gas value. One commenter stated that condensate recovered without resorting to processing should not be included in calculating royalty if the condensate is not allocated to the lease.

MMS Response: The MMS's policy is to allow "reasonable" actual costs incurred by the lessee for processing lease production. The MMS does not believe that it should share in unreasonable costs and has not adopted this suggestion. The MMS does not agree that a lessee should be allowed to remove production from the lease and avoid the royalty obligation for any part of that production. Therefore, MMS will retain the requirement that condensate recovered without resorting to processing be included when determining the value of gas that is processed.

The MMS received a comment regarding the requirement for dual accounting in § 206.155. That commenter stated that dual accounting should be required in all instances where gas is processed from onshore Federal and Indian leases, because that is the only way to ensure that royalty is paid on that portion of the gas stream leaving the lease which becomes a liquid during the transmission of the gas to the plant. These liquids are commonly referred to as drip condensate. The commenter pointed out that in many instances the company transporting the gas retains these liquids and the lessee makes no royalty payment for this portion of the production removed from the Federal or Indian lease.

MMS Response: As the commenter properly pointed out, royalty is due on all gas production removed from the lease, including any gas which becomes a liquid during transmission to a gas plant. When gas is sold at the lease and the lessee does not retain or exercise the right to process the gas, the total gas production removed from the lease is properly accounted for at that point. Thus, the issue of royalty on drip condensate is not involved in these instances.

When gas is processed by the lessee, any portion of the gas removed from the lease which becomes a liquid during transmission to a gas plant must be accounted for to properly define the value of the total gas production removed from the lease upon which royalty is due. Although MMS is not adopting the recommendation to require dual accounting in all instances where gas is processed, MMS is modifying the final rules in § 202.151 and § 206.153 to specify this requirement. Therefore, it is being made clear that the value of gas which is processed by a lessee must include the combined values of the residue gas, all gas plant products *and* any condensate recovered downstream of the point of royalty settlement without resorting to processing.

Section 202.151(b).

Several industry commenters stated that an allowance for boosting residue gas should be allowed under paragraph (b) for operation of the processing plant. The rationale was that costs associated with this process are incurred as a result of processing and should not be regarded as costs necessary to place the gas in marketable condition.

MMS Response: The regulations specify the MMS's policy that the lessee is required to condition the production for market. The cost for boosting residue gas is considered as a cost necessary to place the gas in marketable condition, and will not be an allowable deduction.

Three industry commenters recommended deleting the word "reasonable" before the words "* * * amount of residue gas * * *" and allowing actual amounts of residue gas used to be royalty-free. Indian commenters were concerned that the regulation should specify that residue gas could not be disproportionately charged to their leases royalty-free.

MMS Response: Historically, MMS's policy has been to allow a reasonable amount of residue gas to be royalty-free for the operation of a processing plant. In most instances the actual amounts of residue gas used are considered to be reasonable. However, the final rule specifies that only a lease's proportionate share of the residue gas necessary for the operation of the processing plant may be allowed royalty-free. Although adopted in response to the concerns of Indian commenters, this provision is equally applicable to all Federal and Indian leases.

Section 202.151(c).

Two industry commenters strongly endorsed the language set forth in paragraph (c).

One Indian commenter stated that "* * * the Secretary should not retain unilateral authority to authorize the royalty-free reinjection of residue gas or gas plant products from Indian production into unit areas or communitized areas." The recommendation was that the volume of royalty-free residue gas or gas plant products which can be reinjected into a unit area should be limited to the ratio of lease production to total unit production multiplied by the volume of unit production reinjected.

One industry commenter requested clarification that the use of the word "reinjection" includes original injection. In addition, the commenter recommended deletion of the qualification "* * * when the reinjection is included in a plan of development or operations and the plan has received BLM or MMS approval, * * *" because the recovery must be paid for entirely by the lessee.

MMS Response: The BLM or MMS for onshore or offshore operations, respectively, has the authority to approve the plan of development or operations. The issue regarding reinjection of residue gas or gas plant products is a matter which is addressed by the appropriate operational regulations of BLM and MMS.

Section 202.152 Standards for reporting and paying royalties on gas.

Section 202.152(a)

One industry commenter recommended that the phrase "if the Btu value is required pursuant to the lessee's contract" be added to the end of the last sentence of paragraph (a)(2). This commenter stated the Btu measurement is an expensive process and should not be required periodically unless necessary.

One Federal agency commenter stated that the frequency of Btu measurement be required quarterly, if not monthly, if not covered by the lessee's contract. This commenter stated that there are many situations which may require more frequent monitoring of the Btu heating value to assure proper assessment of gas royalties.

MMS Response: The Btu measurement is necessary in determining the proper value of the gas for royalty purposes. In addition, the BLM onshore and MMS OCS operations regulations require periodic Btu measurements.

Section 202.152(b).

One industry and one Federal agency commenter suggested that the words "where applicable" be added at the end of paragraph (b)(2). They stated that when the production is composed of carbon dioxide, nitrogen, or helium there will be no applicable Btu value.

MMS Response: This regulation has been modified in the final rule to read as follows: "Carbon dioxide (CO_2), nitrogen (N_2), helium (He), residue gas, and any other gas marketed as a separate product shall be reported by using the same standards specified in paragraph (a)." The concern expressed regarding Btu values for nonhydrocarbon gases is resolved by the inclusion of the words "where applicable" in the final rule for paragraph (a).

Regarding paragraph (b)(4), one Indian commenter stated that if sulfur is sold in a unit other than a long ton, the lessee should be allowed to report it to MMS and to Indian lessors in that unit.

MMS Response: The unit for reporting sulfur volumes must be standardized for reporting purposes. The most common unit used by industry for reporting sulfur is the long ton. A simple arithmetic formula can be used to convert a unique sales unit to long tons.

Section 206.150 Purpose and scope.

Section 206.150(a).

Several commenters suggested that Indian and Federal lands are dissimilar and deserve separate treatment when valuation and other gas production matters are under consideration. They recommend that separate regulations be promulgated for Indian leases.

MMS Response: The MMS believes that because these regulations provide for a reasonable and appropriate value for royalty purposes, completely separate rules for Federal and Indian leases generally are unnecessary. The regulations in § 206.150(b) recognize the primacy of terms of statutes, treaties, and oil and gas leases which provide special valuation requirements for both Federal and Indian leases. In addition, certain additional provisions applicable only to Indian leases have been included in these regulations.

The MMS has added a general statement that the purpose of this subpart is to establish the value of production for royalty purposes consistent with the mineral leasing laws and other applicable laws and lease terms.

Section 206.150(b).

One industry commenter suggested the addition of the phrase "in the event that any term of an approved existing unit or communitization agreement is inconsistent with the final rule, then such agreement will govern to the extent of the inconsistency."

MMS Response: Section 18 of the standard Federal form of a unit agreement states: "The terms, conditions, and provisions of all leases, subleases, and other contracts relating to exploration, drilling, development or operation for oil or gas on lands committed to this agreement are hereby expressly modified and amended to the extent necessary to make the same conform to the provisions hereof * * *." Therefore, the offered language is unnecessary owing to this existing unit agreement provision.

One Indian commenter suggested the addition of the phrase "provisions of Title 25 of the Code of Federal Regulations will supersede the provisions of this part, to the extent of any inconsistency."

MMS Response: The valuation regulations which were in Title 25 of the Code of Federal Regulations are identical to the provisions of many Indian leases. Therefore, these final regulations would cover any inconsistencies with lease terms if there were any. Moreover, BIA currently intends to amend the valuation regulations in 25 CFR simply to refer to the MMS valuation regulations.

Indian commenters recommended that, where provisions of any Indian lease, or any statute or treaty affecting Indian leases, as stated or as interpreted by the courts, are inconsistent with the regulations, the lease, statute or treaty, or court interpretation would govern to the extent of the inconsistency.

MMS Response: This suggestion was not adopted because it was not considered necessary. If the regulations are inconsistent with the requirements of any court decision, the court decision would take precedence.

One commenter suggested the MMS include in this section a reference to settlement agreements resulting from administrative or judicial litigation. It was pointed out that some settlement agreement provisions may vary from the regulations.

MMS Response: The MMS has made the suggested change in the final rules because the terms of a settlement of administrative or judicial litigation will govern. In response to a comment on the draft final rules, MMS has included references to settlement agreements involving Indian lessors.

Section 206.150(c).

A few industry commenters requested that consideration be given to the establishment of a "statute of limitations" for MMS audit and adjustment purposes. This commenter suggested that a 6-year period be adopted which would commence with the filing of the lessee's royalty report. It was also suggested that a provision be included for the lessee and MMS to mutually agree to waive the limitation for specific incidents and items under appeal or before the courts, but it should never apply in cases of fraud. This would partially relieve both the lessee and MMS of records archival responsibility and the associated costs, which are significant. Also, the limitation goes well beyond the cost-effective period for conducting normal compliance and follow-up audits. The suggested statute of limitations could be similar in concept and language as that used by the Internal Revenue Service.

MMS Response: The MMS performs all audits in accordance with 30 CFR 217.50. Any limitation such as that suggested would properly be included in a rulemaking to amend that section of the regulations. Therefore, it is beyond the scope of this rulemaking. The MMS has modified the provision in the final rule to make it clear that this provision applies to payments made directly to Indian Tribes or allottees as well as those made to MMS either for Federal or Indian leases. The MMS will address the issue of audit closure elsewhere.

Section 206.150(d).

The MMS received many comments from Indians that this section should specifically reference the Secretary's trust responsibilities to the Indians.

MMS Response: The MMS has incorporated the suggested change.

The MMS received a comment from an Alaska Native Corporation stating that MMS should not make the new regulations applicable to the proportionate share of production which corresponds to an Alaska Native Corporation's proportionate share of leases acquired under section 14(g) of the Alaska Native Claims Settlement Act, 43 U.S.C. 1613(g). Under section 14(g), a native corporation can acquire all or part of the lease. The commenter's point was that at the time a proportionate interest in a lease is acquired, the native corporation had an expectation of what royalties it would receive, and it would be inequitable for MMS to modify that expectation for leases or portions of leases which MMS does not even own.

MMS Response: In the draft final rules accompanying the second further notice of proposed rulemaking, MMS proposed to add a § 206.150(e) which provided that regulations, guidelines, and Notices to Lessees in effect on the date that an Alaska Native Corporation acquired a proportionate interest in a lease will continue to apply to that interest. The MMS received several comments that this provision is unfair and not supportable because the lease terms expressly recognize that regulations may change and that the lease will be subject to the new regulations. The MMS agrees with the comments and has deleted this section from the final rules. However, it should be clarified that these rules do not have any retroactive effect. MMS does not intend that any rules adopted in the rulemaking would apply to production involving Alaska Native Corporation lease interests which occurred prior to the effective date of this rulemaking.

MMS is including in the final rules a new subsection (e) to specify which Notice to lessees are to be terminated by this rulemaking.

Section 206.151 Definitions.

"Allowance"—One industry commenter suggested that the proposed definition be modified as follows: "Processing allowance means an allowance for processing gas; i.e., an authorized or an MMS-accepted or approved deduction for the costs of processing gas determined pursuant to §§ 206.158 and 206.159." The same commenter stated further that "Transportation allowance means an allowance for moving unprocessed gas, residue gas, or gas plant production to a point of sale or point of delivery remote from the lease, unit area, communitized area, or processing plant; i.e., an authorized or an MMS-accepted or -approved deduction for transportation costs, determined pursuant to §§ 206.156 and 206.157." This commenter recommended deleting the phrase "for the reasonable, actual costs incurred by the lessee." The method of determining the allowance should be addressed in the regulation setting forth the calculation method, not in the definition of allowance. If MMS adopts comparable arm's-length transportation and processing costs as a benchmark for non-arm's length contracts, the above cited phrase could be incorrect in certain instances."

A few industry and one Indian commenter stated that certain terms incorporated in the definition are subjective in nature. One industry commenter stated: "The New Rules do not draw a clear, objective line between costs that may be deducted and costs that may not be deducted. What is 'remote'? What is 'field gathering'?" Two industry commenters want the word "reasonable" deleted in the definition of "processing allowance and transportation allowance." They believe that the "Lessee should be entitled to deduct actual cost of processing and transportation. 'Reasonable' implies that the deduction may be something less than actual." One Indian commenter stated: "* * * the use of the terms accepted and approved call into question important issues regarding the relationship of the acceptance or approval with later audit. We assume that acceptance would not preclude later audit review and disallowance or modification when justified." One industry commenter suggested deleting the words "remote from" and replacing them with "off." The commenter "believes what is really intended by the phrase 'remote from' is to cover transportation to sales and delivery points of the lease."

Finally, one Indian commenter, referring to "allowance," pointed out that: "The definition should clearly specify that the transportation allowance applies only to transportation from *the lease boundary* to a point of sale remote from the lease and that such costs be reasonable, actual, *and necessary.*"

MMS Response: The final rule includes some modifications to the proposed language. It should be noted that processing and transportation allowances are "accepted" subject to review and/or audit. The MMS also has deleted the phrase "remote from the lease" and replaced it with the phrase "off the lease" for clarification that any transportation off the lease, except gathering (see definition below), is eligible for an allowance.

"Area"—One industry commenter stated that " 'Area' should be more precisely defined so that there are reasonable limits to how large an 'area' is. In addition, for the sake of clarification, the words 'or producing unit' should be inserted after 'oil and/or gas field' * * *."

MMS Response: For royalty computation purposes, the definition of "area" must remain flexible so that it may be applied to diverse situations. The size of an "area" may vary with each specific royalty valuation determination for gas.

"Arm's-length Contract"—The proposed definition of "arm's-length contract" was addressed by a large number of State, Indian, and industry commenters.

Many commenters stated that the originally proposed definition of arm's-length contract was so restrictive that many perfectly valid arm's-length transactions may fail to qualify, thus potentially rendering this key element of the benchmark system meaningless. These commenters suggested that MMS should adopt a definition of "affiliated person" based on control versus mere ownership of stock. They stated that in order to eliminate this problem, the underlying language should be deleted in favor of language already adopted by BLM in its regulations implementing Section 2(a)(2)(A) of the Minerals Lands Leasing Act of 1920 (MLLA). The rule, 43 CFR 3400.0–5(rr)(3), added by 51 FR 43910, 43922 (1986), specifies that:

Controlled by or under common control with, based on the instruments of ownership of the voting securities of an entity, means:

(i) Ownership in excess of 50 percent constitutes control;

(ii) Ownership of 20 through 50 percent creates a presumption of control; and

(iii) Ownership of less than 20 percent creates a presumption of noncontrol.

One industry commenter further recommended that "* * * MMS also adopt a 5% ownership threshold, below which there is an absolute presumption of noncontrol which is not subject to rebuttal. The 5% threshold is taken from the Investment Companies Act [* * *] which establishes that there is no effective affiliation between parties when direct or indirect ownership of voting stock is below 5%."

One industry commenter stated: "Additionally, for those companies in which there is a definite controlling interest, a transaction should still be treated as arm's-length if the controlling company is regulated by a regulatory agency who approves rates or tariffs charged to third parties."

Many industry commenters recommended changing MMS's reference from "persons" to "parties." One of these commenters stated that "Involvement in one or more joint operations with a competitor should not be viewed as materially affecting the arm's-length nature of transactions between the firms. However, the reference to 'joint venture' in the definition of 'person,' which is referenced in the proposed definition of arm's-length contract, could be improperly construed as including normal joint oil field operations conducted under the terms of joint operating or similar agreements. Joint operations clearly involve no interlocking ownership of the instruments of voting securities as between the firms. Joint operations are undertaken to accomplish effective reservoir management, to satisfy spacing requirements, or to share the enormous costs involved in certain OCS and frontier areas."

One industry commenter was concerned that: "The proposed language does not clarify at what time affiliation is to be determined. Is it when the contract is originally executed or some subsequent time during the term of the contract? In the current climate of mergers and acquisitions, affiliation may change." Another industry commenter stated that although the definition of "arm's-length contract" is well written, any additional language elaborating on the state of being affiliated should be deleted because it would allow auditors to reject too many arm's-length contracts.

One State commenter stated that "The definition of 'arm's-length contract' is clearly deficient because it is limited to *formal affiliation or common ownership* interests between the contracting parties. The assumption behind accepting arm's-length contract prices is that those prices will reflect market value. The definition proposed by MMS ignores the fact that parties may have contractual or other relationships or understandings which would cause them *to price gas below its value, especially if* the benefit of the reduced royalty burden can be shared by means of the gas sales contract." One Indian commenter questioned "* * * whether there are any truly arm's-length relationships in today's market which would make an arm's-length valuation method valid. We are particularly *concerned that the arm's-length label* essentially forecloses any scrutiny by MMS of the value reported by the lessee." One State/Indian association stated that nonaffiliation does not guarantee arm's-length: "For example, arrangements between families (via blood, kinship, heir, or marriage) offer similar conditions for influencing proceeds subject to royalty."

Two State commenters, one State/industry association, one Indian, and one Indian trade group are of the opinion, as expressed by one commenter, that: "MMS's desire for an 'almost purely objective' test provides a totally inadequate justification for giving away the power to prevent manipulation of the public's royalties." These commenters conclude that: "The definition as proposed is not workable even though it is objective." They suggest that MMS's definition in the *draft regulations presented to the RMAC* would allow more legally accurate results:

"Arm's length contract" means a contract or agreement that has been freely arrived at in the open marketplace between independent, nonaffiliated parties of adverse economic interest not involving any *consideration other than the sale,* processing, and/or transportation of lease products, and prudently negotiated under the facts and circumstances existing at that time.

Some Indian and State commenters agreed that, as one commenter phrased it: "The adverse economic interest and open market requirements have long been *standard criteria for determining* the arm's-length nature of contracts. These criteria have allowed for an accurate line of demarcation between arm's-length and non-arm's-length."

One State commenter supplied the following questions to be asked to test the arm's-length nature of a contract: "(1) Is there an individual who is a board member, officer, partner or employee of one of the contracting parties, and also a board member, officer or employee of the other? (2) What, if any, other commercial relationships exist or are being proposed between the buyer and seller? (3) Is there any family relationship between the buyer and seller? (4) Is there any other special relationship between the parties to the gas sales contract?"

Based on the numerous comments concerning the originally proposed definition, MMS included in the first draft final rule a definition which adopted the "control" language found in the BLM's regulations at 43 CFR 3400.0-5 (rr)(3) quoted above. In response to those commenters who believed that parties to an arm's-length contract must have adverse economic interests, MMS included in the first draft final rule definition a provision which required that, to be arm's-length, a contract must reflect the total consideration actually transferred from the buyer to the seller either directly or indirectly. For example, if the parties to the contract agreed that the price for gas from a Federal or Indian lease would be reduced in exchange for a bonus price to be paid for other production from a fee lease, MMS would not treat that contract as arm's-length.

Many of the comments on the first draft final rule again focused on the definition of arm's-length contract. Most of the industry commenters thought that the reference to "reflects the total consideration actually transferred directly or indirectly from the buyer to the seller" did not belong in the definition of arm's-length contract. Rather, they stated that it properly should be dealt with as a "gross proceeds" issue. The States and Indians commented that a reference to adverse economic interests still was necessary. They also thought that there must be a requirement of a free and open market. Finally, the States and Indians thought that MMS should lower the control threshold to 10 percent and that MMS should have more flexibility to rebut presumptions of noncontrol. Many of these commenters also thought that the rules should state that the lessee has the burden of demonstrating that its contract is arm's-length.

The comments on the second draft final rule were similar to those already received. Many commenters raised questions about possible audit difficulties. The American Petroleum Institute supported the definition in the second draft final rule.

MMS Response: The MMS adopted many of the changes suggested for the originally proposed definition. The MMS agrees that the "total consideration" issue is properly a gross proceeds matter that does not reflect the affiliation of the parties. Thus, that phrase has been deleted from the arm's-length contract definition and the matter dealt with under the definition of "gross proceeds". The MMS did not adopt the concept of "free and open market" because that concept is highly subjective. However, MMS did include a requirement that the contract be arrived at "in the marketplace" in support of the concept that an arm's-length contract must be between nonaffiliated persons. Also, in furtherance of that concept, MMS included a provision that an arm's-length contract must be between persons with opposing economic interests regarding that contract which means that the parties are acting in their economic self-interest. Thus, although the parties may have common interests elsewhere, their interests must be opposing with respect to the contract in issue. In response to many comments on the second draft final rule, MMS has reduced the control threshold to 10 percent. The MMS can rebut presumptions of noncontrol between 0 and 10 percent and lessees can rebut presumptions of control between 10 and 50 percent.

Many commenters thought that MMS's inclusion of joint venture in the definition of "person" improperly narrowed the definition of arm's-length contract. These commenters have misconstrued MMS's intent. The definition of "person" includes joint ventures because there are instances where joint ventures are established as separate entities. In those situations, if a party with a controlling interest in the joint venture buys production from the joint venture entity, that contract is non-arm's-length. However, MMS is aware that it also is common for companies to jointly contribute resources to develop a lease and then share the production proportionately. In a situation where four totally unaffiliated companies share the production, if one of the companies buys all of the production from the other three, those three contracts would be considered arm's-length. The company's purchase from its affiliate, of course, would be non-arm's-length.

The MMS also has included in the arm's-length definition a provision whereby if one person has less than a 10-percent interest in another person which creates a presumption of noncontrol, MMS can rebut that presumption if it demonstrates actual or legal control, including the existence of interlocking directorates. For example, there may be situations where ownership of 5 percent of a very large corporation could give a person sufficient control to direct the activities of that corporation. Where there is evidence of actual control, MMS can rebut the presumption of noncontrol.

Finally, in response to those commenters who believed that the lessee has the burden of demonstrating that its contract is arm's-length, MMS has included such a provision in the valuation sections. See §§ 206.152(b)(1)(i) and 206.153(b)(1)(i). The MMS also believes that these sections satisfy the request that the rules prescribe that the lessee has the burden of proving nonaffiliation since one of the requirements for demonstrating that a contract is an arm's-length contract is to demonstrate the degree of affiliation between the contracting parties.

The MMS may require a lessee to certify ownership in certain situations. Documents that controllers or financial accounting departments of individual companies file with the Securities and Exchange Commission concerning significant changes in ownership must be made available to MMS upon request.

The final rule also provides that to be considered arm's-length for any specific production month, a contract must meet the definition's requirements for that production month as well as when the contract was executed. Some industry commenters objected to this provision stating that if the contract was arm's-length when executed, it should satisfy MMS.

MMS Response: When the parties to a contract no longer have opposing economic interests, the reliability of that contract as an accurate indicator of value becomes suspect. In such circumstances, MMS will not rely on a contract price to conclusively establish value.

The MMS asked for comments on whether the term "relatives" needed further definition. Many useful comments were received. The MMS has decided, however, that further explanation of the meaning of relatives is better suited to guidelines which will be prepared after these rules are adopted.

"Audit"—One industry commenter expressed concern over MMS's interpretation of what constitutes an audit: "MMS's use of terms such as 'review,' 'examination,' rather than 'audit,' arbitrarily eliminates the right of lessees to offset overpayments and underpayments discovered during the course of an audit." This commenter believes that an account reconciliation by MMS should be termed an audit.

One Indian commenter did not disagree with the definition but thought that the processed information available to MMS is not adequate to perform thorough audits. "Our view of the definition of audit is academic because the MMS will accept payment reports without review in the future as in the past, unless resources and personnel are provided by the Tribe to accomplish the task."

One industry commenter stated that the review and resolution of exceptions processed by MMS's automated systems constitutes auditing by mail. The industry takes exception to this procedure.

MMS Response: The MMS has simplified the definition of "audit" as follows: "Audit means a review, conducted in accordance 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."

"Compression"—One industry commenter suggested deleting the definition because the term does not require an explanation.

MMS Response: The MMS believes that the definition should be retained because it clarifies a term used in the regulations.

"Field"—One industry commenter suggested adding the underlined language to clarify that this definition is for royalty purposes: "Field means, *for purposes of oil and gas royalty,* a geographic region * * *."

MMS Response: The additional language proposed by the commenter is unnecessary because the underlying premise of all the definitions contained in § 206.151 is that they are for royalty purposes.

"Gas"—One industry commenter stated that "The term should refer to unprocessed gas. The chemical definition is inappropriate in this context because it fails to distinguish between manufactured and raw gas."

MMS Response: The MMS believes that the definition adequately and correctly defines the term "gas" in language which is accepted by the oil and gas industry.

"Gas Plant Products"—One industry commenter stated that the phrase "excluding residue gas" should be deleted from this paragraph. According to this commenter, "Residue gas is a manufactured product as that term has been used by Federal courts in the royalty context. See *U.S. v. General Petroleum; California v. Seaton* affirmed *California v. Udall* * * *. If gas is processed, or manufactured there is no rational basis for limiting the deduction of manufacturing costs against the value of only gas plant products other than residue." An Indian Tribe supported the exclusion of residue gas from the definition.

One industry commenter suggested, "* * * we think the word 'nitrogen' should be excluded from the definition of 'Gas Plant Products' since some natural gas is high in this component, and there is currently a small or nonexistent market for small amounts of nitrogen. Purchasers have traditionally downgraded the price for high nitrogen gas, and if producers have to bear additional royalty as well, they may elect to shut in or plug wells due to poor economics."

MMS Response: The MMS does not agree that the phrase "excluding residue gas" should be deleted from this paragraph. Historically, no processing allowance has been allowed to be applied against the residue gas, and MMS generally has retained this position in the final rule. The MMS has also concluded that the definition should not be modified to exclude nitrogen. The MMS has, however, included in § 206.158(d) a provision for an extraordinary processing allowance for atypical types of gas production operations.

"Gathering"—MMS received numerous comments from industry concerning the phrase "or to a central accumulation or treatment point off the lease, unit, or communitized area as approved by BLM or MMS OCS operations personnel for onshore and OCS leases, respectively." These commenters stated that the phrase was unclear and that it should be removed from the definition. Several industry commenters recommended limiting gathering to the lease or unit area so a transportation allowance may be obtained for all off-lease movement.

MMS Response: The definition has been retained intact. The operational regulation of both BLM and MMS require that a lessee place all production in a marketable condition, if economically feasible, and that a lessee properly measure all production in a manner acceptable to the authorized officials of those agencies. Unless specifically approved otherwise, the requirements of the regulations must be met prior to the production leaving the lease. Therefore, when approval has been granted for the removal of production from a lease, unit, or communitized area for the purposes of treating the production or accumulating production for delivery to a purchaser prior to the requirements of the operational regulations having been met, MMS does not believe that any allowances should be granted for costs incurred by a lessee in these instances.

"Gross Proceeds"—MMS received a large number of comments on this definition.

Three Indian commenters, one State commenter, and one State/Indian association commenter supported the definition and urged MMS to retain the entitlement concept despite pressures to the contrary. A State commenter stated that "MMS has correctly resisted lessee efforts to exclude the royalty owner from sharing in some kinds of consideration, such as severance tax reimbursement and take or pay payments." This commenter recommended clarifying the first sentence by amending it as follows: "Gross proceeds (*for royalty purposes*) means the total monies and *the value of* other consideration paid *or given* to [an oil] and gas lessee, or monies and *the value of* other consideration to which such lessee is entitled, for the disposition of gas." The commenter stated that "These additions are necessary because when 'consideration' is not in the form of 'monies' it is necessary to determine its value."

Many industry commenters opposed the definition of "gross proceeds" as proposed because they believed it is too expansive and contrary to the provisions of the Mineral Lands Leasing Act and the OCS Lands Act. Instead, they propose the following: "Gross proceeds (for royalty payment purposes) means the consideration accrued to the lessee for production removed or sold from Federal, Indian Tribal or Indian allotted leases." One commenter stated further that "Such definition is unambiguous, furthering the MMS's desire for certainty in its regulations. Reimbursement for production-related costs and take-or-pay payments are currently being litigated. If it is eventually determined that royalty is owed on such payments such definition will not have to be modified. On the other hand, the proposed definition will have to be amended if industry is successful in its claims that royalty is not due on such amounts." One industry commenter proposed adopting the definition of "gross proceeds" endorsed by a majority of the RMAC Gas Panel. It reads: "* * * all consideration due and payable to the lessee for the sale of gas and processed gas products, less any applicable allowances for transportation, processing and other post production expenses."

Several of the industry commenters disagreed with the entitlement language contained in the originally proposed definition. Their concerns are represented by the following statement from one of the comments: "Proceeds have long been defined and understood to mean the consideration, money or the monetary equivalent of other nonmonetary consideration *actually received by a lessee.* The MMS' expansive definition of proceeds, including monies to which a lessee is *entitled,* makes product valuation uncertain and subjective. This uncertainty and subjectivity arises because: (1) The meaning of entitlement is not clearly understood, nor is it a clearly defined legal term; (2) lessees do not know how either they or MMS will, or should, apply this standard; and (3) the required steps which a lessee must take to secure entitlements to consideration are unknown. It will put MMS into the business of second guessing lessee's business transactions. To minimize this second guessing problem of uncertainty we recommend the concept of entitlement be eliminated from further consideration." One industry commenter was concerned that "a lessee would be required to pay royalties on monies to which it is entitled, not on what is received or on what is settled for as a matter of compromise." In order to add more certainty to the concept of "entitlement," one commenter suggested "a simple statement to the effect that MMS expects to be indemnified against the negative consequences of a lessee sleeping on its *clear cut uncontested* contract rights should suffice."

Many industry commenters had the opinion, as one commenter phrased it, that "Federal statutes, regulations, and leases do not require lessees to pay royalty on reimbursements received for post-production services." Several commenters believed that "the claim for royalty on production-related cost reimbursements received by a lessee pursuant to the FERC's Order No. 94 series is particularly inappropriate." One commenter stated that "a demand for royalties on Order No. 94 violates the royalty clause of the MLA, the OCSLA, as well as MMS's own regulations implementing these statutes, for at least two reasons. First, these reimbursements do not result from the production of gas but from services performed by the producer subsequent to production. Second, such reimbursements are not consideration for production that is sold or removed and are thus outside the scope of the royalty clause. Consequently, the MMS' proposal to include production-related cost reimbursements in the definition of gross proceeds is simply wrong." Another industry commenter "strongly asserts the producer's right to deduct all post-production costs involved in marketing gas. Further tax reimbursements should be exempt from royalty." Finally, one industry commenter stated that "all post-production costs should be shared by lessor and lessee because such costs enhance the value of the production for the benefit of both lessor and lessee."

Many industry and a few individual commenters responded to the inclusion of take-or-pay payments in the definition of "gross proceeds." The consensus among these commenters is that MMS has no lawful reason or authorization to collect royalties on take-or-pay payments. One commenter stated that "the typical take-or-pay clause in a contract between the lessee and the gas purchaser requires the purchaser to pay for the specified minimum quantity of gas for each contract year. Whenever the gas purchaser takes less than the contract minimum for a particular year, the purchaser is required to make a take-or-pay payment to the lessee. The purpose of take-or-pay payments is to guarantee the lessee a steady cash-flow, regardless of the level of actual production, to meet its operation and maintenance costs. The payments are not for production; indeed, they are made in lieu of taking production. Consequently, to the extent the lessee receives take-or-pay payments there is no gas production or sale because the gas remains in the ground."

Several industry commenters recommended the increased use of "in-kind" royalty clauses to resolve good faith royalty disputes. One industry commenter stated "indeed, the 'in-kind' standard should be considered as the measure of product 'value,' where a producer and the MMS, or a State auditor under a delegation of authority, disagree over whether a contract is 'arm's-length,' or over contract 'entitlements,' the gas should be taken 'in-kind,' by volume at the wellhead. This means that the royalty owner must assume all subsequent costs or marketing the gas."

MMS Response: In the draft final rule, MMS included a definition which was only slightly different than the proposal. In the second draft final rule, MMS again made a slight modification, discussed below, which has been retained in the final rule. The MMS retained the intent of the proposed language because gross proceeds to which a lessee is "entitled" means those prices and/or benefits to which it is legally entitled under the terms of the contract. If a lessee fails to take proper or timely action to receive prices or benefits to which it is entitled under the contract, it must pay royalty at a value based upon that legally obtainable price or benefit, unless the contract is amended or revised. As is discussed more fully below, gross proceeds under arm's-length contracts are a principal determinant of value. The MMS cannot adopt that standard and then not require lessees to pay royalties in accordance with the express terms of those contracts. It is MMS's intent that the definition be expansive to include all consideration flowing from the buyer to the seller for the gas, whether that consideration is in the form of money or any other form of value. Lessees cannot avoid their royalty obligations by keeping a part of their agreement outside the four corners of the contract. Moreover, as noted earlier, many commenters stated that the "total consideration" concept properly belonged as part of gross proceeds, not in the definition of arm's-lenght contract. Therefore, MMS has purposefully drafted the gross proceeds definition to be expansive and thus include all types of consideration flowing from the buyer to the seller. Toward that end, MMS has replaced the word "paid" used in the first draft final rule with the term "accruing." There may be certain types of considerations which are not actually paid by the buyer to the seller, but from which the seller benefits. The term "accruing" ensures that all such consideration is considered gross proceeds.

Costs of production and post-production costs are lease obligations which the lessee must perform at no cost to the Federal Government or Indian owner. The services listed in the definition are all benefits that a lessee may receive under the terms of the contract and are considered part of the value, for royalty purposes, for the production removed or sold from the lease.

It is MMS's position that take-or-pay payments are part of the gross proceeds accruing to a lessee upon which royalty is due.

The MMS retains the exclusive right to determine when it will accept "in-kind" production in fulfillment of a *lessee's royalty obligation. Although*

MMS received many comments supporting a gas royalty-in-kind program. MMS received an equal number identifying significant problems with such a program. The MMS does not anticipate adopting a gas royalty-in-kind program at this time.

"Lease"—One Indian commenter stated the following: "Inclusion of any contract profit-sharing arrangement, joint venture or other agreement in the term 'lease' as opposed to a more standardized BIA form lease may cause confusion. Most joint ventures and profit-sharing arrangements contain explicit provisions on payment of expenses and division of revenues."

MMS Response: This definition must be broad enough to cover any agreement that may be issued or approved by the United States for either Federal or Indian lands.

"Lease products"—One industry commenter stated: "Lease products definition should be deleted as it eliminates the important and necessary distinction between raw gas and manufactured products. Use of the phrase 'gas' and 'gas plant products' is preferable as it serves to make this distinction."

MMS Response: The MMS believes that this definition is appropriate and correct and does not eliminate any distinction between raw gas and manufactured products. The definition of the terms "gas" and "gas plant products" will be retained in the definitions paragraph.

"Lessee"—Several industry representatives and trade groups commented that the originally proposed definition of "lessee" was too broad. One commenter stated that "As drafted, it would include any person who pays royalties, notwithstanding the fact that such payors may have no contractual obligation to the lessor to make royalty payments. Thus, under the proposed definition, the voluntary royalty remitter would become subject to all of the royalty valuation obligations imposed on lessees and would, consequently, become directly liable for any infractions of the application reporting and payment regulations, a result which is not sanctioned by existing statutory law." To be consistent with that law, industry suggests that MMS substitute for its definition of "lessee" the one which is contained in section 3(7) of the Federal Oil and Gas Royalty Management Act (FOGRMA), 30 U.S.C. 1702(7):

"Lessee" means any person to whom the United States, an Indian Tribe, or an Indian allottee, issues a lease, or any person who has been assigned an obligation to make royalty or other payments required by the lease.

Most of these commenters favored this definition because "the statutory definition includes persons who have been issued a lease or who have been *assigned* an obligation to make royalty or other payments required by the lease. The gas proposal would wrongfully expand the definition to include any person who has *assumed* an obligation to make such payments."

One industry commenter recommended adding the phrase "for royalty payment purposes" directly after the word "Lessee" for the purpose of clarity. "We do not believe it is the intent of Congress that a lessee be able to divest himself of all lease obligations by someone else merely assuming royalty responsibility."

MMS Response: The MMS agrees with the comments regarding consistency with the definition found in FOGRMA and, therefore, has replaced the word "assumed" with the word "assigned." It should be specifically noted that the term "assigned," as used in this Part, is restricted to the assignment of an obligation to make royalty or other payments required by the lease. It is in no way related to lease "assignments" approved through the MMS, BLM or BIA. It is MMS's intent that operators and others who pay royalties follow these regulations in determining the royalties due. The lessee of record is ultimately responsible if the operator or other payor does not properly pay the royalties due the lessor.

"Like-quality lease products"—Some Indian commenters recommended deleting any reference to legal characteristics from this definition. They believed that by using legal characteristics of gas in defining like-quality gas many elements would be used to differentiate gas in such a manner as to lower gas values. They were concerned that gas sold in intrastate commerce would not be considered as being like-quality to gas sold in interstate commerce. They believed that such distinction would be contrary to court rulings. Further, the Indian commenters believed that gas should be considered only on its chemical and physical characteristics. The Indians commented that inclusion of the term could lead to the possibility that State regulations could influence the value of gas produced on Indian leases.

MMS Response: The MMS believes that legal characteristics of gas must be considered in determining like-quality production. However, the legal characteristics of gas intended to be considered under this definition are limited to categories under NGPA and the price regulated or deregulated status of the gas. The MMS does not believe that mixing NGPA categories of gas or comparing regulated to deregulated gas is reasonable when defining like-quality gas for royalty purposes. Without such distinction, gas that is price regulated at levels below $1.00 per MMBtu might be used to demonstrate the acceptability of a price for gas that should be compared to gas selling for prices in excess of $2.00 per MMBtu under market-sensitive contract provisions free from Federal price controls. Similar problems could result by mixing price regulated gas with price deregulated gas, even though the gas qualifies under the same provisions of NGPA. For example, between January 1, 1985, and July 1, 1987, all wells qualifying under NGPA Section 103 qualified under section 103(c). However, there were two different maximum lawful price ceilings prescribed by this section and a provision that deregulated certain section 103 gas. Regarding the distinction between intrastate and interstate sales, it has not been MMS's practice, nor is it intended to be under these final regulations, to incorporate the market chosen by a lessee in the definition of like-quality gas (unless adopted as a requirement by NGPA in defining categories).

"Marketable Condition"—One industry commenter suggested changing the definition to "Marketable Condition means condition acceptable to the purchaser under its sales contract."

One industry commenter suggested adding the words *"and/or transporter"* after the word "purchaser" in the definition.

One industry commenter stated that phrases such as "sufficiently free from impurities" and "a contract typical for the field or area" are subjective and ambiguous. The commenter stated that "All references to 'marketable condition' should be dropped in the final regulations. Instead, the regulations should reflect the distinction between production and post-production costs and clearly allow the lessee with an arm's-length contract to deduct post-production costs."

Several industry commenters expressed the view that the lessor should share proportionately in all post-production costs including those costs incident to placing production in a marketable condition.

One commenter expressed the view that the regulations must define "production costs" and "post-production costs." The commenter disagrees with

MMS's position that these costs are costs associated with the obligation of the lessee to place production in a marketable condition, especially when costs are incurred downstream or off-lease. The commenter suggested that MMS should reconsider its position and allow deductions for nonproduction-related or post-production costs.

Another commenter believes that the costs of dehydration, separation, compression, and storage performed at a plant and incurred subsequent to the sales point should be deemed to have occurred for gas processing and not as a cost necessary to place the gas in marketable condition. This commenter also stated that a reasonable amount of gas, residue or unprocessed, should be allowed for fuel.

One industry commenter stated that "The proposed definition of 'marketable condition' is problematic because it seems to set up a normative standard for the condition of a product when, in fact, products may be sold profitably in a variety of conditions. We do not believe the lessee should be required to meet a specific set of processing criteria in all circumstances. The lessee, for its own profit and for that of its lessor, must be able to evaluate potential benefits and costs under each circumstance without being bound by what the lessor may consider 'typical' for the field or area. Furthermore, regarding the term 'typical', what was typical 20 years ago almost certainly is not typical now; yet there is no reference in this definition to the need for contracts to be fairly contemporaneous in order to be comparable. The definition set forth in the report of RMAC's Gas Working Panel is far preferable to the proposed rule."

MMS Response: The MMS believes that the definition is clear, concise, and equitable. The definition is not subject to manipulation, as one commenter stated. Furthermore, the suggestion that a uniform standard be developed for what is "marketable" is unrealistic because the gas marketplace is dynamic. The definition, as written, allows MMS the latitude to apply the concept of "marketable" in a fair and correct manner, now and in future gas markets. Also, MMS adheres to its long standing policy that costs incurred to place production in a marketable condition are to be borne solely by the lessee. Therefore, the MMS has not made any changes to the proposed definition.

"Marketing affiliate"—The MMS received several comments that sales to marketing affiliates who then resell the gas to third persons should not be treated under the rules as non-arm's-length sales. The MMS has addressed this issue in the valuation rules, discussed below, and is including a definition of marketing affiliate as an affiliate of the lessee whose function is to acquire *only* the lessee's production and to market that production. Some industry commenters stated that the term "only" should be deleted to include affiliates that purchase gas from other sources including other sellers in the same field.

MMS Response: The MMS is retaining the term "only". If the affiliate of the lessee also purchases gas from other sources, then that affiliate presumably will have comparable arm's-length contracts with the other parties which should demonstrate the acceptability of the gross proceeds accruing to the lessee from its affiliate. Also, deleting the term "only" from the definition may require the lessee to track the production to a sales point much farther downstream than the point at which it can be valued based upon the comparable arm's-length contracts of its affiliate.

"Net-back Method"—One industry commenter recommended deleting the second sentence of the definition because the procedure for performing a net-back calculation cannot be adequately explained in one sentence. Another industry commenter believed that the reference to net-back method needs clarification. A net-back is simply a means for reconstructing the value of gas to the well and has nothing to do with valuing the disposition of the gas at a point remote from the well. Consequently, a net-back procedure can be employed simultaneously with another valuation criterion to arrive at the value at the well."

One industry commenter stated the following about the definition: "It is vague because there is no explanation of what 'working back' means; it is overly broad because the first 'use' of virtually all gas is downstream from the lease. In addition, exclusive reliance on costs, however 'costs' are determined, may well understate the value added to production by downstream value-enhancement activities."

One State commenter stated that "the definition is internally inconsistent because it declares the 'net-back method' to be a method for valuing 'unprocessed gas' which is first sold downstream of, among other things, 'processing plants.' One of these references must be deleted to preserve consistency. The concept is vague because no standard is provided for determining what is meant by the phrase 'first alternative point which can be used for value determination.' "

MMS Response: Upon review, MMS determined that the proposed definition of net-back was too broad—it applied to any situation where lease production is sold at a point remote from the lease. The MMS's intent is that a net-back method be used for valuation primarily where the form of the lease product has changed, and it is necessary to start with the sales prices of the changed product and deduct transportation and processing costs. An example would be where gas production from a Federal lease is used on lease to generate electricity which is then sold. If the value of the gas cannot be determined through application of the first three benchmarks in the regulations (see § 206.152(c)), then a net-back method would involve beginning with the sale price of the electricity and deducting the costs of generation and transportation, thus working back to a value at the lease. In the draft final rule, MMS used the phrase "ultimate proceeds" to try and refer to the downstream product. Many commenters thought the term would result in MMS doing a net-back from the farthest downstream product, even to the point of "Stainmaster Carpet" or "model airplanes." This was not MMS's intent. Therefore, the term "ultimate" was deleted and a reference included to starting the net-back at the first point at which reasonable values for any product may be determined by a sale pursuant to an arm's-length contract or by comparison to other sales of such products. Thus, if there are five different stages of chemical or fiber products between raw gas production and "Stainmaster Carpet," if the value of the second product can be determined through comparisons with sales of other such products in the same market, MMS would begin the net-back from that product, not from the carpet.

"Net Output"—One industry commenter recommends "substituting the phrase 'actually extracts' for 'produces'. Net output of a plant is that which is *actually extracted,* not theoretically extractable." Another industry commenter suggested that the language be amended to clarify that gas produced at a plant but determined to have been unavoidably lost be excluded from the term.

MMS Response: The MMS disagrees with the commenter's recommended addition. The phrase "actually extracts" could be interpreted as meaning something different than "is produced." The MMS also disagrees that the term should be amended to exclude volumes determined to have been unavoidably lost. It has long been an established practice that incidental losses occurring from the plant be excluded from royalty computations. Also, if the gas produced from the plant is determined by BLM or MMS, as appropriate, to have been unavoidably lost, the regulations when taken as a whole would exclude such volumes.

"Person"—One industry commenter recommended replacing the word "firm" with "company" in the interest of clarity.

Several industry commenters expressed the opinion that if the definition is not altered "then inclusion of joint venture in the definition of person could be extended to oil and gas joint venture operations and further narrow the definition of an arm's-length transaction by clouding the issues of control and affiliation. The sale of hydrocarbons produced through joint venture operations should not be presumed to be other than arm's-length because the individual parties and not the 'joint venture' are responsible for making their own sales of their share of the production." One industry commenter stated that the solution to the problem is to delete the term "joint venture" from the definition. Another industry commenter proposed the following definition: "Person means any individual, firm, corporation, association, partnership, consortium, or joint venture. For purposes of this definition, association, partnership, consortium or joint venture shall not include any relationship or arrangement resulting from persons entering into any joint operating agreement, production sharing agreement, farm-out or farm-in agreement, or any similar agreement or contracts generally found in the oil and gas industry for the cooperative exploration of mineral resources." Another industry commenter recommended adding the phrase "when established as a separate entity" after the term joint venture.

MMS Response: The MMS has adopted the addition of the suggested phrase concerning joint ventures in the final definition. The MMS agrees that two unaffiliated parties jointly developing and producing a lease should not be viewed as one entity unless those parties have formally established a separate entity that involves them both.

"Posted Price"—One industry commenter stated that the word "posted" is an outdated term which should be deleted and that the following underlined language should be added to the definition. "Posted price means the price in the field, net of all deductions, as specified in a publicly available * * * price bulletin *or price notices available as part of normal business operations to an operator desiring to do business with specific purchasers,* that a buyer is willing to pay for quantities of unprocessed gas, residue gas, or gas plant products of marketable condition * * *." The commenter also stated that, "if gas price bulletins become generally circulated, it may be that some buyers may not publish a price bulletin as that term is normally used in the industry, but will provide and make available price quotations or notices to any operator (seller) desiring to do business with the buyer."

MMS Response: The MMS has revised the definition in the final rule. For clarification purposes, the word "condition" replaces the word "quality" which follows the word "marketable" in the first sentence. The phrase "net of all deductions" has been modified to read "net of all adjustments." As used in this definition, the term "adjustments" refers to deductions from the price of gas or gas plant products for quality adjustments. Adjustments for location also may be taken into account where appropriate.

"Processing"—Two industry commenters recommended "that a clarifying statement be included to recognize that a plant may be located on the lessee's Federal/Indian lease. If a gas plant is located on a lease, then any of the 'field processes', as set out in the definition may well be an integral part of the plant process and consequently must be considered elements of processing." One industry commenter suggested that the following sentence be inserted between the proposed second and third sentences: "However, these processes will be considered as processing if they are included as an inherent part of the process to separate the produced gas into gas plant products and residue gas." Two industry commenters recommended "The addition of the word 'fractionation' at the end of the first sentence. Fractionation is a plant process and an allowance should be granted as is currently allowed by MMS."

One Federal agency commenter stated that some confusion may arise when comparing proposed § 206.151(bb) to proposed § 206.158(d). "Once the gas reaches the gas plant it would be arguable that any process associated with treating the gas, such as dehydration or mechanical separation, is generating a gas plant product that would be eligible for a processing cost deduction."

One industry commenter suggested changing the definition of "processing" to: "*Manufacturing:* The transformation of a raw gas stream into one or more saleable products by processes other than dehydration, standard field conditioning and separation techniques. Manufacturing includes gas processing, sweetening, purification, desulfurization, gas separation, adsorption, absorption, liquefaction and other extraction techniques. Furthermore, gas processing should be defined as: *Gas Processing:* The manufacturing technique whereby wet gas is treated to remove natural gas liquids such that the natural gas liquids and dry residue gas are separately marketable." This commenter thinks that "manufacturing also includes the physical operation attendant to the specific manufacturing process such as the dehydration and compression steps which occur within a gas plant. The MMS has instead attempted to limit its attention to 'gas processing' and thus provides an allowance only to such operations. The position of the MMS is based upon a clear misapplication of the *Udall* case, namely, that all operations for placing gas in marketable condition, *including manufacturing operations,* are not deductible. Compounding its error, the MMS ignores the *General Petroleum* holding, not affected by *Udall,* that residue gas is a manufactured product, and so proposes that no manufacturing cost be deducted against the residue gas."

One State commenter stated that the definition of "processing" is very vague. According to this commenter, the distinction between "field processing" and other "processing" is not clearly drawn. The commenter asserted that "The ambiguity of the definition of 'processing' would not be so troubling except for the fact that it seems to control the meaning of the term 'unprocessed gas,' which is not defined in the proposed regulations despite its critical importance. One would think that regulations aimed at providing certainty would present clear guidelines for identifying the 'processing' costs in which the royalty owner must share."

MMS Response: The MMS has considered the comments carefully but disagrees that the proposed definition is confusing and vague. Therefore, it will be retained unchanged in the final rule.

"Residue Gas"—One industry commenter suggested that "Residue gas may also include ethane." Another industry commenter recommends deleting this definition but states: "Nevertheless, if this definition is maintained residue gas should be restricted to residue gas resulting from processing sweet gas containing hydrocarbons."

MMS Response: The MMS has not adopted the suggestions made by the commenters and the definition remains unchanged. The definition recognizes that residue gas may include ethane.

"Spot Sales"—One industry commenter suggested deleting all language in the proposed definition that follows the word "duration." According to this commenter, "The additional language is not necessary to define a spot sales agreement as it defines what is *not* required, versus what *is* required."

One industry commenter suggested deleting the clause "* * * which does not require a cancellation notice to terminate * * *" "Many spot sales agreements require ten (10), thirty (30), or sixty (60) days notices of cancellation * * *. The MMS purpose of including only those contracts which do not imply an intent to continue in subsequent periods is adequately served by the balance of the definition."

Three industry/trade group commenters recommended that this paragraph should be retitled as "'spot/direct sales agreements' and a definition for direct sales be added as follows: A direct sale (which generally does not contain a reserve dedication) is a similar agreement but is usually made with an end user or local distribution company *and can be a short or long term contract.*"

One industry commenter recommended adding the following sentence to the definition: "A spot or direct sale which meets all of the criteria of an arm's-length contract as defined in § 206.151(d) of these regulations shall be treated as an arm's-length contract according to these regulations." The commenter believes that the proposed definition must clearly state that a spot sales agreement will be treated as arm's-length if it meets all the requirements of an arm's-length agreement.

MMS Response: In the final rule, MMS has inserted the word "normally" immediately preceding the phrase "require a cancellation notice to terminate." The MMS also agrees that there are spot sales which constitute arm's-length contracts. However, to be considered as a comparable arm's-length contract in the valuation of gas which is not sold pursuant to an arm's-length contract, these contracts also must meet other standards. See, for example, § 206.152(c)(1).

"Take-or-pay payment"—Several industry comments were received on this definition and all recommended its deletion. The comments are reflected by the following statement of one of the commenters: "While the definition proposed is technically correct, it should be deleted from the proposed rule because, as stated in the discussion of § 206.151(m) above, take-or-pay payments are not consideration for the sale of production."

MMS Response: The MMS has decided that the definition of take-or-pay payment is unnecessary. Take-or-pay payments have a generally understood meaning in the industry and may take different forms. MMS has decided to remove any definition from the final rules since a regulatory definition may not correspond with all types of payments which fall within the concept of take-or-pay payments which should be royalty bearing. The MMS already addressed above the issue of whether take-or-pay payments should be included in gross proceeds.

"Warranty Contract"—One industry commenter stated that "the exclusion of warranty contracts from the valuation of gross proceeds under an arm's-length contract is intended to exclude those low-value warranty contracts that were entered into prior to the mid 1970's. However, the proposed definition is so broad that it will encompass future negotiated selling arrangements." To clearly express the MMS's intent, the commenter "proposes that the definition be restricted to those contracts entered into before a specific date."

MMS Response: The MMS has modified the definition to refer only to long-term contracts entered into prior to 1970. This also includes contracts entered into prior to 1970 that may have been amended either before or after 1970.

Proposed New Definitions

Commenters have proposed adding the following definitions to the list of existing definitions: natural gas liquids; post-production costs; production; production costs; royalty; and unavoidably lost gas.

MMS Response: The MMS has decided not to include any of the suggested additional definitions. The terms either have a recognized meaning (such as "royalty") or are not used in the regulations (such as "post-production costs").

Section 206.152 Valuation standards—unprocessed gas.

Section 206.152(a).

Paragraph (a)(1) provides that the provisions of § 206.152 apply only to gas that is sold or otherwise disposed of by the lessee pursuant to an arm's-length contract prior to processing. The section expressly does not apply to contracts where the lessee reserves the right to process the gas or to percent-of-proceeds contracts. Several industry commenters stated that the proposal to exclude percent-of-proceeds contracts from this section is unreasonable and unfair to the lessee. They stated that the percentage of proceeds mechanism is a means of arriving at the wellhead value and is not a sale of processed gas. The commenters also stated that the requirement to submit allowances forms to MMS in these cases would be burdensome and, with the provision for exceeding the processing allowance limitations, such treatment is unnecessary. All industry commenters recommended classifying percent-of-proceeds contracts under unprocessed gas.

MMS Response: The MMS still believes that the percentage-of-proceeds contracts should be treated as processed gas as proposed. Without such treatment, lessees would be free to avoid many requirements and limitations of the valuation regulations simply by the manner in which they structure their contracts. In many cases the lessee will agree to any terms dictated by the processing plant owner to be able to realize revenue from the oil production from its wells. Under some cases MMS is familiar with, lessees have agreed to provide fuel to run compressors off the lease without compensation and lessees have given all or a substantial portion of any condensate recovered between the point of title transfer and the inlet of the plant to the plant operator without compensation. Further, in some cases, the lessee may allow itself to be paid based upon prices received by the plant operator under a non-arm's-length contract without the lessee being able to ensure that those prices reflect market value. Finally, MMS does not believe that any percentage-of-proceeds contracts, even being arm's-length contracts, would be an acceptable benchmark for determining values under non-arm's-length percentage-of-proceeds contracts. However, the final rule includes provisions for an exception from processing allowance limitations (see § 206.158(c)(3)), which should address many of the commenters' concerns).

An Indian commenter stated that this section is inconsistent with the ruling in *Jicarilla Apache Tribe v. Supron*, which held that under the terms of the Indian leases in dispute, wet gas had to be valued as the higher of the value at the lease or as the value of all products at the tailgate of the plant, less transportation and processing costs.

MMS Response: The MMS's regulations recognize the primacy of statutes, treaties, and oil and gas leases, thus providing a means for determining special valuation requirements not only for Indian leases, but also for Federal leases. Many Indian leases have provisions that require dual accounting for processed Indian gas production.

Section 206.152(a)(2).

One Indian commenter stated that this proposed rule authorizes alterations in dealings between the Indian lessor and the industry lessee. The commenter further stated that this provision will result in royalties which are adjusted for transportation costs not contemplated by either party to the lease. The commenter recommended that all references to transportation allowances be deleted and that value be defined, for royalty purposes, to be the fair-market value of the gas at the lease in marketable condition.

One industry commenter objected to the concept of determining royalty on the value of gas and the associated products after completion of the manufacturing or processing phase. The commenter recommended that royalty be due only on the market value of the product as it is produced at the wellhead.

Industry commenters recommended that the phrase "less applicable transportation" should be expanded to include other cost allowances such as production costs.

MMS Response: The MMS has modified the final rule to refer to "applicable allowances". In response to the comments, transportation allowances generally are appropriate for most Indian leases. The regulation refers to "applicable" allowances and does not imply that any and all transportation costs can be deducted. If transportation allowances are not appropriate, the word "applicable" restricts application only to those leases where they can be applied.

The MMS is including in the final rule a new paragraph (a)(3) which states that for any Indian leases which provide that the Secretary may consider the highest price paid or offered for a major portion (major portion) in determining value, MMS will, where data are available and where it is practicable, compare the value determined in accordance with the prescribed standards with the major portion. The rule provides that the royalty value, for royalty purposes, will be the higher of those two values. The draft final rule included a provision that if MMS determines that the major portion results in an unreasonably high value, then it will not be used for royalty purposes. Many Indian commenters thought that, for their leases which include a specific reference to the major portion, value should establish a minimum value, and a major portion value in most cases will be reasonable because at least half the gas is sold at or above that price. The MMS agrees and has made the change to the final rule.

Many Indian commenters raised concerns about the qualifications included in this paragraph. These commenters must recognize that if data are not available, it is impossible to do a major portion analysis.

The MMS is also including in paragraph (a)(3) a description of how the major portion is computed. It will be determined using like quality gas, which includes legal characteristics (generally, the specific NGPA category). Only gas sales under arm's-length contracts will be used because non-arm's-length contracts may not reflect market value. The production will be arrayed from highest price to lowest price (at the bottom). The major portion is that price at which 50 percent (by volume) plus one mcf of the gas (starting from the bottom up) is sold. An industry commenter recommended deletion of the reference to "area". However, because only arm's-length contracts are used in the analysis, the field may not yield a sufficiently reasonable sample in all cases. Generally, it will not be necessary to look beyond the field.

The MMS believes that for these Indian leases, by comparing the major portion to values determined using arm's-length-contract prices or the benchmarks for non-arm's-length-contracts, and using the higher of the two, the Indians will be receiving royalties in accordance with their contract with the lessee.

Section 206.152(b).

Several industry commenters stated that they supported the concept of relying on gross proceeds in an arm's-length transaction as the principal determinant of value. Some industry commenters also endorsed the overall approach to valuation determination procedures and eliminating the requirement that a lessee obtain preapproval. Industry commenters supported the acceptance of the gross proceeds received by their marketing affiliates under arm's-length contracts as value rather than treating the initial transfer to the marketing affiliate as a non-arm's-length transaction subject to valuation under the benchmark system. Industry also suggested that the regulations be amended to provide that, when the marketing affiliate sells commingled production from many leases to many parties and the sales contracts do not specify the source of the gas, the value of the gas sold from all contributing leases be defined as the weighted average price at which the production was sold.

MMS Response: The MMS agrees with the commenter that the value of gas sold in the manner described by the commenter is properly defined by the weighted average price at which the commingled stream was sold, but believes that guidelines to be prepared for inclusion in the MMS oil and Gas Payor Handbook would be the proper place to specifically address the issue.

One Indian commenter recommended that a definition of gas value, for royalty purposes, be based on the highest price paid or offered for similar gas in the same field or area, and requested MMS to adopt the following approach:

Section 206.102 (sic) Valuation Standards.

(a) Remains the same.

(b) The value of gas which is sold pursuant to a contract shall be the gross proceeds accruing, or which could accrue, to the lessee, *provided that* such proceeds do not fall more than 10 percent below the greater of the highest price paid or posted for similar gas in the same field or area. If such proceeds fall more than 10 percent below such prices, the value of gas in that case shall be 10 percent below the greater of the highest price paid or posted for similar gas in the same field or area.

A State commenter stated that the proposed regulations would allow substantial manipulation and undervaluation of the royalty amount because it is unacceptable to allow lessees to use contract prices as the royalty value without adequate safeguards to assure a fair valuation. They recommended at a minimum, only prices under "genuine" arm's-length contracts should be acceptable for royalty purposes and urged MMS to at least impose a floor value, such as 80 percent of the value of production as determined under the "value" criteria applicable to gas not sold under arm's-length contracts.

One Indian commenter recommended the inclusion of provisions specifically reserving to MMS the right to review and audit "arm's-length" contracts and that the proceeds under all contracts should be subject to price checks—market value analysis—before being accepted as value. Another Indian commenter requested that all arm's-length contracts be filed with MMS and that MMS require that agreements for the sale or disposition of gas within different branches of the same company be in writing and on file.

One Indian commenter stated that "if MMS is to properly undertake its responsibilities, a predetermination of value on which royalty is to be based should be made *before* production value is reported." In addition, it was recommended that the Secretary should determine whether each contract is arm's-length or non-arm's-length instead of allowing the lessee to make this determination. Also, it was suggested that the Secretary should have all benchmarks available to him and MMS should have the flexibility to set benchmark minimum prices established by the highest price paid or offered for a major portion of gas produced from the field or area.

MMS Response: The suggestions to predetermine the value on which royalty is to be based were not adopted because of the increase in administrative burden which would be very costly for MMS (and, in some instances, to industry). An internal sales agreement cannot be considered to be arm's-length.

In response to a large number of comments from the States, Indians, and industry, MMS has modified the regulations which govern the valuation of gas production sold pursuant to arm's-length contracts. For almost all such sales, the value for royalty purposes will continue to be the gross proceeds accruing to the lessee. Under MMS's existing regulations, the lessee's gross proceeds pursuant to an arm's-length contract are acceptable, though not conclusively, as the value for royalty purposes. The MMS believes that the gross proceeds standard should be applied to arm's-length sales for several reasons. The MMS typically accepts this value because it is well grounded in the realities of the marketplace where, in most cases, the 7/8ths or 5/6ths owner will be striving to obtain the highest attainable price for the gas production for the benefit of itself. The royalty owner benefits from this incentive.

It also adds more certainty to the valuation process for payors and provides them with a clear and logical value on which to base royalties. Under the final regulations, in most instances the lessee will not have to be concerned that several years after the production has been sold MMS will establish royalty value in excess of the arm's-length contract proceeds, thereby imposing a potential hardship on the lessee. This is particularly a concern for lessees who have long-term arm's-length contracts where sales prices under newer contracts may be higher. If MMS were to establish royalty value based on prices under those newer contracts, (*i.e.*, prices which the lessee cannot obtain under its contract), the resulting royalty obligation could, in some instances, consume the lessee's entire proceeds.

Establishing gross proceeds under an arm's-length contract as the royalty value also has benefits for MMS and those States which assist MMS in the audit and enforcement efforts. The gross proceeds standard will give auditors an objective basis for measuring lessee compliance. It will reduce audit workload and reduce the administrative appeal burden which results when valuation standards are too subjective, particularly when values are determined to be in excess of a lessee's arm's-length contract gross proceeds.

The MMS recognizes, however, that there must be exceptions to the general rule that the lessee's arm's-length contract price should be accepted without question as the value for royalty purposes. One such situation is where the contract does not reflect all of the consideration flowing either directly or indirectly from the buyer to the seller. For example, in return for Seller's reduced price for gas production from a Federal lease, Buyer may agree to reduce the price of oil it sells to the Seller from a non-Federal lease. This agreement is not reflected in the gas sales contract. In the event that MMS becomes aware of consideration that exists outside the four corners of the contract, MMS could accept the lessee's gross proceeds as value, adjusted to reflect the additional consideration. However, in some circumstances the additional consideration may not be easily calculable. Thus, even if the parties are not affiliated and the contract is "arm's-length," MMS may require in paragraph (b)(1)(ii) that the gas production be valued in accordance with paragraph (c), the standards used to value gas disposed of under non-arm's-length contracts. Under these standards, the lessee's gross proceeds still may determine value, but the lessee will be required to demonstrate comparability to other arm's-length contracts. Thus, despite many industry comments suggesting that this section be deleted, MMS is retaining it in the final rules.

The MMS recognizes that some parties may have multiple contracts with one another. This fact alone would not cause a contract to be treated as non-arm's-length. Rather, there must be some indication that the contract in question does not reflect the full agreement between the parties. Although many commenters disagreed with the requirement, the final regulations also include a provision whereby MMS may require a lessee to certify that the terms of its arm's-length contract reflect all the consideration flowing from the buyer to the seller for the gas. The commenters believed that values already were subject to audit and that was a sufficient safeguard. The MMS is retaining this provision because there may be circumstances where an auditor could not reasonably be expected to find other consideration, yet there is good reason to believe it exists. Because of the potentially severe penalties for a false certification, this will assure that no other consideration exists when the certification is received.

In other situations it may not be apparent why an arm's-length contract price is unusually low, yet the lessor should not accept the arm's-length contract proceeds as value. It may be because of collusion between the buyer and seller or improper conduct by the seller, or it could be the result of a patently imprudent contract. Even if the contract is between unaffiliated persons and thus "arm's-length," pursuant to paragraph (b)(1)(iii), if MMS determines that the gross proceeds do not reflect the reasonable value of the production because of misconduct by the contracting parties or because the lessee otherwise has breached its duty to the lessor to market the production for the mutual benefit of the lessee and the lessor, then MMS may require that the gas production be valued pursuant to paragraph (c)(2) or (c)(3). Thus, MMS first must determine that a price is unreasonable; for example, by looking at comparable contracts and sales. Then MMS must determine that the unreasonably low price was the result of misconduct or a breach by the lessee of its duty to market its production for the mutual benefit of itself and the lessor.

A breach of the lessee's duty to market production to the mutual benefit of the lessor includes, but is not limited to, collusion between the producer/seller and buyer, pricing practices found by a court or regulatory authority to be incorrect or fraudulently manipulated, or negligence in negotiating contracts.

The MMS believes that new § 206.152(b) establishes a more definable standard than subsection (b) of the first draft final rule at 52 FR 30813 ("whether there may be factors which would cause the contract not to be arm's-length"). Although MMS retains the discretion under this section not to accept an arm's-length contract price as value, which many commenters thought was a necessary provision in these regulations, there are limits on the exercise of that discretion.

Some commenters requested that the rules require MMS to give a lessee an opportunity to respond before making a finding under subsection (b)(iii). As a general matter, the appeals regulations in 30 CFR Part 290 give the lessee such an opportunity before a final MMS decision is made. However, MMS will give a lessee an informal opportunity to comment when it determines the lessee has breached its duty to market the gas for the mutual benefit of the lessee and the lessor.

If valuation in accordance with the second and third benchmarks in paragraph (c) is required, then the lessee also must follow the notification requirements of paragraph (e)(3).

The suggestion that the Secretary should determine whether each contract is arm's-length or non-arm's-length was implied in the rules. However, the MMS has added a clarifying provision to the final rule which provides that the lessee will have the burden of demonstrating that its contract is arm's-length. This includes overcoming presumptions of control where two parties are possibly affiliated.

Section 206.152(b)(2) of the proposed rules excepted warranty contracts from the general acceptance of gross proceeds as value for arm's-length contracts. One industry commenter recommended that advance MMS approval not be required for the value of gas sold pursuant to a warranty contract since all activities are subject to audit.

Two industry commenters stated that this section should be deleted and that the gross proceeds received by the producer under a warranty contract should be used for determining royalty just as it is for other arm's-length contracts.

Two industry commenters recommended that MMS consider limiting the warranty contracts exception to those contracts entered into before a specific date, such as prior to the mid-1970's.

MMS Response: The MMS has adopted the rule that the value of gas sold pursuant to a warranty contract will be determined by MMS. The issue of limiting the definition of warranty contracts to those executed prior to 1970 was discussed above in the definition of warranty contract.

Most industry commenters strongly disagreed with the language "or which could accrue" contained throughout the regulations. Most companies recommended that the language be deleted. Most commenters stated that the language is too speculative and appears to provide for a second-guess mechanism under which a lessee's sale today can be reviewed in light of knowledge gained at a later date.

MMS Response: The MMS has determined that the phrase "or which could accrue" will be deleted in reference to gross proceeds. Many commenters thought that this phrase would allow MMS to second guess the price which the lessee agreed to in its contract by arguing that other persons selling gas may have received higher prices—thus, more proceeds "could have accrued" to the lessee. This was not MMS's purpose in including the "or which could accrue" language in the proposed rule. Rather, MMS's intent is to ensure that royalties are paid on the full amount to which the lessee is entitled under its contract, not just on the amount of money it may actually receive from its purchaser. However, MMS is satisfied that the phrase "the gross proceeds accruing to the lessee" properly includes all consideration to which the lessee is entitled under its contract, not necessarily just what it actually receives from the buyer. Therefore, the "or which could accrue" phrase was unnecessary. Because it caused confusion as to MMS's intent, it was deleted from the final rule.

One Indian commenter stated that "acceptance of gross proceeds as conclusive evidence of value is an abrogation of the Secretary's fiduciary duties," and that they do not believe "gross proceeds accruing or which could have accrued in an arm's-length transaction should be determinative of value for gas produced from Indian and Federal leases."

MMS Response: As discussed previously, these rules do not provide for conclusive acceptance of gross proceeds except in well-defined and appropriate circumstances. The MMS believes that the rules as adopted with the changes discussed earlier will result in appropriate values for Indian leases, in accordance with the Secretary's responsibilities.

Section 206.152(c).

Gas which is not sold pursuant to an arm's-length contract is required by the regulations to be valued in accordance with a series of benchmarks. Several State, Indian, and industry commenters disagree with various aspects of the proposed benchmark system because they think that it is vague and subjective. Two State commenters stated that because the majority of gas contracts are not arm's-length, the benchmark system proposed by MMS may be too complex. They recommend that "* * * MMS should study the numerous pricing provisions related to gas sales, and on the basis of the study establish Federal floor values which could be used by lessees to compute a minimum royalty and which would be publicly available."

One State commenter believes that the appropriateness of using the benchmark system depends upon whether the benchmarks are fair and reliable. According to this commenter, "The proposed system would not be fair to the royalty owner because it would lead to the potential for abuse and would certainly result in the diminution of royalties. It would be unreliable because the standards are vague, subjective, and subject to abuse. Unlike the proposed benchmarks for oil valuation, we do not believe that the proposed gas valuation benchmarks can be developed into a fair and workable system. Instead, we believe all the factors listed in paragraphs (c)(1) through (c)(4) should be combined into a single valuation standard." One industry commenter stated that although the proposed benchmark system gives producers more confidence in arriving at value, it falls short of providing a method to determine an exact royalty amount when royalty is due.

Many industry representatives and trade groups and one Indian trade group, with minor changes, support the benchmarks and giving them priorities because both will add certainty to valuation determinations. They commend MMS for the recognition of market forces as the principal determinant of value. One commenter stated that "The truest representation of the value of a product is what it can be sold for on the open market, at arm's-length. The proposed benchmarks for valuation of gas under arm's-length contract, non-arm's-length contract, and no contract transactions promote accurate valuation according to the marketplace, and provide rational standards for MMS to follow in monitoring establishment of gas value."

Some commenters stated that the benchmarks should not be prioritized. Rather, value should be determined using the most applicable benchmark. These same commenters recommended combining the first two benchmarks. Other commenters suggested a different ordering of the benchmarks.

MMS Response: The MMS believes that a prioritized benchmark system is a valid and usable system for determining the value of gas not sold pursuant to an arm's-length contract. The system allows the lessee some certainty in determining its own value without dependence upon MMS to establish the value. The suggestion that MMS develop Federal floor values is not feasible or equitable and would be difficult to administer. Therefore, other than some minor modifications, the benchmarks have been adopted as proposed. The MMS believes that the proposed ordering of the benchmarks basically is correct and equitable to both the lessee and lessor. The MMS agrees that the net-back method will not be used frequently. The net-back analysis should only be used where less complex procedures are not feasible. For purposes of this section, MMS does not consider a situation where either transportation or processing allowances are deducted from an arm's-length delivered sales price for gas as a net back. Such procedures will typically be used for royalty valuation. See the discussion of the net-back method above.

In the draft final rule, MMS combined the first two benchmarks. The standard still was the lessee's gross proceeds, but the lessee was determining comparability against a broader sample which helps ensure that the lessee's gross proceeds reflect the value of the gas in the market, not just what that lessee considers to be the market value.

MMS received many industry comments suggesting that the first two benchmarks be separated again because the lessee's own sales data are a good measure of value and are determinable. Sales data of other persons often are not available, according to these commenters.

MMS Response: The MMS believes that the benchmarks will be retained as revised in the second draft final rule. These benchmarks best ensure that the lessee's non-arm's-length prices are reasonable determinants of value.

Some States and Indian lessors stated that when applying benchmarks, it should not be necessary in all circumstances to consider all other sales in the field. In other instances, it may be necessary to look beyond the field. The MMS agrees that the size of any sample cannot be predetermined but must be based upon the actual circumstances in the field or area.

Three Indian commenters stated that MMS's failure to recognize its obligation to maximize tribal royalties is evidenced in the proposed benchmark system. One commenter stated that "MMS, however, relies on lessee-generated information for that determination and, moreover, relies upon the truthfulness of that information. For example, under alternative number one, MMS proposes to look at the lessee's comparable contracts in the same field or area, notwithstanding possible underselling during the same period. Plainly, this benchmark is so riddled with potential conflicts of interest that it cannot possibly be urged as consistent with the Federal fiduciary duty to maximize Indian oil and gas resources." Another commenter stated that the proposed benchmark system is based on the premise that gross proceeds represents market value and "Gross proceeds have always been considered as the minimum value of production because it has long been recognized that price does not always indicate value. The proposed benchmarks appear to treat gross proceeds as the maximum value." This commenter "believes that gas production should be valued at the highest price posted or paid in the field regardless of whether the contract is arm's-length or non-arm's-length * * *." Finally, one Indian commenter stated that "The lease provisions should prevail and should require the Secretary to formulate and implement procedures for the majority portion analysis. These provisions of the regulations should include a statement which indicates that it will not be applied to Indian Tribal and allottee leases. If, however, these provisions will be applied to Indian tribal and allottee leases, then each benchmark should be considered a reasonable option that the Secretary can utilize to determine value and the Secretary should use the reasonable option which brings the highest revenue to the Indian Tribe or allottee."

MMS Response: The MMS believes that the regulations adopted will permit the Secretary to discharge his responsibilities to the Tribes and allottees because the value determined in accordance with the benchmarks will be compared to the major portion, with royalties due on the higher value. This process is required by paragraph (a)(3), discussed above.

One industry commenter recommended that "the last benchmark of net-back pricing be eliminated from the list because we believe that it would not be routinely used and would be administratively impractical to implement. The reference to any other reasonable method to determine value should be retained."

MMS Response: The MMS disagrees that the net-back method should be deleted. The net-back method is a viable valuation procedure, even though it will not be routinely used.

One industry commenter stated that "* * * depending upon how one treats 'spot sales', the hierarchy of measures which they establish could result in a substitution of a poorer measure for one that represents the best measure of gas value." This commenter recommended placing spot-sale agreements higher in the hierarchy of benchmarks.

MMS Response: The MMS believes that the position of "spot sales" in the benchmark system is appropriate. The first two proposed benchmarks, combined as one in the final rule, are a better measure of establishing value for royalty purposes than spot sales. The rule has been modified to reference "arm's-length" spot sales.

One industry commenter suggests that the wording of the criteria should be amended to avoid ambiguity in their application: "As currently written, these provisions are unclear as to how royalty should be valued if the proceeds under the non-arm's-length contract is not 'equivalent' to the proceeds of the lessee's arm's-length contracts (first criterion) or the arm's-length contracts of other lessees in the field (second criterion)." This commenter "* * * understands the intent of the proposed regulations is that the proceeds under the referenced arm's-length contracts would be used to set royalties, but the regulation does not expressly so state. Indeed, as presently worded, the regulation would suggest that if the non-arm's-length contract was not 'equivalent', then the next criterion in the hierarchy would apply. This ambiguity should be removed."

MMS Response: The MMS disagrees that these provisions are unclear. Under the benchmark system, value will 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 be reasonably applied. Therefore, if the proceeds under comparable arm's-length contracts in the field are not "equivalent" to the proceeds under the non-arm's-length contract, then the first benchmark does not apply and the lessee should try to apply the second benchmark. If that one also does not apply, then the lessee must apply the third benchmark.

One industry commenter stated that "for making comparisons to arm's-length contracts, when the producer is selling gas to an affiliate and that affiliate is also purchasing gas in the same field or area under an arm's-length contract, the marketing experiences of the parties to the arm's-length contract should be a primary consideration (not just of the volume of gas sold, for example). If the producer under a comparable arm's-length contract is active in the marketplace, it is only reasonable that he would neither accept less nor pay more than the market price for gas. In addition, larger volumes of gas do not always attract a better price than a smaller volume. In some cases, the larger volume is harder to move because it has to be sold in pieces."

MMS Response: The rules, as adopted, require that there be numerous factors considered before an arm's-length contract could be deemed comparable. The purpose for consideration of these factors is to prevent abuses through application of only a few factors so that contracts containing unusually low or high prices could be used.

Many industry commenters recommended that legal characteristics of the gas be included in the comparability criteria in paragraph (c)(1).

MMS Response: This addition is unnecessary as the section already refers to like-quality gas, which is defined as including legal characteristics.

One industry commenter suggested "an alteration to the proposed regulations under §§ 206.152 and 206.153 to validate any intracompany or affiliate intercompany 'sale', if that transaction is monitored by a regulatory body to determine the market responsiveness of the transaction. Specifically, the commenter suggests that MMS's proposed regulations recognize the FERC's right to determine the justness and reasonableness of (producer) 'first sale' market rates, where those costs are 'passed on' to interstate pipeline sale-for-resale customers via Purchased Gas Cost Adjustment Clauses filed by interstate pipelines as part of their FERC Gas Tariff."

MMS Response: The MMS and FERC have different statutory responsibilities. It is MMS's responsibility to determine the value of production from Federal and Indian leases. Although FERC's actions may be one criterion to consider in determining value, MMS cannot accept them as conclusive.

One industry commenter stated that under the benchmark system it is difficult for an affiliated producer to prove its determination of value, especially with respect to those properties it does not operate. According to this commenter, "The MMS is in the unique position of having access to data, facts, and information that are not readily available to an individual producer. Indeed, attempts to gather such information might violate antitrust laws. Without access to this information on a continuing basis, application of these benchmarks becomes difficult, if not impossible." This commenter recommended "that the burden of proof be shifted to the MMS such that a rebuttable presumption exists that the gross proceeds accrued to an affiliated producer is reasonable value absent a clear showing to the contrary by the MMS using these benchmarks." Other commenters also suggested that MMS gather and make available sales data in certain fields.

MMS Response: Obviously, a lessee will be able to obtain the necessary data on its sales for application of the first benchmark. The MMS also believes that in most fields or areas lessees will be able to obtain data on third-party transactions. If those data are unavailable, the lessee will have to use one of the succeeding benchmarks, but in no event can the lessee use a value which is less than its gross proceeds. Because values determined under the second and third benchmarks must be the subject of a notice to MMS (see § 206.152(e)(3) of the final rules), and because a lessee may seek a value determination from MMS (see § 206.152(g) of the final rules), MMS is satisfied that ultimately the lessee will be able to determine the proper royalty value for its gas.

One State commenter noted that it is inappropriate to put the valuation process into a benchmark straight jacket. In addition, this commenter stated that this paragraph permits a lessee to deliberately price its non-arm's-length disposition at the lowest price it can argue to be "comparable" in the field, even where much higher values may be obtained in other dispositions from the field.

MMS Response: A lessee will have many factors to consider in establishing a price under its non-arm's-length contracts, including tax consequences and regulatory concerns. If the price selected is equivalent to the price under comparable arm's-length contracts which must meet the standards in paragraph (c)(1), MMS is satisfied that the price reflects market value and is acceptable for royalty purposes.

One Indian commenter was concerned that the lessee would apparently make the determination as to whether the "arm's-length" contract under which the comparison is made is, in fact, arm's-length. Also, although the data are subject to monitoring, review, and audit by MMS, the commenter believes that in view of the past experience with audits by MMS, the lessees' reporting of gross proceeds under non-arm's-length contracts would remain on the honor system.

MMS Response: Under most valuation procedures MMS considered for these regulations, it would be up to the lessee in the first instance to apply those procedures and report royalties each month. The MMS has adopted rules which it hopes are clear and comprehensible. It must be assumed that lessees will apply the rules properly considering the likelihood of audit and the possibility of significant interest and perhaps penalties for intentional underpayment of royalties.

One industry commenter interpreted the regulations to require that gas sold pursuant to spot-sales contracts would be valued under the first benchmark, even though "spot sales" are mentioned in a later benchmark. In addition, the commenter stated that the best measure of value for gas sold pursuant to arm's-length spot sale contracts are those contracts and not other long-term contracts which are not comparable.

MMS Response: If a spot-sales contract is arm's-length, the value of the gas sold under it would be determined pursuant to paragraph (b), not by application of the benchmarks.

Two industry commenters stated that the net-back method should be stricken from this section because the net-back method is to be used as a benchmark only when the preceding benchmarks are inapplicable; therefore, to these commenters it seems inappropriate to include it as a presumed priority when any other reasonable method is what is actually intended.

One industry commenter stated that the reference to net-back method needs clarification. Further, the commenter stated that net-back method is simply a means for reconstructing the value of gas to the well and has nothing to do with valuing the disposition of the production at a point remote from the well.

One State commenter noted that there is no logical basis for favoring valuation on the basis of "gross proceeds" less allowable deductions while disfavoring "net-back method". Also, the net-back method is essentially the same thing as "gross proceeds" with allowable deductions.

MMS Response: The MMS believes that the benchmark priority system is appropriate. As explained above in regard to the definition of net-back method, MMS does not anticipate that this method will be used frequently. It generally will be used where the nature of the product has changed (i.e., gas to electricity) and it is necessary to work back from the sales price of the electricity to get a value for the gas.

Section 206.152(d).

Two industry commenters supported the premise that "if the maximum lawful price permitted by Federal law is less than the value determined pursuant to the valuation regulations, MMS would accept such maximum price as value."

One industry commenter recommended deleting the last sentence of this paragraph because gas sold under a warranty contract is valued in the same manner as gas sold pursuant to any other arm's-length contract.

The MMS also received several comments from the Indians and States stating that the rules should specify that State and local price ceilings will not operate to limit the value for royalty purposes. The MMS proposed to include such a provision in the second draft final rule. Some commenters supported this provision. Others, including mostly industry and one State commenter, objected to the provision on the grounds that it is unfair to producers who must be bound by these ceilings when selling their production.

MMS Response: The final rulemaking adopts this paragraph with the addition of a provision that price limitations set by any State or local government will not be considered to be a maximum price permitted by Federal law. Therefore, in some situations, value for royalty purposes may exceed a State or local price limitation. The MMS agrees with those commenters who argued that States and local governments should not be able to limit royalty values, particularly for Indian leases.

The last sentence, which is now paragraph (d)(2), was not deleted because the MMS believes that warranty contracts must be viewed differently than other arm's-length contracts for purposes of value. Unlike arm's-length contracts for gas production which is committed to the contract, the seller under a warranty contract often had the sole authority to determine the origin of the gas production to be delivered. Therefore, the seller had the option not to sell particular production from a Federal or Indian lease under the warranty contract and to sell it at a higher price. Thus, although in some NGPA categories the warranty contract price is the maximum price permitted by law for gas sold *under that contract,* it is the sole decision of the lessee to dedicate gas from Federal or Indian leases to that contract.

Section 206.152(e).

Several industry and State commenters supported establishing a valuation procedure which does not require the prior approval of MMS because it will expedite and simplify the valuation process. Two industry commenters stated that "the time during which the MMS may direct a lessee to pay royalty at a different value should be limited to a specific period so that the lessee is not required to indefinitely retain the records it relies upon to support the value determination." A State commenter noted that "Also, the lessee should be required to retain 'all data relevant to determination of royalty value', not simply the evidence supporting the lessee's claimed value. A lessee should not be allowed to destroy relevant evidence supporting a different royalty valuation, and to retain only that which is self-serving. Also, the regulation should specify that MMS 'will' order compliance when incorrect payments are discovered."

Many industry commenters stated that the provision is too broad and should be limited to fee lands within the boundaries of approved Federal unit or communitized areas. They argued that lessees should not be required to provide information on their other sales prices or volumes.

MMS Response: The MMS has adopted in the final rule a valuation procedure that generally does not require MMS's prior approval. The second sentence has been modified to read as follows: "* * * the lessee shall retain all available data relevant to the determination of value." Lessees are required to retain all records to support value determinations for a period of 6 years, unless an audit is ongoing, as mandated by section 103 of FOGRMA, 30 U.S.C. 1713. The lessee is responsible for complying fully with the regulations by properly valuing lease products, for royalty purposes, in accordance with the appropriate benchmark and to retain all relevant data. The MMS believes that the adopted language clearly states this requirement. The MMS also has adopted in paragraph (e)(2) of the final regulations a requirement that lessees make available to authorized MMS State and Indian representatives, or to the Department's Office of the Inspector General, arm's-length sales and volume data which it has available for like-quality production sold from the same field or area or nearby fields or areas. Because lessees in many instances will be determining value for Federal or Indian production by reference to other sales in the field or area, MMS must have access to the data to the same extent as the lessee to determine whether the lessee's valuation was in accordance with the regulations.

Several industry commenters recommended that MMS delete the requirement of proposed paragraph (e)(2) that a lessee must notify MMS if it uses the third or fourth (now second or third) benchmarks because it is not consistent with MMS's self-implementing concept and current MMS auditing and monitoring rights are adequate to allow the MMS to verify royalty compliance.

MMS Response: The MMS believes that what is now paragraph (e)(3) in the final rule is consistent with its self-implementing policy because lessees that determine value pursuant to paragraphs (c)(2) or (c)(3) of this section must notify MMS of their determination after the fact and not before the fact. In every instance, value for royalty purposes is subject to future audit. This section has been modified so that the notice is due the end of the month following the month the lessee first reports royalties on the Form MMS-2014 using paragraph (c)(2) or (c)(3).

Section 206.152(f).

One State commenter suggested that a "provision should be made for penalties for willful violations and violations made in reckless disregard of royalty obligations."

Industry representatives commented that if the lessee must pay any difference plus interest, MMS should also pay, when applicable, any difference plus any interest statutorily authorized.

MMS Response: If a lessee knowingly or willfully underpays royalty, it may be subject to civil penalties in accordance with FOGRMA, 30 U.S.C. 1719, and MMS regulations at 30 CFR Part 241. With regard to the second comment, MMS is barred by law from paying interest on royalty overpayments but is required by law (i.e. FOGRMA) to collect interest on late payments.

Section 206.152(g).

This paragraph provides that the lessee may request a value determination from MMS. One State commenter noted that "the lessee should be required to submit 'all data relevant to determination of royalty value'. Again, a lessee should not be able to limit its documentary submittal to evidence which 'supports' its claimed royalty value. Also, because of the impact upon the States and Indians, and in light of the existing cooperative and State audit programs, an opportunity should be given for review and comment on royalty determination requests by the potentially impacted State, Alaska Native Corporation, Indian Tribe or Indian allottee." One Indian commenter suggested that in addition to a lessee, a lessor should at any time be able to request a royalty value determination from MMS. This commenter also stated that "this paragraph should require MMS to notify the Tribe or allottee involved of any change in value determinations."

Several industry commenters stated that "the MMS should impose a time limitation on itself to respond to requests for valuations from a lessee, in the absence of which the lessee should not be held liable for interest or penalties for underpayment of royalty." Further, one industry commenter stated that this section should be used to allow a value determination to be made by MMS which would accommodate the circumstances of a particular lessee when its circumstances do not allow for a definitive value determination under the applicable benchmark. As an example, the commenter stated that, although its gas sales are made under arm's-length contracts, the manner in which the gas is marketed (bundled sales of gas from many leases on the spot market to many purchasers) prevents the tracing of the gas produced from any one lease to a particular sales outlet and, thus, the defining of the gross proceeds received from the sale of the gas produced from that one lease.

MMS Response: The proposed language has been modified to require that a lessee submit all available data relevant to its valuation proposal. The MMS does not consider it practical to include in the regulations a requirement for review by the State or Indian lessor when a value determination is made. This does not make the cooperative audit program in accordance with FOGRMA less effective because MMS will make every effort to assist and consult with States and Indian lessors in valuation matters. The MMS also will make every effort to respond timely to requests by lessees, but this is necessarily dependent upon available resources; thus, MMS cannot agree to a regulatory time limit. The MMS has added a sentence to accommodate the requested flexibility. Therefore, this section now provides that MMS may use any of the valuation criteria authorized by the regulations when issuing a value determination. The MMS has adopted this change because of the continuing changes in the way gas is marketed.

Section 206.152(h).

This paragraph provides generally that the value of production, for royalty purposes, cannot be less than the lessee's gross proceeds less applicable allowances. One industry commenter recommended that the last sentence be replaced with "* * * allowance determined pursuant to these *regulations.*" Another industry commenter recommended that the phrase "less applicable transportation and processing allowances" be expanded to include "and other cost allowances." Some industry commenters recommended deleting these paragraphs entirely.

MMS Response: For reasons discussed earlier in this preamble, MMS has determined that the phrase "or which could accrue" should be deleted from the final rule. The MMS also has modified this section to refer to all applicable allowances, not just transportation allowances.

Section 206.152(i).

This paragraph addresses the lessee's obligation to place lease production in marketable condition. Several State, Indian, and individual commenters agree with the MMS's proposed provision that costs such as those for compression to meet pipeline pressure requirements to place the gas in marketable condition should be borne by the lessee.

One industry commenter was concerned that "marketable condition" is not a constant, but acknowledges the lessee should act as a reasonably prudent operator in marketing its products. Many industry commenters believed that the statutory framework and lease terms provide that royalty is due only on the market value of gas as it is produced at the wellhead and any obligation the lessee may have to render the gas marketable does not entitle the lessor to a free ride on those expenses incurred by the lessee subsequent to production. These commenters also believed the lessee is entitled to deduct all reasonable post-production expenses, including any costs incurred by the lessee to make the product marketable.

Some industry commenters recommended deleting this provision because of the changes occurring in the marketplace. They stated that these costs are subject to negotiation and may be incurred by either party. They believed that it is incorrect to assume that costs incurred by a purchaser have a direct effect on the price to be paid and suggested that the price paid by the purchaser should be used for royalty valuation unless stated specifically in the contract that it was adjusted to cover the subject costs.

One industry commenter noted that the Federal Energy Regulatory Commission has rejected imposition of any national quality standards for gas sold in first sales and has left to each producer-purchaser contract the resolution of which downstream-of-the-wellhead services are to be provided by which party to the contract. Reference was made to FERC Order No. 94A, 22 FERC 61,055 (1983).

Most industry commenters essentially believed that the lessor should proportionately share in all costs subsequent to production, including the costs of placing production in marketable condition. They believed that all so-called "post production" costs should be shared because such costs are incurred to enhance the value of the production from the lease for the benefit of both the lessee and the lessor; proportionate sharing of those costs would yield a value of production that is equal for both lessee and lessor. These commenters believed that royalty is due on the market value of production at the lease or well, and that proportionate sharing of any post-production costs incurred to enhance the value of production is necessary to meet this requirement.

They stated that, under the proposed rules, no allowance is made for the costs of processing residue gas to place it in marketable condition or for any other post-production costs incurred to dehydrate, compress, or gather the product. They further stated that MMS has abandoned the definition of "associated" and "principal" products but the unjustified concept underlying these terms has apparently been retained.

The industry commenters generally argued that MMS improperly sweeps all post-production operations under the holding of the *California* v. *Udall* case. They stated that MMS goes so far as to say that even if a buyer willingly buys raw, unconditioned gas (i.e., if there is an actual market for such gas in the field), any of the costs the buyer incurs to place the gas in "marketable" condition will be added to the purchase price of the gas. They believed that this approach totally distorts the concept of market value at the lease, ignores the holding in *Udall*, and exceeds the reasonable and legal limits of the Secretary's discretion. They further stated that the Secretary should recognize the realities of today's onshore leasing and production and that all post-production costs should be deductible but, at the very least, they believed that off-lease post-production and unusual or extraordinary on-lease post-production costs should be shared proportionately.

The industry commenters stated that the MMS should recognize that manufacturing/processing, transportation, and other post-production costs are legitimate deductions necessary to arrive at the value of production, for royalty purposes, at the lease or well and that such costs should be deductible from the value of all marketable products when necessary to reflect the actual expenditures that enhanced the value of the gas after production. They further stated that if MMS continues to rely on the *Udall* holding, its proper application requires a consideration of the purpose served by a particular facility to distinguish between costs "incidental to marketing" and manufacturing or transportation costs.

The MMS specifically requested comment on a provision in the draft final rules which would provide an allowance for certain production related costs in extraordinary situations. Many comments were received from industry supporting this provision and suggesting that it be broadened.

MMS Response: Historically, the policy and practice of MMS is that the lessee is responsible for placing the lease product in marketable condition at no cost to the lessor. This practice has been upheld by court decision. The MMS has adopted the suggestion that the language "unless otherwise provided in the lease agreement" be added at the end of the first sentence because there are a few leases in which the lessor shares in such costs. Also, as noted earlier, MMS received many comments that so-called post-production costs should be allowed as a deduction in determining value for royalty purposes. Generally, these costs are not allowed as a deduction because they are necessary to make production marketable.

The MMS received many comments on the section added to the draft final rules that provided for certain extraordinary cost allowances. State and some Indian commenters thought that this section was an unwarranted exception from the requirement that the lessee is obligated to bear the costs of placing gas in marketable condition or that further restrictions should be included, while one Indian commenter endorsed the principle introduced by this new section. Industry commenters generally thought that the new section was a step in the right direction, but thought that the dual qualification process was too rigid. They suggested that the extraordinary allowance be granted if a lessee could meet the requirements of either paragraph (i) or (ii). Industry commenters also suggested that the reference to 400 meters be changed to 400 feet because that is the point at which costs begin to escalate significantly. They also thought that use of the term "unique" was inappropriate because it would limit the applicability to only the first lessee with a particular type of extraordinary operation. Some commenters also requested that, when approved, the allowance extend beyond one year.

MMS Response: After carefully considering all of the comments on this issue, MMS has decided not to retain the extraordinary cost allowance provision in the final rules. It was concluded that the burdens placed on the lessee by the environment in which it must operate were matters taken into account at the time the lease was issued, affecting the amounts of bonus bids and, in some instances, the royalty rate. The MMS has concluded that if a lessee is entitled to further economic relief, it is inappropriate to provide that relief by adjusting the value of the production by methods which are inconsistent with MMS's historical practice and interpretation of the lessee's express obligation to place production in marketable condition at no cost to the lessor. Rather, the more appropriate mechanism is for the Department to consider royalty rate relief in circumstances where it is warranted for existing leases, and for lessees to consider such factors when entering leases in the future under royalty reduction procedures which can be adjusted to the price and cost circumstances prevailing on a particular lease and at a particular time.

Section 206.152(j).

One industry commenter stated that this provision, as proposed, goes against the firm notion of gross proceeds and grants an exception only in situations where the lessee is entitled to a contractual price increase. According to the commenter, this ignores the reality of the existing situation in the gas marketplace where many purchasers have unilaterally suspended contractually obligated takes and payments under the pretext of "force majeure." The commenter believed that it may be more prudent in many instances to diligently renegotiate contracts which would be in the best interest of the lessee and lessor. The commenter further stated that such renegotiations may take place over an extended period of time during which the lessee may be receiving less than its contract price for its gas; therefore, under these circumstances, where the lessee is taking documented, reasonable measures to force purchaser compliance and to favorably renegotiate its contract, the lessee should only be required to pay royalty on the gross proceeds it receives from the purchaser for its gas.

The industry commenter also stated that rapid deterioration of purchasers' markets has caused unilateral price actions; further, difficult and protracted negotiations have ensued during which proceeds are less than the contractually agreed-to price. The commenter mentioned that lengthy litigation is a last resort. The lessor benefits from continued production at market prices pending final resolution and, therefore, a more realistic approach would be to accept proceeds if proceeds were not less than the prevailing market price in the field or area.

One Indian commenter foresaw the ability of willing parties to amend contracts to compromise payments that have accrued to or would accrue to the lessee under its existing contract. The commenter believed that, of course, such contract revisions cannot be avoided in all instances but, if they are made, the lessee should not be able to compromise the lessor's right to receive royalty payments pursuant to the original contract and not under any amendments that have compromised the price.

One industry commenter argued that MMS has neither the authority nor the expertise to determine "the highest price a prudent lessee can receive through legally enforceable claims under its contract." The commenter also suggested deleting most of this section with the exception of the third sentence (of the second draft final rule) and the requirement that the lessee must pay royalties on all volumes of production which are sold.

One State commenter expressed that, by freely allowing contract revisions (even retroactive ones), MMS would provide a gaping loophole in the requirement that a lessee seek to enforce its contract "entitlements." The commenter believed that when a lessee is challenged by the MMS about not enforcing its contract rights, there are few buyers who will not agree to assist their sellers by retroactively amending their contracts to the lower amount actually paid.

MMS Response: The MMS has adopted this provision with only minor changes from the original proposal. However, the paragraph does not preclude the approach suggested by the commenters. This section requires a lessee to pay royalty in accordance with the contract price, but also expressly recognizes that contract prices may be amended retroactively. The MMS is aware that often there is a process of negotiation that occurs before the contract is formally amended and that lower payments may be received in the interim. Royalties may be paid on the gross proceeds received by the lessee until all attempts to force the purchaser to renegotiate the contract or to comply with the existing contract are exhausted, provided the lessee takes proper or timely action to receive prices or benefits to which it is entitled, or to revise the contract retroactively. Thus, the MMS will accept a renegotiated or a revised contract price if the main reason for renegotiating or revising the contract is not solely to reduce royalties.

However, if a higher price can be legally enforceable under a contract and the lessee is not diligent in obtaining that price, royalties will be due on that higher price.

Two industry commenters suggested that the phrase "the lessee will owe no additional royalty until monies are * * * received" be reworded to insert the phrase "unless or" before the word "until". They believed that it is contrary to the concept of "proceeds received" to attempt to assess royalty on proceeds which have never been received when only part payment is made to the lessee in contract disputes.

MMS Response: The MMS adopted the suggested change in the final regulation.

One commenter stated that retroactive application of contract revisions may be inconsistent with FOGRMA because it requires that royalties be keyed to production and not to sales. The commenter further stated that timely application by a lessee for a price increase should not be sufficient to allow a lessee to defer payment of royalties until monies or consideration resulting from the price increase are received. The commenter stated that a lessee should be required to go further in pressing its claim for benefits accruing or which could accrue to the lessee under the contract before nonpayment of additional royalties is allowed, perhaps even to the point of instituting litigation.

Two industry commenters stated that the "prudent operator" clause is unnecessary because it is in the lessee's own best interest to obtain the maximum amount of revenue possible under the terms of the applicable contract. They believed that the inclusion of a "prudent operator" standard in the regulations contradicts the concept of using market proceeds and merely serves to impose an obligation on MMS auditors to evaluate and second-guess the prudency of the actions of lessees. They also believed the "prudent operator" clause opens the door to regulatory uncertainty and the basing of royalties on amounts in excess of the market value of gas. They believe the provision should be eliminated.

MMS Response: Although most lessees will try to maximize the amount of revenue possible under the terms of the applicable contract, not all will be diligent. Therefore, MMS must protect the Federal Government's and Indian's interests by using the "prudent operator" clause.

Two industry commenters stated that they disagreed with MMS's attempt to enforce contract entitlements. They believed that, as proposed, royalties would be based on the highest price obtainable and would serve to encourage the pursuit of price increases, rather than the proper payment of royalties based on the prices received. They also believed that this provision is contrary to MMS's own statement 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 interest, advancing those of the royalty owners as well;" therefore, they recommended this provision be deleted.

MMS Response: The MMS does not view this provision as contrary to the approach it has taken to determine values. It would be inconsistent with the theme of these regulations for MMS to not require full compliance with its principal value determinant.

Section 206.152(k).

The MMS has added a new paragraph (k) to the draft final rules which provides that in those situations where MMS may make a preliminary value determination in the course of monitoring compliance with these regulations, that determination will not be binding until MMS has done an audit and the audit formally is closed. The MMS intends to issue further guidelines on when an audit is closed.

Several industry commenters thought that any determinations by MMS should be binding.

MMS Response: The MMS is adopting this section. The MMS cannot be bound by a preliminary determination which may not be based on a full array of information as would be available during an audit.

Section 206.152(l).

Two individual commenters stated that this paragraph, which was proposed as paragraph (k), appears to preclude the lessor or overriding royalty interest owner from obtaining any information to substantiate the transportation and processing costs he is being charged. Therefore, they are opposed to this provision.

One Indian commenter stated that this provision perpetuates restrictions upon disclosure of data required in reviewing a lessee's computation of royalty. The commenter believed that Indian Tribes should be provided copies of all reports submitted by their lessees to MMS, upon request. The commenter also stated that the Tribes need this information to monitor lessees as well as responsible Federal agencies, and requested that the information provisions be revised to ease release of this information to Tribes subject to reasonable restrictions upon disclosure to third parties.

One Indian commenter stated that this provision should make it clear that all information will be available to Indian lessors and States without going through the Freedom of Information Act procedures. The commenter also stated that to place such a burden on Indian Tribes and States who are the beneficiaries of the production would not be reasonable.

One Indian commenter stated that the scope of this provision is so broad that it effectively denies Indian Tribes and allottees and States access to the information required to assure that valuations are properly determined. The commenter reminded MMS that the intent of the FOGRMA is to provide all interested parties, including Indian Tribes and allottees and States, the data necessary to conduct audits, oversee the audits performed by MMS, and in the case of Indian Tribes, to manage their mineral resources and to plan for governmental operations. The commenter stated that it could not understand why the MMS included this provision inasmuch as the almost unanimous vote of the Royalty Management Advisory Committee on a resolution recommending that the regulations provide Indian Tribes access to data demonstrates that industry also understands that Indian Tribes require and should have access to such data.

MMS Response: The intent of this paragraph is not to preclude access to information for those who are working in concert with the MMS to the extent allowed by law, but rather to ensure the lessee that disclosure of proprietary information is in accordance with established procedures. There are statutory restrictions on providing certain types of information to persons outside the Department of the Interior, and MMS must act in accordance with those limitations. States and Indians with FOGRMA delegations and cooperative agreements will have broader access to information which otherwise could not be released. This section is not intended to limit in any manner an Indian lessor's right to obtain information directly from the lessee or from MMS to the extent provided in lease terms or applicable law. In the draft final rule, MMS changed the phrase "will be maintained" to "may be maintained." Many industry commenters were concerned that this change would allow MMS to release proprietary information. This was not MMS's intent, and to avoid any confusion the term "will" has been substituted for "may."

Section 206.153 Valuation standards—processed gas.

This section is almost identical to § 206.152 and the comments received were also similar. Therefore, MMS will not repeat the section-by-section analysis or response to comments for this section. Interested persons should refer to the corresponding part of § 206.152.

Section 206.154 Determination of quantities and qualities for computing royalties.

Paragraph 206.154(a) establishes procedures for determining the volumes and quality of unprocessed gas that must be used in computing royalties. Three industry commenters were opposed to MMS or BLM assigning a point of royalty settlement that is different from the lessee's sales point where the transfer of title occurs, as stipulated in the lessee's arm's-length gas sales contract.

One industry commenter stated that MMS must recognize that the proper point of royalty valuation is the lease and that MMS cannot confiscate the entrepreneurial profits which are added by downstream activities of the lessee and are not part of the value of the production in which the lessor is entitled to share.

Two industry commenters stated that this provision is inconsistent with the statutes, lease terms, and the proposed gross proceeds valuation methodology.

MMS Response: Historically, MMS has required that royalties be computed on the basis of the quantity and quality of unprocessed gas in marketable condition as measured on the lease unless prior approval to measure off-lease is obtained from BLM or MMS, for onshore and offshore leases, respectively. This will assure the lessor that the total production from the lease is accounted for. This provision is consistent with the statutes, lease terms, and the gross proceeds valuation methodology because this provision establishes a point of royalty measurement upon which a quantity, at a quality, is valued for royalty purposes.

One industry commenter stated that paragraph (a)(2) would adjust the price received under an arm's-length contract in the event that there were some line loss between the point of royalty settlement and the point of sale. The commenter stated that the arm's-length contract whose quantity provisions MMS would modify requires the purchaser to pay only for production which is actually received but, by adjusting the quantity figures, MMS is, in effect, amending, solely for royalty purposes, the deal between the lessee and the purchaser.

MMS Response: The MMS must structure its royalty accounting program to be in concert with the administration of oil and gas leases by the other components of the Department of Interior's full mineral leasing program. As such, this provision simply recognizes that it is the measured production, as required by BLM or MMS operations personnel, that must be valued for royalty purposes.

Paragraph 206.154(b) establishes the procedures for determining the quantity of residue gas and gas plant products on which royalty must be paid. One industry commenter suggested that this provision be reworded to indicate that "net output" means the production from the plant and not tailgate deliveries. The commenter stated that net monthly output could be interpreted to mean plant tailgate deliveries. The commenter said that if this were the case, royalty would not be paid on plant products until they were sold.

Another commenter stated that, in current marketing situations, it is impossible to avoid temporary storage of gas plant products. The commenter said that purchasers are nominating volumes they will purchase which may or may not coincide with production. The commenter also stated that royalties should not be paid on production stored until it is sold because, in that manner, value can be properly determined. The commenter said that residue gas must be delivered as produced because there will normally be no means by which the lessee can store it.

MMS Response: As adopted at § 206.151, net output means the quantity of residue gas and each gas plant product that a processing plant produces. Therefore, royalty is due on residue gas and gas plant products at the time they are produced.

One industry commenter stated that this *methodology* of net output is contrary to the MMS concept of gross proceeds accruing from the *sale* under an arm's-length contract. The commenter said that many gas plants place the net output in temporary storage awaiting sales and that the net output of gas plant products is not valued until removal from temporary storage and sale. The commenter stated that, if this paragraph is implemented, it is probable that there would be many MMS audit exceptions as a result of the valuation of net output rather than actual sales from temporary storage facilities.

One industry commenter stated that it may be difficult to establish the value of the product that remains in storage. The commenter also stated that, if the lessee is forced to compute a value, then the concept of "gross proceeds" becomes meaningless because the lessee, in effect, becomes the purchaser of the product. The commenter claims that when the product is disposed of at a later date, MMS would have no basis on which to review the proceeds eventually realized by the lessee for sale of the production.

MMS Response: The MMS believes that there is no conflict between the gross proceeds methodology and these provisions. It must be recognized that it is the volume of gas leaving the lease which must be valued, for royalty purposes, and the use of the cumulative value of any condensate recovered downstream of the point of royalty settlement without resorting to a manufacturing process, plus the residue gas and gas plant products, less applicable allowances, is the method by which this is done when gas is processed. Therefore, all such condensate, residue gas, and gas plant products attributable to this production must be used in determining value. Adjusting the gross proceeds to reflect the net output attributable to the lease would be accomplished by applying the unit value established by the actual product sales to the portion of the net output attributable to the lease, which was not sold in the month produced. Likewise, if the quantity of any product sold during a month is greater than the net output attributable to a lease because of sales of a quantity of product which was previously placed in storage, the gross proceeds would be reduced. If proper documentation is maintained by the lessee and made available to MMS during an audit, no audit exceptions should result.

Paragraph 206.154(c) establishes the procedure to allocate the net output of a processing plant back to the leases. One industry commenter proposed that the language be modified to reflect the view that any lease allocation method agreed to between a seller and purchaser and/or processor will be deemed acceptable, including methods where the parties are affiliates, subject to review by MMS.

One industry commenter suggested that any contractually prescribed method should be deemed acceptable in preference to "a generally accepted lease allocation method", which may be a contention in the future.

An industry group recommended that MMS recognize the validity of allocation methods approved by BLM.

MMS Response: The MMS has adopted a specific procedure for allocating the net output of a processing plant back to leases. The method adopted is the method prescribed by the current regulations. The MMS believes that this procedure is the predominant method used by industry. However, MMS has adopted a provision in the final rule whereby a lessee may request approval of other allocation methods.

One industry commenter suggested the addition of the sentence "This same methodology shall also apply to allocations among unitized and communitized areas." The commenter believed that this inclusion of units and communitized areas was intended.

One Federal agency commenter suggested the modification of the proposed rule to include a tight definition of the term "generally accepted." The commenter said this term should be defined as an allocation method used consistently by a majority of gas plant operators and this method must be in accordance with the method promulgated by an industry group such as COPAS.

MMS Response: The final rule adopted limits the use of methods other than the one prescribed, as outlined above. Therefore, the term "generally accepted" has been eliminated from the final rule. Unitized and communitized areas will be covered under this provision and MMS does not deem it necessary to add a specific reference.

Paragraph (d) prohibits deductions from royalty volume or royalty value for actual or theoretical losses. Indian and State commenters agreed with this provision, stating that no deductions should be allowed for actual or theoretical losses prior to the point of royalty settlement.

Many industry commenters stated that line losses are attributable to several factors. They stated that line losses are partially attributable to metering differences and partially attributable to physical factors, and they are a part of the reality of oil and gas field operations. They believed that the provision should be amended for both valuation and allowance purposes to provide a credit for line loss not attributable to negligence, because such a change in the regulations would be in conformance with FOGRMA. They stated that allowing losses would also make the allowance regulations conform to the overall market orientation underlying the valuation proposal, because costs associated with line loss are commonly explicit components of arm's-length contracts and tariffs.

MMS Response: When a volume of gas, upon which royalty is due, has been determined in accordance with the requirements of MMS's offshore operations and BLM's onshore operations personnel, MMS must collect royalty upon its value. Likewise, it is imperative that the quantities of residue gas and gas plant products attributable to a lease be determined once, and only once, and royalty paid on those volumes. This is consistent with the historical practice of the Department. The treatment of line losses as a cost of transportation is addressed later in this preamble.

Section 206.155 Accounting for comparison.

In the proposed rule, MMS required so-called dual accounting only in situations where the lessee (or a person to whom the lessee transferred gas pursuant to a non-arm's-length contract) processes the lessee's gas and, after processing, the residue gas is not sold pursuant to an arm's-length contract.

Some industry commenters stated that the removal of the requirement to perform dual accounting for OCS gas sales where the residue is sold pursuant to an arm's-length contract is a substantial improvement in the regulations which will reduce paperwork for both MMS and lessees.

Another industry commenter endorsed the MMS's decision to abolish "accounting for comparison" (more commonly known as dual accounting) for processed gas except where the lessee has no arm's-length contract for the sale of residue gas or where dictated by lease terms. The commenter had no objection to such value comparison if the gas is processed in a lessee-owned plant, and the residue gas is not sold under an arm's-length contract.

Several industry commenters stated that they believed the continuation of dual accounting for most processed gas in non-arm's-length residue sales is unnecessary. They said that because the residue gas will be valued pursuant to MMS's guidelines in both arm's-length and non-arm's-length situations, the elimination of dual accounting for one and not the other will create substantial administrative effort when both arm's-length and non-arm's-length residue sales occur at the same plant. They also stated that as long as a substantial portion of sales from a plant continue to be arm's-length, which they propose to be set at 25 percent or higher, elimination of the dual accounting requirement for the remainder of that plant will not result in any lesser degree of accuracy in determining market value.

One industry commenter stated that this provision stops short of being totally consistent with other MMS proposals on gas valuation. The commenter said that inasmuch as MMS has determined that there is an acceptable method to value residue gas sales under non-arm's-length or no-contract situations, there is justification for eliminating dual accounting for residue gas valued in accordance with this provision, regardless of the types of sales contracts.

Another industry commenter believes that royalty is due only on the market value of gas, associated products, and oil because they are produced at the wellhead. The commenter stated that the concept of dual accounting under which MMS assesses royalty on either the value of the principal and associated products after processing or the value of the unprocessed gas, whichever is higher, is fundamentally unfair.

Two industry commenters recommended that this paragraph be deleted because dual accounting results in higher value to the lessor than the lessee. They believed that the value should be based upon the value of the unprocessed gas at the lease if the gas is not processed, or upon net realization (gross proceeds minus allowances) if gas is processed, and not the higher of the two. They stated that, because the proposed method is applied after the fact, only the lessee bears any losses. Another commenter stated that it would be unfair and inequitable to require the payment of royalty on a basis higher than the value of the processed gas when the value differential is not because of the negligence or imprudent actions on the part of the lessee but instead represents the current market fluctuations for the gas plant products and residue gas. The commenter also suggested the addition of the word "applicable" before the word allowances in paragraph (a)(1).

MMS Response: To ensure that the Federal and Indian lessors receive the proper royalties, MMS continues to believe that dual accounting must be used 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 and, after processing the gas, the residue gas is not sold pursuant to an arm's-length contract. This provision will encourage the producer under a non-arm's-length contract to obtain the highest price for the gas produced whether that higher price comes from processing the gas or whether it comes from selling the unprocessed gas.

One industry commenter stated that dual accounting imposes an unreasonable accounting burden on both the lessee and the Department and allows the Department to effectively second-guess the lessee each month on the decision to process the gas.

MMS Response: The MMS's current policy is to require dual accounting for all offshore gas processed by the lessee, including affiliates, and for onshore gas processed by the lessee in a lessee-owned plant or onshore gas sold to an affiliate of the lessee and that affiliate processes the gas. Because the requirement for dual accounting adopted in the final rule eliminates some of the current requirements, the accounting and administrative burden should be reduced for both industry and MMS.

Proposed paragraph (b) specifically provided for dual accounting where required by the terms of a Federal or Indian lease. Industry commenters agreed with this provision provided that the lease terms, whether Indian or Federal, specifically require dual accounting.

Three Indian commenters stated that dual accounting should be required for all Indian leases whether specifically stated in the lease terms or not. They stated that this is needed for the Secretary to fulfill his trust responsibilities to the Indians.

MMS Response: The MMS has adopted this provision essentially as proposed.

Section 206.156 Transportation allowances—general.

The MMS received a large number of comments from the States, Indians, and industry on this section of the regulations. Comments on transportation allowances which did not relate to any specific section of the regulations were considered to be addressed to the General section of the transportation regulations, § 206.156. These comments addressed four broad issues—validity issues, adequacy/inadequacy issues, post-production costs and other cost issues, and issues relating to the definition of terms.

1. One issue concerned the validity of any transportation allowances whatsoever and proposed that MMS should not consider transportation allowances as valid deductions from royalty computations, or only consider such allowances if transportation is necessary for lease development or results in a higher royalty.

Some State and Indian commenters stated that transportation allowances should only be granted when necessary (1) to market the product, (2) to promote development of the lease, (3) to obtain a higher royalty value, (4) to enhance offshore development, or (5) if the royalty revenue increases enough to offset the allowance. The key word in these comments was "necessary." None of the parties believed that any transportation allowance should be given if it was not necessary. A State representative suggested approving the transportation allowances on the basis of individual cases only if necessary.

One Indian commenter stated that only the reasonable, actual, and necessary transportation costs from a lease boundary to a point of sale should be allowed and the costs should not include any profit or allocated overhead from the regional or home office.

One Indian commenter stated that the regulations should establish transportation allowances as an exception, not as a rule.

Several Indian commenters stated that MMS should not grant any transportation allowances as a deduction against Indian royalties. The commenters opposed the transportation allowance for Indian leases for such reasons as (1) Indian leases do not provide for transportation as a deduction from royalty, and (2) transportation allowances have never been granted for Indian leases.

The Indian commenters emphasized that MMS must take into account its trust responsibility to the Tribes and allottees in preparing valuation regulations. These commenters advised that MMS must protect the Indians' interests.

The MMS received comments from Tribes and State representatives asserting that the royalty interest should be cost-free. These comments all stressed that royalties have always been and should always remain free of costs. All commenters believed that the costs of making lease production marketable, including transportation, are the responsibility of the lessee. A State representative suggested that MMS "* * * keep the door closed on all presale costs. Once it's opened, it's hard to let only the chosen ones in."

MMS Response: Based on Interior Board of Land Appeals decisions, Solicitor opinions, and judicial decisions, it has been DOI policy since 1961 to grant transportation allowances when production is moved to a sales point off the lease in order to calculate the value of the product at the lease. Furthermore, the IBLA has specifically ruled that transportation allowances must be granted for Indian leases. *Kerr-McGee Corp.*, 22 IBLA 124 (1975). Therefore, the transportation allowance regulations being adopted are consistent with past practice and consistent with the Secretary's responsibility to the Indians. The MMS believes generally that royalty should be free of cost. However, values may need to be adjusted for transportation and/or processing to determine value at the lease. The MMS believes that the policy of granting transportation allowances to properly value lease production is appropriate and should continue.

2. Another issue concerned the adequacy or inadequacy of the proposed gas transportation regulations in general. Some commenters believed that the regulations were generally deficient, while others pointed to specific instances where changes should be made to improve their specific applicability. Following is a brief summary of these types of comments.

Some industry and State respondents commented on the flexibility of the regulations. One industry commenter stated that the regulations should be modified to embrace both traditional and nontraditional transportation arrangements. Another industry commenter suggested that the regulations should accommodate changes in transportation and marketing. One State representative expressed concern that the regulations do not address new marketing opportunities related to the unbundling of pipeline services and market area gas storage which allow for greater sales levels in higher priced periods.

The MMS received comments from Tribes regarding the relationship between the lease terms and the regulations. One commenter requested that the regulations not be allowed to change the lease terms. Another commenter stated that the regulations should be consistent with the lease terms. A third commenter stated that, where the lease is silent, the regulations should not allow the gross proceeds received under an arm's-length contract to be reduced for transportation costs.

The MMS received comments regarding the effect of transportation allowances on revenues. A State organization stated that MMS should develop simple and concise rules that do not adversely affect Western States' revenues, and which will allow for more effective auditing. One Tribe requested that the royalty rate not be decreased in effect by redefining the rate basis. One local community commenter stated that the proposed regulations should not be issued without assessing the impact on the school or other local subdivision budgets. Five local community commenters opposed the proposals on the grounds that deductions would be taken too liberally, or perhaps royalty payments would be eliminated completely.

One Tribe stated that the regulations should apply only to new leases. One industry party and one Tribe recommended that a separate set of regulations be developed for Indian lands only.

MMS Response: The MMS believes that the regulations are complete and are sufficiently flexible to apply to the different types of gas transportation arrangements that might arise in the future. MMS is aware of nothing in the transportation allowance regulations that would change the terms of any Indian mineral lease. The MMS agrees that the procedure for determining a transportation allowance places initial reliance on the gas industry. However, this program will be under continuous review and oversight by MMS. Thus, the ability to effectively review, evaluate, and audit transportation allowances has been maintained under the new regulations. The MMS believes that the consideration of transportation costs is necessary to determine the value of lease production at the lease.

3. One broad issue discussed by commenters was the deduction of post-production costs and other costs from royalty payments.

The MMS received many comments concerning the issue of post-production costs as an allowable deduction from royalty. Many industry commenters commented in favor of allowing all post-production costs to be deducted from the royalty portion.

MMS Response: This section of the regulations addresses only transportation allowances. The issue of post-production cost allowances is properly addressed in other sections of the regulations.

4. One issue commented on by several commenters concerns the definition of terms used in the regulations.

Some industry respondents commented that the term "reasonable" should be deleted from this section. One industry concern was that this term will only result in a wide diversity of opinion as to what a reasonable cost is.

One industry representative suggested that the term "actual" should be deleted for clarification purposes.

The MMS received several comments from the States, Indians, and industry suggesting that the term "remote from the lease" should be defined or changed. An industry representative stated that many terms, such as "remote" and "field gathering" beg for definition. This commenter requested that a distinction between "gathering" and "transportation" be delineated, for royalty purposes, and also suggested that the term "remote" should mean anything outside the lease boundary. Two industry commenters identically recommended changing this phrase to "first available market."

MMS Response: The term "reasonable" is defined by the Merriam-Webster New Collegiate Dictionary as "moderate, fair." The MMS intends that this same definition apply in the determination of a transportation allowance.

The MMS agrees that the term "gathering" should be defined. The definition of "gathering" has been included in § 206.151 and was discussed above. The phrase "remote from the lease" has been deleted from the final rule which uses the phrase "off the lease."

Section 206.156(b)

The MMS received several comments on paragraph (b), proposed as paragraph (c), which requires that transportation costs be allocated among all products transported. The proposed paragraph also provided that no allowance may be taken for transporting products which are not royalty-bearing.

Industry commenters recommended deletion of this paragraph. One industry representative stated that transportation costs represent the rate for moving the aggregate product stream. The industry commenters stated that allocation is an administrative burden and is unfair and inequitable, and it is inequitable to require allocation of transportation costs for the incidental movement of nonroyalty-bearing products.

One industry representative recommended that transportation costs be taken as an aggregate charge against the value of the full product stream.

One industry representative stated that this paragraph adapts an unrealistic transportation deduction exception by not allowing a transportation deduction for nonroyalty-bearing products. According to this commenter, practical realities dictate that nonroyalty-bearing products entrained with gas be transported.

Other industry commenters recommended that allowances be granted for nonroyalty-bearing substances up to 30 percent of the volume of the transported stream.

MMS Response: The MMS does not agree with the commenters' proposal that the cost of transporting nonroyalty-bearing substances should be shared by the lessor in all instances. However, upon review, MMS has recognized that it is appropriate to provide an allowance which includes the costs of transporting certain nonroyalty-bearing substances such as waste products, including water. For example, there may be circumstances where transportation of water along with the royalty-bearing portion of the production is necessary. For other than waste products, the final rule provides, however, that prior MMS approval is required before an allowance may be taken for the costs of transporting non-royalty-bearing substances.

The MMS is aware that the allocation of transportation costs in situations where more than one product is involved could be burdensome. However, it is MMS's experience that the allocation requirement would only be burdensome in a few instances where the products being transported are not all in the same physical state.

Section 206.156(c).

Paragraph 206.156(c) was proposed as paragraph (b). The MMS received a large number of comments on this provision which limited the transportation allowance to 50 percent of the value of the product transported. The comments on this paragraph related to one major topic: Whether the limitation should be eliminated or retained.

Industry commenters and trade group representatives stated that MMS should abolish the 50-percent limitation for one or more of the following reasons: (1) If the proposed limit is retained, the exception to the 50-percent limitation may not be exercised freely enough; (2) The 50-percent limit could impose a serious economic deterrent to the development of frontier areas; (3) The limitation figure is strictly arbitrary and totally unjust to the lessee/working interest owners; (4) It would be a rare case when a natural gas transportation cost would come close to the proposed 50-percent cap, much less exceed it; and (5) The proposed 50-percent cap is a deviation from the stated intent of MMS to base royalty valuation on "gross proceeds."

Several commenters stated that MMS should approve requests for transportation allowances exceeding the 50-percent limitation upon submission of adequate documentation by the lessee.

Many industry commenters and trade groups stated that MMS should allow lessees to carry forward transportation costs otherwise allowable (except for the 50-percent limitation) from the current year to subsequent years. According to the commenters, this procedure should be applied to all transportation systems, but it would be especially important in the frontier areas. One commenter from industry stated that MMS should not permit roll forwards because it would create paperwork and allow the lessees to use the 50-percent limit permanently.

Industry commenters and trade groups stated that the 50-percent limit could be a disincentive for exploration and for building transportation systems when costs exceeding the cap may not be recovered.

One State representative stated that the 50-percent limitation provides incentive to keep costs under control while allowing some relief for legitimate hardship conditions.

Several industry commenters suggested that MMS should specify the conditions for which MMS will approve an allowance in excess of 50 percent. Three Indian commenters and one Congressman recommended that the standard should be whether the allowance in excess of 50 percent is in the best interests of the lessor.

MMS Response: The MMS has decided generally to retain the 50-percent limit on transportation in the final rule. For unprocessed gas valued pursuant to § 206.152, the transportation allowance deduction based on a selling arrangement is limited to 50 percent of the value of the unprocessed gas determined in accordance with § 206.152. For processed gas, the transportation allowance for gas plant products or residue gas based on a selling arrangement is limited to 50 percent of the value of the residue gas or gas plant product determined in accordance with § 206.153. Natural gas liquids are considered one product.

A lessee may request, and MMS may approve, a transportation allowance in excess of 50 percent if the lessee demonstrates that the costs incurred were reasonable, actual, and necessary. Thus, the 50-percent threshold merely gives MMS the ability to monitor more closely the situation where the allowance based on reasonable actual costs will exceed that limit. In no event may the allowance for any lease product equal 100 percent of the value of that product. MMS received comments that the transportation allowance in excess of 50-percent should be allowed only when it is in the "best interests of the lessor." MMS did not include this standard because it is too subjective. The requirement that the costs be "reasonable, actual, and necessary" is sufficient to protect the lessor's interests.

The MMS is not including in the final rule any specific standard as to when the 50-percent limit may be exceeded. This will require a case-by-case determination.

Section 206.156(d).

The MMS received comments from industry representatives on this paragraph (d), which recommended that MMS should be required to pay interest on overpayments by lessees to the extent permitted by law.

MMS Response: The MMS has no legal authority to pay interest to lessees on their overpayments.

Section 206.157 Determination of Transportation Allowances.

Paragraph (a) of the regulations addresses transportation allowances where the lessee has an arm's-length contract for transportation services. The MMS received many comments on this paragraph of the regulations. Although there were comments on a wide variety of subjects, 11 principal issues were addressed: Acceptance of arm's-length transportation agreements; excessive penalty and retroactive approvals; MMS's approval of the transportation allowances; acceptance of transportation reduced prices; status of currently approved allowances; required filing every 12 months; allowance on nonroyalty bearing production; allocation of transportation costs; suggested deletion to regulations; period for filing a proposed allocation; MMS payment of interest on lease overpayments; and clarification of the conversion process.

1. Acceptance of arm's-length transportation agreements as an accurate indicator of reasonable, actual costs.

Industry commenters supported the proposal to accept arm's-length contract costs as a reasonable transportation allowance. These commenters explained that arm's-length contracts provide an accurate indicator of "reasonable actual costs" because they reflect the true costs to the lessee for transporting production to a sales point downstream of the lease.

Some Tribes expressed serious concern about the validity of using arm's-length contracts as an indicator of value. One Tribe stated that arm's-length contracts are not a bona fide indicator of reasonable, actual costs. One Tribe expressed doubt that there can ever be an arm's-length contract between companies in the gas industry. Another Tribe stated that arm's-length contracts should not be accepted unless a thorough analysis of lessee/purchaser affiliations is undertaken. One Tribe also expressed considerable doubt that the criteria used by MMS would assure that an arm's-length contract is present in any given case. An Indian trade organization stated that MMS should establish appropriate criteria to determine the accuracy and reasonableness of allowances granted under arm's-length contracts (and non-arm's-length contract situations).

MMS Response: The MMS currently uses the payments made by a lessee under an arm's-length transportation agreement as an accurate indicator of reasonable, actual costs. The MMS has determined that payments made under arm's-length contracts are the best available indicator of reasonable, actual costs incurred by the lessee. MMS has added a sentence clarifying that the lessee has the burden of demonstrating that its contract is arm's-length. MMS also has added two new paragraphs to address situations where a contract, though arm's-length, should be treated as non-arm's-length pursuant to paragraph (b). The first situation is where MMS determines that the transportation contract reflects more than the consideration transferred from the lessee to the transporter for the transportation; i.e., the transportation cost has been inflated. The second situation is where the MMS determines that there has been misconduct by or between the contracting parties, or because the lessee otherwise has breached its duty to the lessor to market the production for the mutual benefit of the lessee and the lessor. The types of misconduct or breach of duty which would trigger application of these provisions are essentially the same as those discussed above in the valuation section.

2. Disallowance of a transportation allowance for a reporting period not covered by a Form MMS-4295.

The MMS received responses from several industry commenters and industry trade groups stating that the disallowance of a transportation allowance for a reporting period not covered by a Form MMS-4295 is an excessive penalty for what was considered by the commenters to be such a minor infraction of the rules. The point was also made that the lessee does not always have the data to timely file a Form MMS-4295 before the Form MMS-2014 is filed.

Many commenters stated that the regulations should have a provision allowing transportation allowances on a retroactive basis because a lessee does not always have the details on transportation worked out before production begins. Thus, it sometimes is necessary to go back and revise data related to an allowance after agreements are reached because of the fast changing current oil and gas markets.

It was suggested that MMS should consider a monetary fine for failure to file, or disallow the deduction for any period until Form MMS-4295 is filed. The lessee would not lose a deduction.

but would be precluded from taking the deduction until the proper forms are submitted to MMS for the periods covered.

MMS Response: After careful consideration of the comments, MMS has determined that the reporting penalties included in the proposed regulations were excessive. The MMS has also considered the comments on retroactive approvals and has revised the final regulations to allow lessees to request transportation allowances retroactively for a period of not more than 3 months prior to the first day of the month that Form MMS-4295 is filed with MMS, unless MMS approves a longer period upon a showing of good cause by the lessee. Also, paragraph (d) of the final rules provides that if a lessee deducts a transportation allowance on a Form MMS-2014 without complying with the requirements of this section, the lessee will owe interest on the amount of the deductions until the date proper forms are filed. However, the lessee will be required to repay the amount of any deduction disallowed because of the limitation on retroactivity.

3. The MMS's preapproval of transportation allowances.

The proposed rule provided that prior MMS approval was not required before a lessee could deduct a transportation allowance based on an arm's-length contract. Representatives of trade organizations, oil and gas companies, and one business expressed approval of the self-implementing concept for transportation allowance regulations. This was seen as a method of relieving a considerable administrative burden on both industry and MMS. Tribes disagreed with the self-implementing nature of the regulations because it was seen as a method of establishing the 50-percent limitation as a floor for transportation allowances.

One Tribe stated that MMS should preapprove all transportation allowances and should do so only on a showing of necessity to promote development or a showing that a higher value could be obtained for the gas at a point of sale away from the lease. It was also pointed out by this commenter that neither the MMS nor Indian Tribes have the resources to audit all leases and, if these allowances are not monitored "up front," they will never be audited.

MMS Response: The MMS considers arm's-length contracts a valid indicator of reasonable, actual costs. Thus, it is not necessary to preapprove transportation allowances based on such contracts. The MMS will monitor the transportation allowances, and they are subject to later audit.

4. Acceptance of transportation-reduced prices without requiring the filing of Form MMS-4295 for both arm's-length and non-arm's-length situations.

Representatives of oil and gas companies and trade organizations commented that MMS should accept transportation-reduced prices without requiring the filing of Form MMS-4295 for both arm's-length and non-arm's-length situations. It was believed that this policy would reduce the administrative burden on industry and MMS. However, one commenter disagreed with this proposal because it was considered a potential technique to exceed the 50-percent limitation provisions of the regulation.

MMS Response: The MMS has determined that the regulations should be revised to provide that transportation factors which reduce arm's-length sales contract or posted prices are to be considered as reductions in value rather than transportation allowances. This provision is included in paragraph (a)(5). However, so as not to provide a means of avoiding the 50-percent limit on transportation allowances, the final rules provide that the transportation factor may not exceed 50 percent of the base price of the product without MMS's approval.

5. Should current approved transportation allowances remain in effect until they expire?

Industry respondents stated that the transportation allowance reported on Form MMS-4295 should continue until the applicable contract or rate terminates, or is modified or amended. State respondents stated that, because some allowances are currently being taken without specific, written MMS approval, only those with documented approval should be allowed to continue without the submission of Form MMS-4295.

MMS Response: The MMS has revised the regulations in paragraphs (c)(1)(v) and (c)(2)(v) to provide that any transportation allowances in effect on the date these regulations become effective will be allowed to continue until such allowances terminate subject to later audit. However, MMS is limiting this provision only to those allowances that have written MMS approval. Because the regulations are being revised to remove any prior approval by MMS before a deduction may be taken, and the submission of Form MMS-4295 is to increase MMS's ability to monitor the allowances being taken, MMS believes that the intent of the final rules will be best served by having all allowances to be deducted under the new rules documented as of the effective date.

6. Should MMS require the filing of Form MMS-4295 every 12 months?

Industry representatives stated that there is no benefit to MMS in submitting a form that duplicates information on file when a change has not occurred, and there is no apparent reason for MMS to require the filing of Form MMS-4295 every 12 months. One industry representative recommended that this section be deleted.

MMS Response: The MMS requires the annual filing of Form MMS-4295 for use as a control and monitoring mechanism even when there is no change in the applicable contract or rate.

7. Should MMS allow transportation allowances for production which is not royalty-bearing.

Several industry representatives suggested deleting this section and proposed that transportation costs be taken as an aggregate charge against the value of lease production or that MMS cover cost allocation methodology in the MMS Royalty Management Program Oil and Gas Payor Handbook. One industry respondent recommended deleting any references concerning the disallowance for transporting lease production which is not royalty-bearing.

MMS Response: As discussed earlier, MMS will allow transportation allowances that include costs of transporting certain production which is not royalty-bearing, such as waste products.

8. Allocation of a cost applicable to more than one product.

One industry representative stated that allocation of costs presents a burdensome administrative task, but if allocation of costs is deemed necessary, it should be allocated on the basis of relative value rather than on relative volume. One business representative suggested that MMS provide an alternative allocation procedure for situations which would require a variance from the proposed allocation method.

Another industry representative recommended that allocation be based on the weighted average value of each product having a commercial value in that area. According to this commenter, transportation costs should not be allocated to by-products or products with no commercial value.

An industry representative suggested using an allocation procedure only when substantial volumes of nonroyalty-bearing products are being transported because of the considerable costs and reporting burdens involved in allocating costs.

MMS Response: The MMS has added a new paragraph which provides that, upon request by the lessee, MMS will approve the allocation of costs on the basis of the values of the products transported unless such allocation method is not consistent with the purposes of the regulations in Part 206. In situations involving the transportation of both gaseous and liquid products, it is difficult for MMS to provide guidance on acceptable methods of allocation because of the many different circumstances that exist. The MMS believes it would be advantageous to have the lessee submit an allocation proposal to MMS in these situations.

9. Should MMS extend the period in which to submit a proposed allocation method?

Representatives from industry suggested periods of 90–180 days, instead of the proposed 60-day period, to submit a proposed allocation method where an arm's-length contract includes both gaseous and liquid products and the transportation costs attributable to each cannot be determined from the contract.

Representatives from oil and gas companies and one trade organization stated that the requirement to submit a proposed allocation method within 60 days will create a significant workload burden, and a more reasonable provision of time would be from 90 to 180 days.

MMS Response: The MMS has modified § 206.157 (a)(3) of the final rule to provide a 3-month period.

10. Should MMS pay interest on lease overpayments?

One industry commenter stated that MMS should pay interest on overpayments consistent with statutory authority.

MMS Response: The MMS has no legal authority to pay interest to lessees on their overpayments.

11. Clarification of the conversion process.

Two respondents from the oil and gas industry commented that proposed paragraph (a)(5), concerning the conversion of payment to a dollar-value equivalent, should not be adopted because it is too complicated. If it is retained, it should be clarified with guidelines.

MMS Response: The value of production upon which royalty is due is reported to MMS as a dollar value; therefore, MMS believes that any deduction from that value when determining the royalty due also must be expressed as a dollar value. The MMS does not consider the conversion to a dollar-value equivalent to be complicated. This requirement is included in § 206.157(a)(4) of the final rules.

Paragraph (b) establishes the procedures for claiming a transportation allowance where the lessee has a non-arm's-length transportation contract or has no contract. The comments received under this section addressed eight principal issues: Acceptance of State or FERC tariffs, use of the benchmark system, penalties, prior approval, allowable costs, rate of return, retaining Alternatives 1 and/or 2, and allocation of costs.

1. Should MMS accept published State or FERC tariffs instead of using actual costs as the basis for approving transportation allowances?

Many industry commenters and trade groups stated that MMS should accept published State or FERC tariffs as the transportation allowance in non-arm's-length and no-contract situations. These commenters believed that MMS should rely on the expertise of FERC and State agencies that set pipeline tariffs to determine fair and reasonable transportation charges. Several industry representatives stated that if MMS does not rely on FERC and/or State tariffs, there would be a wasteful duplication of effort between FERC, State agencies, and MMS.

MMS Response: After careful consideration, MMS has decided that generally the fairest and best way to determine transportation allowances for non-arm's-length or no-contract situations is to allow actual, reasonable costs plus an acceptable rate of return on the lessee's undepreciated capital investment. However, MMS has concluded that where a lessee has a tariff approved by FERC or a state regulatory agency, it is unnecessarily burdensome and duplicative to recompute costs. Therefore, MMS will recognize FERC tariffs (for both Federal and Indian leases) and tariffs approved by a State regulatory agency (for Federal leases) as a valid cost in computing a transportation allowance when it is an actual (out-of-pocket) expense pursuant to an arm's-length transportation contract. Existence of such tariffs for a transportation system also will authorize MMS to grant an exception to the requirement to use actual costs for non-arm's-length or no-contract situations. See discussion below.

2. Should the transportation allowance be based on the market value of transportation service as determined under a benchmark system?

Several industry commenters and trade groups stated that MMS should allow the market value of the transportation service based on a benchmark system.

For those commenters recommending a benchmark system for determining the transportation allowance, the commenters suggested that MMS allow the lessee the market value of the transportation service based on a benchmark system featuring arm's-length contracts and tariffs and cost accounting to be used only as a last resort. It was suggested that this procedure was in keeping with the market-based concept and objective of bringing certainty to the regulations.

MMS Response: It is MMS's past and present practice generally to allow only those costs which are directly related to the transportation of lease production. Costs incurred under "comparable arm's-length contracts" or any other benchmark criterion may include costs such as Federal and State income taxes, or socioeconomic costs incurred by the lessee in order to obtain State or county land access, such as the construction of schools or city sewer facilities. The MMS considered these comments in revising the regulations and decided that it was in the best interests of the Government, States, and Indians to base gas transportation allowances on actual, reasonable costs plus a return on investment.

However, in an effort to simplify procedures for both the lessee and MMS, the regulations at § 206.157(b)(5) will provide an exception to the requirement to compute actual costs where the lessor's interest is adequately protected. The lessee must apply to MMS for the exception, and MMS will grant the exception only if the lessee has a tariff for the system approved by FERC (for both Federal and Indian leases) or a State regulatory agency (for Federal leases). However, the rules contain protection from unreasonably high tariffs. The MMS will deny the exception request if it determines that the tariff is excessive as compared to arm's-length transportation charges by pipelines owned by the lessee or others, providing similar transportation services in that area. If there are no such arm's-length transportation charges to use for comparison, MMS will deny the exception request if no FERC or State regulatory agency cost analysis exists and the FERC or State regulatory agency has declined to investigate pursuant to MMS timely objections upon filing, and the tariff significantly exceeds the lessee's actual costs for transportation as determined under the regulations in subsection (b)(2).

3. Should a penalty be imposed for late submission of the Form MMS–4295?

One industry commenter objected to the penalty of disallowing a transportation allowance for failure to file the applicable Form MMS–4295.

One industry spokesperson stated that the lessee should be assessed a fee of $10.00 per day for each day the Form MMS–4295 is not received.

One industry commenter suggested 120 days as a reasonable time in which to submit a completed page one of Form MMS–4295.

MMS Response: MMS has determined that the reporting penalties included in the proposed rule were excessive. MMS also has considered the comments on retroactive approvals and has revised the final regulations in § 206.157(b)(1) to allow lessees to request transportation allowances retroactively for a period of not more than 3 months prior to the first day of the month that the Form MMS–4295 is filed with MMS, unless MMS approves a longer period upon a showing of good cause by the lessee. Also, (d) provides an interest assessment for taking a transportation allowance without complying with the reporting requirements of the regulations, as well as a requirement that a lessee repay the amount of any deduction disallowed because of the limitation on retroactivity.

4. Should MMS require prior approval for allowances?

Several industry commenters and one trade group commented that they were in support of the self-implementing feature of the regulations which would not require prior approval of each allowance by MMS before the allowance could be claimed.

States and Indians stated that prior approval of allowances should be required. Because of the numbers of selling arrangements involving costs, these commenters were concerned that as a practical matter MMS will not question or audit the majority of deductions.

One Indian Tribe commenter stated that prior approval should be required before overhead expenses and depreciation are allowed; otherwise, transportation allowances will be subject to abuse and Indian royalties will suffer.

One Indian Tribe representative stated it was not proper to allow depreciation, unless prior approval and prior audit is required.

MMS Response: The MMS currently reviews and approves all transportation allowance requests and has considered preapproval and preaudit of transportation allowances. It has been decided that a more effective use of resources can be attained by doing exceptional processing on allowances and selectively reviewing certain allowances in depth to determine the propriety of the allowance reported by lessees on Form MMS–4295. Therefore, with limited exceptions, no prior MMS approval will be required. However, the lessee will be required to file a completed Form MMS–4295 before taking the allowance.

5. Should costs other than actual, reasonable costs be considered in calculating the transportation allowance?

Industry commenters stated that State and Federal income taxes are legitimate expense items and should be allowed.

One industry spokesperson recommended that dismantling costs be included in the calculation of transportation allowances because this is a real cost of doing business.

One trade group representative recommended that MMS reformulate the transportation provisions to allow a firm or entity providing necessary transportation services a complete recovery of costs plus an acceptable profit for assuming the risks involved in providing transportation service.

MMS Response: The MMS views income taxes to be an apportionment of profit rather than a valid operating expense. However, interest on money borrowed for operations would be considered as a valid operating expense. Interest on money borrowed to build a transportation facility is not considered allowable. A return on investment is given in lieu of interest on capital investments.

6. What rate of return should be used to calculate return on capital investment?

Industry commenters, trade groups, private businesses, one city mayor, and Indian Tribes stated that the use of the Moody Aaa corporate bond rate proposed by MMS in paragraph (b) is inequitable for the rate of return. Following are some of the reasons provided by the respondents for this viewpoint:

a. The prime rate represents a nearly risk-free return on short-term borrowing.

b. The use of Moody's Aaa bond rate assumes minimal risk and 100-percent debt financing.

c. For fairness, a rate of return must consider both cost of credit and equity capital.

d. A rate of return based solely on a prime lending rate would not make the investment in the transportation system a competitive project when compared with other projects.

e. The choice of Moody's Aaa rated debt is very conservative and arbitrary.

Industry commenters and trade groups recommended various alternatives to the Moody Aaa corporate bond rate:

a. A rate equal to 150 percent of the 20-year T-bill rate.

b. The prime rate plus 5 percent.

c. One and onehalf times the average 30-year T-bill rate.

d. The 20-year corporate industrial bond rated Baa.

e. A yearly average of the monthly rate for 20-year T-bills.

f. The 20-year corporate industrial bond rated Baa plus 9 percentage points.

g. One and one-half times the prime rate.

h. The FERC tariff rate of return.

i. The before-tax rate of return of double the Moody's Aaa bond rate.

j. A specific rate of return should be determined for each lessee.

MMS Response: The MMS has examined several options relating to rate of return and decided that a rate of return should be closely associated with the cost of money necessary to build a transportation system. The MMS is not persuaded that a rate of return should include a profitability factor as a part of the transportation allowance. The MMS has examined the use of the corporate bond rate very carefully and has concluded that the use of such a rate would be feasible and would be appropriate for use as a rate of return considering the risks associated with the transportation of gas and gas plant products. There is no doubt that there are some very high risks involved with some oil and gas ventures, such as wildcat drilling. However, the risk associated with building and developing a pipeline to move gas that has already been discovered is a much different risk (and a risk that can reasonably be insured against) than the risk associated with the drilling of a well. Considering the risks related to transportation systems, a rate of return based on an applicable corporate bond rate would be appropriate for transportation systems.

The MMS has considered the prime rate, the prime rate plus 5 points, one and one-half times the average 20-year Treasury Bill rate, the Moody's bond rate, Standard and Poor's bond rate, and the other rates suggested by the commenters. The MMS believes that the use of an appropriate rate of return based on the corporate bond rate adequately considers the risk associated with a transportation system and that there is no rational basis for increasing a rate of return by arbitrarily adding percentage points simply to increase the allowance granted to a lessee. After carefully considering the comments and the options available, MMS determined that the rate of return should be based on Standard and Poor's BBB industrial bond rate. Section 206.157 (b)(2)(v) has been revised accordingly in the final rule. However, because of the substantial and diverse comments received on this issue, including comments on both the draft final rules that the BBB bond rate is not much better than the first proposal, MMS will issue a notice of proposed rulemaking to consider further modifications to this section.

7. Should MMS retain the provisions of Alternative 1 and/or Alternative 2?

Some industry commenters recommended that MMS retain both alternatives of depreciation and return on initial depreciable capital investment. One industry commenter and one trade group stated that both alternatives should be included in any cost-based methodology for determination of a transportation allowance. One industry commenter recommended that both methods be made available for use at the lessee's election on the basis of an individual transportation arrangement because adoption of this approach would assure the flexibility necessary to adapt to unforeseen changes in the business and transportation environments.

Two industry commenters and one trade group stated that MMS should retain Alternative 1. One industry spokesperson sought clarification on Alternative 1 to ensure both depreciation and return on depreciated investments are allowed.

One trade group representative endorsed Alternative 2, provided that its use is an option for the lessee. One industry commenter supported Alternative 2, suggesting that the initial capital investment should be the basis for depreciation of any newly acquired transmission facility or gas plant. One trade group representative stated that Alternative 2 should be applicable to instances where a lessee has purchased a transportation system that has previously been depreciated to some extent. One private business representative stated that Alternative 2 should be available without the limitation on new or newly acquired transportation systems because it provides a viable substitute where original cost records no longer exist.

One industry commenter recommended not adopting Alternative 2 because it provides a significantly lower rate of return to the lessee.

Two commenters stated that MMS should not tie the rate of return to a diminishing value. Both commenters stated that if the intention is to provide the lessee with a rate of return for his invested capital, the lessee should not be penalized by a diminishing return caused by tying the return into a depreciation option. One industry representative stated that, based on the current Moody's bond rate, Alternative 2 should only be advantageous for projects with over 30 years of life.

One industry commenter stated an inequity could result in the case of transferring transportation facilities from one party to another because it may be impossible to allocate specific capital costs to particular segments for purposes of determining the depreciation cost allowance and the return on undepreciated capital investment cost allowances. One industry commenter stated that MMS should accept a depreciation method recognized by FERC whether or not the method is one of the two suggested. According to the commenter, this would eliminate the administrative burden of maintaining another set of depreciation records. One Federal agency commenter suggested there be no restriction on the depreciation method used.

Several industry commenters stated that disallowing recapitalization is inequitable. One industry representative stated that the rule, as proposed, prohibits a new owner from recovering his costs because those costs would be based on the present market value of the pipeline. One industry commenter stated that it would be administratively burdensome to disallow recapitalization because it would require the lessee to maintain two separate sets of books on depreciation, one for normal business and one for royalty purposes. One industry representative stated that prohibiting establishment of a new capital cost based upon the sale or transfer of a pipeline is inconsistent with both the philosophy of arm's-length transactions and of approving an allowance based on actual costs.

Two industry commenters stated that the regulation should be more specific on how the lessee must adjust for continuing changes in reserves. For example, the continued development of different unitized depths in complex geologic areas or in areas with multiple leases will result in the continued redetermination of reserves.

MMS Response: The MMS has reviewed the comments received regarding both Alternative 1 and Alternative 2 and concluded that both alternatives should be retained. However, under the final rule, § 206.157(b)(2)(iv)(B), Alternative 2 can only be used for transportation facilities first placed in service after the effective date of these regulations.

The MMS has considered the issue of recapitalization and decided that it was appropriate for the Government to pay its share for the depreciation of a system transporting royalty-bearing gas only once.

The MMS has carefully considered the issue of basing the rate of return on a diminishing value and has decided that this procedure is consistent with longstanding Government policy on allowances and that MMS should continue this policy for transportation facilities in operation on the effective date of these regulations.

The use of reserve life as a depreciation method is at the election of the lessee. If the method does not serve the lessee's needs, then a different depreciation method may be chosen. If the reserve life method of depreciation is chosen, it would be entirely appropriate for the lessee to adjust the reserve life when changes in reserves occur.

The MMS has determined that a transportation system may be depreciated only once, and that the depreciation schedule established by the original transporter/lessee cannot be altered by a change in ownership.

8. Should costs be allocated among lease products?

Two industry commenters and one trade group suggested deletion of the sections requiring allocation of costs (§ 206.157 (b)(3) and (b)(4) of the final rule). Two industry representatives stated that requiring allocation of transportation costs is an unjustified expense to the lessee and a burdensome administrative task for both industry and MMS.

One industry commenter stated that allocation of costs among products is at odds with the basic valuation equation.

MMS Response: MMS believes that the cost to transport a product should correspond with the product transported. MMS recognizes that accountability is difficult and allocation may be a burdensome task but there is no acceptable way to avoid this responsibility.

Section 206.157(c).

The MMS received many comments from industry, States, and Indians on paragraph (c), which establishes reporting requirements for transportation allowances.

The comments received addressed the following issues: General comments pertaining to the requirement to file for allowances, comments on the initial 90-day submittal period, the subsequent annual requirement to submit Form MMS-4295, Gas Transportation

Allowance Report, establishment of alternate reporting dates, and miscellaneous comments.

1. The requirement to submit a Form MMS–4295 in order to claim a transportation allowance.

Two industry commenters commend the MMS for proposing an allowance that does not require prior approval. One industry commenter and one trade group disagree with proposed Form MMS–4295 because it requires too much information and puts a burden on industry. One trade group representative stated that MMS should substitute a form entitled "Intent to Take a Transportation Allowance" in lieu of the complicated annual filings proposed. One State representative stated that the reporting scheme would demand a major commitment of resources and would be difficult to administer. One trade group commenter stated that submission of Form MMS–4295 will greatly increase the paperwork of both industry and MMS. Two industry commenters stated that, without proper public review and comment, they cannot endorse the use of Form MMS–4295. Ten commenters—seven industry and three trade groups—stated that provision should be made for allowances currently in effect on the effective date of the regulations to continue until the allowance expires to avoid an undue administrative burden on MMS and lessees. Some commenters also pointed out that flexibility is needed to deal with special circumstances such as spot sales contracts.

MMS Response: Form MMS–4295 is required in order for MMS to monitor the transportation allowance program. The MMS believes it can monitor the transportation allowance deductions more effectively than with the preapproval of the allowances. The MMS has made the information on Form MMS–4295 as clear and uncomplicated as possible considering the complex nature of transportation allowances. The filing of a Form MMS–4295 equates to an "intent to deduct transportation."

For arm's-length contracts, paragraph (c)(1) requires the filing only of page one of the Form MMS–4295. Pursuant to paragraph (c)(2), for most non-arm's-length contracts, the lessee must submit the entire form. Lessees who receive an exception under subsection (b)(5) and are authorized to use their FERC tariff will be required to file only the first page of Form MMS–4295. See §§ 206.157 (c)(2)(i) and (c)(2)(viii).

For transportation allowances in effect on the effective date of these rules (which includes only those approvals from MMS which are in writing), no form needs to be filed until the allowance terminates. See § 206.157 (c)(1)(v) and (c)(2)(v). These continued allowances will be subject to audit.

The MMS has also included in paragraphs (c)(1)(vi) and (c)(2)(vii) of this section authority to establish reporting requirements different from those in the regulations where necessary to accommodate special circumstances.

2. Requirement to file a Form MMS–4295 within 90 days after the end of the reporting period.

One industry commenter stated that a 120-day filing period should be permitted for filing Form MMS–4295 to ease the administrative burden. This commenter suggested that if the form is not received within the prescribed 120 days, the lessee could be assessed a fee of $10.00 per day for each day the form is not received. One industry representative suggested that a minimum 180-day conversion should be allowed from the date of publication of the final regulations.

One trade group representative agreed that a 12-month term should be endorsed for both onshore and offshore allowances. One industry representative recommended that allowances be based on data from a full calendar year and be reported to MMS by April 1 for the preceding year. Nine commenters, seven industry and two trade groups, stated that an annual reporting request is unduly burdensome and that lessees should only be required to file Form MMS–4295 when there is a change in the allowance amount.

Industry representatives stated that failure to file a completed Form MMS–4295 should not result in a denial of allowances because this constitutes a substantial penalty.

One industry spokesperson stated that to ease MMS's workload, each lessee should be assigned a particular due date for filing all forms. One Indian trade group was concerned over the provision establishing different reporting dates from those specified in order to provide more effective administration.

One industry commenter on the second draft final rule stated that a 90-day filing deadline is unacceptable.

MMS Response: The final regulations in § 206.157(c)(1)(iii) and (c)(2)(iii) give the lessee 3 months after the end of the previous reporting period to file the required forms. The lessee will continue to use the previous allowance during that three-month period. Also, as described earlier, the final regulations allow for transportation allowances to be claimed retroactively for a period of not more than 3 months prior to the first day of the month that Form MMS–4295 is filed with MMS. Therefore, even if the lessee is not able to timely file the Form MMS–4295, the lessee could file the Form MMS–4295 and claim the transportation allowance on a corrected Form MMS2014 at a later date.

The MMS concurs with a 12-month term and the final regulations require that a Form MMS–4295 will be filed on the basis of a calendar year.

3. Miscellaneous comments received.

One industry representative stated that MMS should continue its policy of not requiring reporting or approval of reduction in sales prices which reflect transportation. One industry commenter recommended that deductions taken as an offset against price should be accepted by MMS without the necessity of filing Form MMS–4295.

MMS Response: In situations where the purchaser is reducing the contract price for a transportation cost and the lessee is incurring no out-of-pocket expense, a Form MMS–4295 is not required. In these situations, because the reduction in price represents a cost incurred past the point of first sale, a transportation allowance would not be allowed by the regulations. However, in determining the value of the gas, the reduction in price for the transportation costs past the point of sale would be considered. As explained above, MMS has placed some limits on the reduction before MMS approval is required.

Section 206.157(d).

MMS has added a new § 206.157(d) to the final regulations. This paragraph requires a lessee that deducts a transportation allowance from its royalty payments before complying with the requirements of this paragraph (i.e. filing the proper forms) to pay interest from the date it improperly took the deduction until the form is filed. As noted above, pursuant to paragraph (c), the lessee also will be required to pay back any allowance deducted more than 3 months prior to the first day of the month the proper forms are filed, plus interest.

Section 206.157(e).

This section was proposed as paragraph (d) and provides an adjustment procedure where the estimated allowance differs from the actual allowance.

Industry representatives commented that the MMS proposal for handling interest payments is unfair, and stated that "It is equitable that, if the lessee must pay any difference in royalty owed plus interest, MMS should also pay any difference plus interest statutorily authorized."

MMS Response: The MMS has no legal authority to pay interest to lessees on their overpayments.

Several industry commenters recommended that positive or negative differences between estimated and actual costs should be rolled forward into the transportation rate for the subsequent period because this would relieve the immense administrative burden on MMS and industry. One oil and gas company recommended that actual data from one period be used as the allowance for the following period, thus requiring no adjustments.

MMS Response: The MMS considered alternatives such as (1) rolling forward differences into subsequent periods or (2) using actual data from one period to be used as the next period's allowance, but determined that such procedures could be inequitable to lessees, MMS, Indian Tribes, and Indian allottees. Consequently, MMS has decided to retain the estimated and actual cost procedure.

Two oil and gas companies commented that refunds for estimates tendered in excess of actual costs should not be classified as refunds of a royalty payment under Section 10 of the OCS Lands Act because estimates are not "actual" payments of royalty. Overpayments could then be treated as line item adjustments not subject to the refund process. It was the firms' position that the OCS Lands Act, Section 10, does not require requests for refunds when estimated costs are less than actual costs and stated that the concept of estimate versus payment is clearly discernible. "Payment" is defined as a discharge of indebtedness, while "estimate" is a rough or approximate calculation, not an overpayment.

One oil and gas company commented that the current extensive review and audit process is causing lessees to lose the time value of money in the refunds which are due them under section 10 of the OCS Lands Act. Audits on such refunds were described as fruitless and wasteful, and it was suggested that MMS consider transportation allowance adjustments to be exceptions to the refund requirements. Overpayments could then be recovered by lineitem adjustments on Form MMS-2014.

Two oil and gas companies strongly emphasized that the requirement to submit written requests for refunds for under-deducted transportation costs in accordance with Section 10 of the OCS Lands Act will be an extraordinarily difficult financial and reporting burden for industry and the MMS.

MMS Response: It would not be proper for these rules to prescribe the refund procedures. MMS is reviewing the issue and will provide guidance to lessees.

Three oil and gas companies and one trade organization representative rejected using prior year actual costs for the current reporting period, stating that it automatically requires retroactive adjustment. They recommend that lessees be allowed to use forecast rates based on their knowledge and experience with the operations. Three oil and gas companies proposed that MMS establish an allowable range and not require retroactive adjustments if performance is within the allowable range.

One oil and gas company recommended using market-based allowances, requiring a single entry and resulting in fewer adjustments and fewer transportation records to be reviewed. One oil and gas company recommended that, to reduce costs, adjustments should be made by a single entry each year, not monthly.

MMS Response: The MMS was unable to develop an acceptable accounting methodology that would eliminate retroactive adjustments of prior period tentative transportation allowances for non-arm's-length and no-contract situations. The final regulations do, however, permit a lessee to adjust its estimates in the succeeding period based on forecasted rates. Moreover, because MMS now will accept FERC tariffs for most non-arm's-length transportation situations where they exist, fewer adjustments will be necessary because fewer lessees will be required to use the actual cost methodology.

Section 206.157(f).

Paragraph (f) of this section was proposed as paragraph (e) and, as proposed, provided that no cost is allowed for transportation which results from payments for actual or theoretical losses. The MMS received many different comments on this paragraph from industry, trade groups, and one U.S. Senator and an Indian tribal organization. Generally, the commenters stated that line losses are actual costs of doing business, should be allowable, and that this paragraph of the regulations should be deleted. The Indian commenter, however, said such deductions are not justifiable.

Industry commenters and the U.S. Senator commented that line losses are actual transportation costs which should be allowed by MMS. One industry commenter stated that line losses occur beyond the control of the lessee and are practical and legitimate occurrences. Another industry commenter stated that such allowances are real transportation costs borne by the lessee. Seven industry commenters stated that MMS should allow line losses not attributable to negligence.

Three commenters-two industry and one trade group representative—commented that line losses in arm's-length contracts and FERC tariffs should be allowed. One industry commenter stated that if a loss provision is a part of an arm's-length contract or a FERC tariff, MMS should accept such a provision, just as it accepts the dollars-and-cents rates in the contract or tariff because the losses are part of the total cost of the transportation arrangement. One industry representative stated that producer-owned pipelines should include transportation losses as part of operating expenses in the formulation of an allowance. Other commenters recommended deletion of this paragraph.

MMS Response: All of the issues of theoretical and actual line losses have been considered at length by MMS. Because of the difficulty of demonstrating that losses are valid and not the result of meter error or other difficult-to-measure causes, MMS has decided not to treat line losses as valid costs for purposes of computing transportation allowances in non-arm's-length and no-contract situations. However, the final rule provides that costs associated with payments for losses under arm's-length transportation agreements should be allowed because the payment is an out-of-pocket expense to the lessee. Also, the final rule provides that when a tariff approved by FERC or a State regulatory agency is authorized to be used by the lessee as its transportation allowance, any component of that tariff representing such losses will be allowed.

Section 206.157(g).

The MMS received comments on § 206.157(g), which was proposed as paragraph (f). This paragraph allows use of the transportation allowance rules where transportation is a component of a valuation procedure such as a net-back method.

The industry respondents stated that use of cost-based transportation allowances is inequitable when using net-back valuation because actual costs incurred should be recognized. According to these comments, if MMS collects royalty on the enhanced downstream value, MMS should bear its share of actual costs incurred to move the hydrocarbon for sale downstream.

MMS Response: The MMS remains convinced that the cost-based allowance procedure for determining gas transportation allowances is appropriate for determining value under a net-back procedure. If there is an applicable tariff, upon application, that could be used instead.

Section 206.158 Processing allowances—general.

The processing allowance regulations are almost the same as the transportation allowance regulations. As expected, therefore, most of the comments were the same. Because responding to the same comments and explaining the same regulatory section is duplicative and unnecessary, in this section MMS generally will respond only to comments and explain regulatory provisions which are unique to gas processing allowances.

Section 206.158(a).

The MMS received many different comments from Indians, industry, and States, as well as from some other persons, on paragraph (a) of this section of the regulations, which generally provide for a processing allowance. Comments on gas processing allowances, which did not relate to any specific section of the regulations, are addressed in this paragraph of the gas processing regulations.

One industry representative cautioned that, although the final processing regulations must contain certainty, they should also be flexible enough to encourage innovative marketing of the gas plant products. Similarly, one State agency said that the proposed regulations must reflect the changing nature of industry, serve to encourage rather than discourage new projects, and allow existing operations to identify new markets.

MMS Response: The MMS believes that the regulations are complete and sufficiently flexible to accommodate different types of gas processing arrangements that might arise in the future. The MMS further believes that the regulations are reasonable. To not discourage new development, MMS has provided an exception process whereby a lessee may be able to justify a processing allowance in excess of the 66⅔-percent limitation and has provided the lessee with broad latitude to deduct processing costs under arm's-length contracts. For processing under non-arm's-length and no-contract situations, MMS has provided the lessee with several alternatives for depreciation and return on investment. MMS also has provided for an extraordinary cost allowance for processing gas production. The MMS does not believe that the objectives of certainty and flexibility should replace the Federal Government's responsibility to properly account for the removal of minerals from a Federal or Indian lease.

One industry commenter and one industry trade organization thought that this section should incorporate a provision to include the deduction of fractionation costs.

One industry commenter and one industry trade representative recommended that processing allowances continue to be granted on the basis of percentage of value.

MMS Response: The regulations, as adopted, accommodate fractionation costs as part of the processing allowance cost. Therefore, a specific provision is not necessary. The MMS has determined that an allowance based on a cost per unit is more equitable and will result in less difference between actual and estimated allowances than an allowance based on percentage, especially in times of rapid price fluctuations.

Section 206.158(b).

Paragraph (b) of this section requires allocation of processing costs among gas plant products. Comments were received principally from industry.

There was general opposition from industry to the allocation of processing allowances by gas plant product. They recommended either to delete this paragraph or to rewrite it in such a manner as to allow all processing costs in full to be deducted from the value of both the residue gas and gas plant products. One industry representative proposed a change which would allow the allocation of processing costs to both the value of gas plant products and residue gas.

One industry representative stated that the cost of processing should not be allocated to one product when it benefits all products. One industry trade group stated that the allocation of costs among products is contrary to the valuation principle that the value of production should equal the sum of all gross proceeds less the sum of all post-production costs.

Two industry representatives plus one industry trade group recommended that, if allocation of costs are necessary, allocation should be based on percentage of sales rather than on a cost per unit; that is, based on value rather than volume. Two industry representatives and one trade group thought that the allocation of costs presents an administrative burden for both industry and MMS.

Two industry commenters recommended the addition of the phrase "(fractionated or unfractionated)" between the words "liquids" and "shall" in the last sentence of this subsection.

MMS Response: It has been a longstanding MMS policy and regulatory requirement that no processing allowance be granted against the value of residue gas. Among the reasons for this is that processing is viewed as necessary to place the residue gas in marketable condition and that processing does not generally enhance the value of residue gas. Thus, generally no processing allowance is authorized against the value of the residue gas in the final rule. The MMS believes that allocating processing costs based on relative volume rather than on relative value is more equitable because the costs of extracting any given product may be unrelated to that product's value. Also, MMS will not include the addition of the phrase "(fractionated or unfractionated)" in the last sentence because it does not clarify the meaning of the sentence.

Section 206.158(c).

As proposed, paragraph (c) of this section generally limited the processing allowance deduction to two-thirds of the value of each gas plant product. The MMS received a large number of comments on this paragraph.

Most industry-related commenters expressed their objection to the 66⅔-percent limitation on the processing allowance, and the exclusion of residue gas value from the allowance determination. Other commenters supported this position.

One State representative suggested that the limitation creates a floor and feared that a 66⅔-percent processing allowance will be taken as an automatic deduction.

An industry trade organization commented that in processing a sour, low quality gas stream, the 66⅔-percent limitation does not reflect actual costs to industry. This trade group plus four industry commenters stated that in high-cost or lowquality areas, the limitation will discourage development.

Many industry commenters recommended, in lieu of a strict limitation, that the 66 2/3-percent level be a threshold above which an allowance will be granted according to specific criteria. For example, one industry commenter recommended a higher allowance upon MMS approval. Another industry commenter requested that a higher allowance be approved on the basis of "national interest" criteria.

Some industry commenters stated that MMS should allow lessees to carry forward processing costs otherwise allowable (except for the 66⅔-percent limitation) from the current year to subsequent years.

The MMS also received several comments from parties who supported the proposed 66⅔-percent limitation on the processing allowance, including two oil producers, one interest owner, one State representative, and one State and Tribal organization. Another oil producer added that it opposed increasing the limitation. One interest owner stated that the limitation should be lowered.

An additional comment from a State and Tribal organization stated that it favors the exclusion of residue gas from the allowance determination. An Indian trade group stated its objection to the Director approving an allowance in excess of 66⅔-percent.

Six parties (one oil producer, one State representative, one interest owner, two industry parties, and one State and Tribal organization) stated their opposition to a "carry forward" provision for costs exceeding the 66⅔-percent limitation. One industry commenter stated that such a process would be "impractical."

One industry commenter suggested that the 66⅔-percent limitation should not apply to arm's-length processing contracts. It also was recommended that the 66⅔-percent calculation should be done before deducting transportation allowances.

Two industry commenters and three industry groups recommended that the rules should specify the conditions for which an allowance in excess of two-thirds would be approved.

MMS Response: The MMS has devoted considerable time and effort in evaluating the 66⅔-percent limitation on the processing allowance, and the exclusion of the value of residue gas from the allowance computation. Section 206.158(c)(2) of the final rule provides that the processing allowance deduction on the basis of an individual product cannot exceed 66⅔-percent of the value of each gas plant product at the point of sale determined in accordance with § 206.153. No processing allowance may be taken against the value of the residue gas, except for certain extraordinary allowances specifically approved by MMS in accordance with paragraph (d), discussed below.

The 66⅔-percent limit is to be applied against the value of the product already reduced by any transportation allowance for transportation costs incurred after the gas is processed. Transportation allowances related to transportation from the field to the processing plant would not be deducted before applying the 66⅔-percent limitation.

The MMS has retained in the final rule a procedure whereby the lessee may request an exception from the 66⅔-percent limitation. The lessee must demonstrate that any costs in excess of the limitation are reasonable, actual, and necessary. This procedure will allow MMS to monitor more closely those situations where the allowance based on reasonable, actual costs will be in excess of the 66⅔-percent limitations. Under no circumstances may the processing allowance equal 100 percent of the value of any product. As with transportation allowances, many commenters suggested that any additional allowance must be in the "best interests of the lessor." As stated earlier, MMS believes that this standard is too subjective and that the standard included in the rules will protect the lessors' interests.

The MMS will not include any specific standards in the rule for when the two thirds limit may be exceeded. This will require case-by-case review.

Industry respondents and industry trade groups stated their objection to the requirement regarding substitution of other products for residue gas in situations where residue gas is absent. One industry trade group stated that, in this situation, the lessee should be able to deduct the processing costs against the sum of all marketable products. Industry commenters recommended that this sentence be deleted. Industry commenters were also concerned that this paragraph would prohibit an allowance from being taken against all gas plant products if the residue gas was returned to the lease for reinjection or other uses.

MMS Response: The MMS did not intend, where residue gas was returned to the lease, that this provision would require the lessee to designate at least one gas plant product as being placed in marketable condition as a result of processing. The provision was intended to cover those situations where no residue gas was produced at the plant at all owing to the absence of, or very low levels of, hydrocarbons in the gas when produced from the well. However, because the extraordinary processing allowance procedure discussed below would most likely be applicable in these situations, MMS has modified the final rule to eliminate the requirement that the lessee designate a gas plant product against which no allowance would be granted. Instead, the final rule provides that MMS may designate a gas plant product against which no allowance would be applied if circumstances warrant.

Section 206.158(d)

The MMS received many comments on paragraph (d) of this section, which provides generally that no processing cost deduction will be allowed for the costs of placing lease production in marketable condition. Comments were received from industry, Indian Tribes, local businesses, a town mayor, a Federal agency, and individuals.

The major issue raised in this paragraph was whether or not costs associated with placing a product in marketable condition, generally referred to by the commenters as post-production costs, should be deductible from royalty.

All industry-related commenters, the local businesses, and one town mayor supported the concept that all post-production costs be allowable deductions from royalty.

Industry commenters expressed their view that certain post-production costs should be deductible from royalty. One industry trade group stated that the costs related to the manufacture and sale of separately marketable products are extraordinary and should be allowed. One industry commenter stated that ". . . other off-lease post-production costs and certain 'extraordinary' on-lease costs" should be deductible.

MMS Response: MMS already has addressed the post-production cost issue with regard to other sections of these regulations. Post-production costs, excluding those for transportation and processing, are not allowable deductions from royalty. Post-production costs for the services of gathering, separation, measurement, dehydration, compression, and sweetening are considered to be a requirement to place the lease production into marketable condition, at no cost to the lessor. These costs are not considered part of the processing costs and, therefore, are not deductible in a processing allowance.

MMS has included in the final regulations a new § 206.158(d)(2) which was included in the second draft final rule. Pursuant to this paragraph, if a lessee incurs extraordinary costs for processing gas production, it may apply to MMS for an extra allowance above that to which it otherwise would be entitled pursuant to these regulations. The allowance is discretionary with MMS, but may be granted only if the lessee can demonstrate that the costs are, by reference to standard industry conditions, extraordinary, unusual, or unconventional. Under this paragraph, an allowance could be provided against the value of the residue gas. The MMS has removed any reference to "unique" processing operations. It is not MMS's intent to limit the allowance to one-of-a-kind plants. MMS also has included flexibility for longer approval periods.

Section 206.159. Determination of processing allowances.

Section 206.159(a).

The MMS received a large number of comments from States, Indians, and industry. Again, most of the issues raised in the comments were the same as for the corresponding section of the transportation allowance regulations and will not be repeated.

Two industry commenters responded in favor of the provision in § 206.159(a)(1) whereby MMS would accept costs incurred under arm's-length processing agreements as the reasonable, actual costs incurred by the lessee because they thought these arrangements reflect true processing costs experienced by the lessee. One Indian Tribal trade group opposed this proposal because of the concern that, under these procedures, the Indian lessor's royalty could be reduced to virtually nothing.

One industry commenter suggested changing section (a)(1) to read "If a lessee has an arm's-length contract or a negotiated Products Purchase Agreement (PPA) to process gas, the processing cost deduction shall be the reasonable actual cost incurred * * *"

MMS Response: The MMS believes that processing costs incurred by a lessee under arm's-length agreements represent actual costs to the lessee and should be appropriate as a processing allowance. The suggestion that a negotiated Products Purchase Agreement be recognized as properly defining the actual cost incurred is not adopted. A Products Purchase Agreement may not be an arm's-length contract. However, where the lessee's arm's-length processing agreement specifies that the costs are to be those contained in the Products Purchase Agreement, then those costs would be acceptable owing to the arm's-length processing agreement of the lessee. MMS has added a provision clarifying that the lessee has the burden of demonstrating that its contract is arm's-length. Under the provisions of these regulations, the lessor's royalty cannot be reduced to zero. Also, as with transportation allowances, MMS has added two paragraphs which provide that MMS will treat as non-arm's-length any processing contracts which reflect more than the consideration actually transferred from the lessee to the processor (i.e., the cost is inflated) or where there is misconduct by or between the contracting parties or the lessee otherwise breaches its duty to the lessor to market the production for the mutual benefit of the lessee and the lessor.

With regard to the requirement of § 206.159(a)(2) that processing costs be allocated among all products, one industry commenter was critical of the proposal to treat all NGL's (but no other plant products) as one product. The commenter thought this was discriminatory toward the lessees in favor of processors of wet gas, not only because some lessees typically will be able to recover total processing costs from the value of the NGL's, but if other products are produced, costs would need to be allocated to them, with the possibility that some of these costs would not be totally recovered. This industry representative stated that all of the marketable products should be treated as one product, including residue gas, for purposes of allocating processing costs. Another industry representative made proposals which would make the allocation procedure unnecessary.

MMS Response: The NGL's, historically, have been considered one plant product, for royalty purposes, because they are commonly extracted first as raw make at an extraction facility. MMS has determined that all other individual plant products must be evaluated separately for processing allowances for the reasons stated previously.

Section 206.159(b).

The MMS received a very large number of comments on § 206.159(b), which provides for a processing allowance determination where the lessee has a non-arm's-length contract for processing or no contract. Comments were from industry commenters, industry trade organizations, State representatives, a Federal agency, an interest owner, local businesses, and from a town mayor.

The major issues addressed regarding this paragraph were (1) the requirement of a lessee's actual costs versus use of a benchmark system, (2) the use of "Alternative 1" or "Alternative 2" for depreciation or a return on capital investment, and (3) the rate of return on capital investment. These issues are basically the same as for the transportation allowance and have been responded to. However, some comments were specific to processing costs.

Industry comments disagreed with the proposal under this paragraph to base allowances on cost accounting procedures.

Industry commenters explicitly voiced their support for a market value concept; i.e., MMS should accept the market value of service for the allowance determination. One industry commenter added that, under the proposed methodology, MMS ignores "competitive market forces." Another industry commenter requested that MMS adopt a "market-oriented" approach. Still another industry commenter stated that, if a non-arm's-length contract for processing reflects the market value for that service, it should be acceptable.

The industry commenters specifically recommended that MMS should adopt a benchmark system for allowance determinations under this section. These commenters suggested that comparable arm's-length contracts be used to determine the allowance for non-arm's-length processing arrangements in the same facility. One of the industry commenters added that the use of comparable arm's-length contracts will reduce the number of adjustments and other records to be filed.

One State representative opposed a benchmark system.

Four industry commenters and one industry trade group complained that cost accounting is a departure from the valuation requirements and that it discriminates against lessee affiliates.

Another industry commenter recommended that, if plant ownership interest is sufficiently small, it should be treated as an arm's-length arrangement.

MMS Response: The MMS considered a benchmark valuation system featuring comparable arm's-length contracts to determine processing allowances, with cost accounting being used as a last resort. MMS concluded that such a procedure is not the fairest and best way to determine gas processing allowances considering the overall interests of industry, the Federal Government, States, and Indian Tribes. The MMS does not believe that allowances generally should be valued on a "market-based system" the way products are valued for royalty determination purposes for several reasons.

First, the determination of an allowance on a "market-based system" would not be representative of a lessee's actual, reasonable costs. Second, if one lessee bases its allowance on actual costs, and another lessee processing gas in the same facility bases its allowance on market value, an inequity will result.

For these reasons, MMS has decided that generally the gas processing allowance is best determined on actual, reasonable costs plus a return on undepreciated capital investment, or its initial capital investment. However, MMS has included in § 206.159(b)(4) of the final rules a provision whereby a lessee may apply to MMS for an exception from the requirement to use actual costs. MMS may grant such an exception, at its discretion, only if two conditions are met: (1) The lessee has arm's-length contracts for processing other gas production at the same processing plant; and (2) at least 50 percent of the gas processed at the plant is processed pursuant to arm's-length processing contracts. MMS has decided not to include a third requirement that the persons purchasing processing services from the lessee had a reasonable alternative to processing at the lessee's plant. Industry commenters noted that there often is no choice for the purchaser, thus the third requirement would render the exception unrealistic. If the exception is granted, the lessee must use as its allowance the volume-weighted average of the prices it charges other persons pursuant to arm's-length contracts at the same plant. Although some State and Indian commenters expressed concern over deviating from a true cost-based approach, MMS is satisfied that if these conditions are met, the processing allowance will reflect the market and that MMS will be able to monitor the use of these allowances.

Three industry commenters recommended that the 50-percent threshold be reduced to 25 percent. The MMS did not adopt this change because there did not appear to be broad support for a change to the 50-percent threshold.

Two industry commenters stated that State and Federal income taxes should be considered as allowable costs on the premise that such costs are real, tangible costs to the lessee.

Two other industry commenters suggested that plant dismantling and abandonment costs should be allowable, advising that such costs are a real cost of doing business.

MMS Response: The MMS views income taxes to be an apportionment of profit rather than a valid operating expense. Therefore, income taxes are not an appropriate expense that should be included in the processing allowance. The MMS takes the position that, because it does not participate in the profit or losses from the sale of processing facilities, no costs for dismantling and abandonment should be included in processing allowances.

The basic issue regarding requirements to allocate processing costs among all plant products is discussed under § 206.158(b). However, specific comments pertaining to the allocation under non-arm's-length and no-contract situations are discussed here.

Industry commenters disagreed with the requirement to allocate costs on generally accepted oil and gas accounting principles. One of these commenters recommended deleting this requirement. Other commenters advised that generally accepted principles for cost allocation do not exist. One commenter suggested instead that allocations be based on (1) cost-benefit analysis, and (2) cause-and-effect relationships.

One industry commenter recommended that this requirement be modified to include an allocation of costs to residue gas.

MMS Response: The MMS believes that if cost-benefit analysis and cause-and-effect relationships are generally acceptable procedures in cost allocation, these procedures would be acceptable to MMS. MMS will consider cost allocation procedures for unique situations on the basis of individual cases in order to arrive at an equitable allocation procedure. As stated previously, MMS believes that it is not appropriate to allocate processing costs to residue gas.

Section 206.159(c).

The MMS received several comments on paragraph (c) of this section, which addresses reporting requirements for processing allowances. Again, this paragraph is virtually identical to the corresponding provision for transportation allowances, and the response to comments for that section is, for the most part, applicable here.

The two major areas of concern were (1) use of Form MMS-4109, and (2) the terms of the reporting periods and filing timetables.

Industry commenters and Indian Tribes expressed some opposition to Form MMS-4109. One industry respondent and one industry trade group objected to commenting on the form until it is published, adding that it should not conflict with any rights of the lessee. Several industry commenters opposed the filing of Form MMS-4109 at all. One of the industry commenters stated that processing rates under an arm's-length or non-arm's-length contract should be accepted at face value. An industry trade group claimed that filing of the form would be an unnecessary burden for both industry and MMS. Another industry commenter stated that it opposed any reporting requirements such as annual renewals or contract change updates. A Tribe opposed industry taking an allowance on the honor system and merely filing a form to claim it.

MMS Response: The MMS believes that Form MMS-4109 must be required in order for MMS to monitor the processing allowance program. The MMS believes it can effectively monitor the processing allowance deductions without the preapproval of the allowances. The MMS has made the information on Form MMS-4109 as clear and uncomplicated as possible considering the complex nature of processing allowances. The filing of a Form MMS-4109 does not conflict with any lease provisions or rights of the lessees. The MMS agrees that its procedure for determining a processing allowance places initial reliance on the gas industry. However, this program will be under continuous review and oversight by MMS. Thus, the ability to effectively review, evaluate, and audit processing allowances has been maintained under the new regulations.

The MMS received several comments on the Form MMS-4109 format. These comments will be considered in designing the final form.

The initial concern about reporting periods was MMS's proposal to create a new reporting period for all allowances which would commence the date the new regulations are effective. Industry commenters opposed this, recommending instead that all existing allowances be grandfathered under the new regulations. Another industry commenter requested 180 days for conversion to the new reporting period.

Another topic addressed by the respondents was the term of the reporting period. Industry commenters favored a reporting period that extends as long as the contract terms are effective, instead of an arbitrary 12-month period. One of the industry commenters stated that resources are wasted by requiring the lessee to file year after year even though there are no changes. However, one industry commenter and one industry trade group endorsed the 12-month reporting period. The industry commenter specifically requested a calendar-year period.

Two industry commenters recommended a longer grace period in which to file subsequent Forms MMS-4109. These commenters both suggested 120 days to file updated forms.

MMS Response: The MMS concurs with a 12-month term and the regulations have been changed to allow filing of Form MMS-4109 by calendar year. The regulations have also been changed to allow a grace period of 3 months during which the lessee continues to use the previous allowance. The MMS also decided that existing allowances (but only those approved in writing by MMS) will continue in effect until they expire, subject to later audit, with the exception of processing allowances for OCS production, which are based on non-arm's-length or no-contract situations. Because these allowances are based upon a procedure radically different from the procedure adopted in the final rule, they will continue in effect until they expire or until the end of the calendar year, whichever occurs first.

Section 206.159(d)

Paragraph (d) of this section is the same as for transportation allowances. If a lessee deducts a processing allowance without filing the proper forms, it will owe interest on the amount of the deduction until the proper forms are filed, subject to the 3-month retroactivity provision.

Section 206.159(e).

As with transportation allowance adjustments, the issues regarding paragraph (e) of this section were (1) the requirement to file adjustments, (2) the refund procedure under Section 10 of the OCS Lands Act, and (3) the payment of interest.

It was the general consensus that adjustments were a very large burden on both industry and MMS and that some way should be found to eliminate the need for so many adjustments resulting from differences between actual and estimated processing allowances. Six industry representatives and two industry trade groups recommended that positive or negative differences between estimated and actual costs should be rolled forward into the processing allowance for the subsequent period, or prospectively.

One industry commenter asserted that retroactive adjustments should not be necessary if the actual allowance falls within an allowable range of the estimated allowance, and two other industry commenters suggested rolling forward small differences into next year's costs within an allowable range.

One industry commenter proposed single-entry adjustments for an entire year instead of month-by-month adjustments. This party also made the comment that if a market-based allowance were permitted, it would be more certain and fewer adjustments would be necessary.

MMS Response: The MMS expended considerable effort in an attempt to arrive at an accounting methodology that would eliminate retroactive adjustments of processing allowances and continue to be fair to industry, MMS, and Indian lessors, but was unable to do so.

One industry representative stated that overpayments, when estimates were less than actual costs, should not be judged as refunds of a payment of royalty under section 10 of the OCS Lands Act because estimates are not "actual" payments of royalty. Overpayments could then be treated as line-item adjustments not subject to the refund process.

MMS Response: The refund procedure will not be specified in these regulations. MMS is reviewing the issue and will provide guidance to the lessees on refund procedures.

Industry representatives commented that the MMS-proposed procedure for handling interest payments was not fair. These commenters believed that, if the lessee must pay any difference plus interest, MMS should also pay any difference plus any interest statutorily authorized. Another issue of concern was the payment of interest requirement.

MMS Response: The MMS has no legal authority to pay interest to lessees on their overpayments.

Section 206.159(f).

Paragraph (f) of this section requires that the provisions in this section will apply to determine processing costs in situations where value must be established under other methods such as net-back.

One industry commenter recommended that the definition of "net-back method" be clarified.

MMS Response: A definition of the netback method has been included in § 206.151, which is slightly different from that proposed. The MMS believes this revised definition clarifies MMS's intent.

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 the 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 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. 601 *et seq.*).

Paperwork Reduction Act

The information collection and recordkeeping requirements located at §§ 206.157 and 206.159 of this rule have been approved by the Office of Management and Budget under 44 U.S.C. 3501 *et seq.* and assigned clearance number 1010-0075.

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.

List of Subjects

30 CFR Part 202

Coal, Continental shelf, Geothermal energy, Government contracts, Indian lands, Mineral royalties, Natural gas, Petroleum Public lands-mineral resources, Reporting and recordkeeping requirements.

30 CFR Part 206

Coal, Continental shelf, Geothermal energy, Government contracts, Indian lands, Mineral royalties, Natural gas, Petroleum, Public lands-mineral resources, Reporting and recordkeeping requirements.

Date: January 6, 1988.

J. Steven Griles,

Assistant Secretary, Land and Minerals Management.

For the reasons set out in the preamble, 30 CFR Parts 202 and 206 are amended as follows:

TITLE 30—MINERAL RESOURCES

PART 202—ROYALTIES

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. A new Subpart D consisting of §§ 202.150, 202.151, and 202.152 is added to read as follows:

Subpart D—Federal and Indian Gas

Subpart D—Federal and Indian Gas

§ 202.150 Royalty on gas.

(a) Royalties due on gas production from leases subject to the requirements of this subpart, 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. When paid in value, the royalty due shall be the value, for royalty purposes, determined pursuant to 30 CFR Part 206 of this title multiplied by the royalty rate in the lease.

(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 MMS or BLM, as appropriate) produced from a Federal or Indian lease to which this subpart applies is subject to royalty.

(2) When gas is used on, or for the benefit of, the lease at a production facility handling production from more than one lease with the approval of MMS or BLM, as appropriate, or at a production facility handling unitized or communitized production, only that proportionate share of each lease's production (actual or allocated) necessary to operate the production facility may be used royalty free.

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

(c) If BLM determines that gas was avoidably lost or wasted from an onshore lease, or that gas was drained from an onshore lease for which compensatory royalty is due, or if MMS determines that gas was avoidably lost or wasted from an OCS lease, then the value of that gas shall be determined in accordance with 30 CFR Part 206.

(d) If a lessee receives insurance compensation for unavoidably lost gas, royalties are due on the amount of that compensation. This paragraph shall not apply to compensation through self-insurance.

(e)(1) 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 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 nonetheless is subject to the royalty payment and reporting requirements of this title. Except as provided in paragraph (e)(2) of this section, the value for royalty purposes of production attributable to unitized or communitized leases will be determined in accordance with 30 CFR Part 206. In applying the requirements of 30 CFR Part 206, the circumstances involved in the actual disposition of the portion of the production to which the lessee was entitled but did not take shall be considered as controlling in arriving at the value for royalty purposes of that portion, as if the person actually selling or disposing of the production were the lessee of the Federal or Indian lease.

(2) If a Federal or Indian lessee takes less than its proportionate share of agreement production, upon request of the lessee MMS may authorize a royalty valuation method different from that required by paragraph (e)(1) of this section, but consistent with the purpose of these regulations, for any volumes not taken by the lessee but for which royalties are due.

(3) For purposes of this subchapter, all persons actually taking volumes in excess of their proportionate share of production in any month under a unitization or communitization agreement shall be deemed to have taken ratably from all persons actually taking less than their proportionate share of the agreement production for that month.

(4) If a lessee takes less than its proportionate share of agreement production for any month but royalties are paid on the full volume of its proportionate share in accordance with the provisions of this section, no additional royalty will be owed for that lease for prior periods at the time the lessee subsequently takes more than its proportionate share to balance its account or when the lessee is paid a sum of money by the other agreement participants to balance its account.

(f) For production from Federal and Indian leases which are committed to federally-approved unitization or communitization agreements, upon request of a lessee MMS may establish the value of production pursuant to a method other than the method required by the regulations in this title if: (1) The proposed method for establishing value is consistent with the requirements of the applicable statutes, lease terms and agreement terms; (2) to the extent practical, persons with an interest in the agreement, including royalty interests, are given notice and an opportunity to comment on the proposed valuation method before it is authorized; and (3) to the extent practical, persons with an interest in a Federal or Indian lease committed to the agreement, including royalty interests, must agree to use the proposed method for valuing production from the agreement for royalty purposes.

§ 202.151 Royalty on processed gas.

(a) A royalty, as provided in the lease, shall be paid on the value of: (1) Any condensate recovered downstream of the point of royalty settlement without resorting to processing; and (2) residue gas and all gas plant products resulting from processing the gas produced from a lease subject to this subpart. 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 30 CFR Part 206.

(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, except as provided in 30 CFR Part 206. In those situations where a processing plant processes gas from more than one lease, only that proportionate share of each lease's residue gas necessary for the operation of the processing plant shall be allowed royalty free.

(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 other disposition off-lease.

§ 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, except 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 provided that the sales contract does not conflict with FERC regulation.

(2) The frequency and method of Btu measurement as set forth in the lessee's contract shall be used to determine Btu heating values for reporting purposes. However, the lessee shall measure the Btu value at least semiannually by recognized standard industry testing methods even if the lessee's contract provides for less frequent measurement.

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

(2) Carbon dioxide (CO_2), nitrogen (N_2), helium (He), residue gas, and any other gas marketed as a separate product shall be reported by using the same standards specified in paragraph (a) of this section.

(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—PRODUCT VALUATION

1. The authority citation for Part 206 continues 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. A new § 206.10 is added to Subpart A to read as follows:

Subpart A—General Provisions

§ 206.10 Information collection.

The information collection requirements contained in 30 CFR Part 206 have been approved by the Office of Management and Budget (OMB) under 44 U.S.C. 3501 *et seq.* The forms and approved OMB clearance numbers are as follows:

Form No., name, and filing date	OMB No.
MMS-4109—Gas Processing Allowance Summary Report—due within 3 months following the last day of the month for which an allowance is claimed, unless a longer period is approved by MMS	1010-0075
MMS-4110—Oil Transportation Allowance Report—due within 3 months following the last day of the month for which an allowance is claimed, unless a longer period is approved by MMS	1010-0061
MMS-4295—Gas Transportation Allowance Report—due within 3 months following the last day of the month for which an allowance is claimed unless a longer period is approved by MMS	1010-0075

The information is being collected by the Department of the Interior to meet its congressionally mandated accounting and audit responsibilities relating to Federal and Indian mineral royalty management. The information will be used to determine the transportation and processing allowances that may be deducted from royalty payments due on Federal and Indian lands. The reports are required to receive a benefit.

§§ 206.106 and 206.107 [Removed]

3. Sections 206.106 and 206.107 are removed from Subpart C.

4. Subpart D is revised to read as follows:

Subpart D—Federal and Indian Gas

Subpart D—Federal and Indian Gas

§ 206.150 Purpose and scope.

(a) This subpart is applicable to all gas production from Federal and Indian (Tribal and allotted) oil and gas leases (except leases on the Osage Indian Reservation). The purpose of this subpart is to establish the value of production for royalty purposes consistent with the mineral leasing laws, other applicable laws and lease terms.

(b) If the specific provisions of any statute, treaty, settlement agreement between the United States (or Indian lessor) and a lessee resulting from administrative or judicial litigation, or oil and gas lease subject to the requirements of this subpart are inconsistent with any regulation in this subpart, then the lease, statute, treaty provision or settlement agreement shall govern to the extent of that inconsistency.

(c) All royalty payments made to MMS or to any Tribe or allottee are subject to audit and adjustment.

(d) The regulations in this subpart are intended to ensure that the trust responsibilities of the United States with respect to the administration of Indian oil and gas leases are discharged in accordance with the requirements of the governing mineral leasing laws, treaties, and lease terms.

(e)(1) Notice to Lessees 1 is terminated.

(2) Notice to Lessees 1A is terminated.

(3) Notice to Lessees 5 is terminated.

(4) Notice to Lessees and Operators (NTL) on the Outer Continental Shelf (OCS) concerning royalty payments on oil and gas lost or used on leases or units on the OCS is terminated.

§ 206.151 Definitions.

For purposes of this subpart:

"Allowance" means an approved or an MMS-initially accepted 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 approved or MMS-initially accepted deduction for costs of such processing, determined pursuant to this subpart. "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 off the lease, unit area, communitized area, or away from a processing plant, excluding gathering, or an approved or MMS-initially accepted deduction for costs of such transportation, determined pursuant to this subpart.

"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, economic, and legal characteristics.

"Arm's length contract" means a contract or agreement that has been arrived at in the marketplace between independent, nonaffiliated persons with opposing economic interests regarding that contract. For purposes of this subpart, two persons are affiliated if one person controls, is controlled by, or is under common control with another person. For purposes of this subpart, based on the instruments of ownership of the voting securities of an entity, or based on other forms of ownership:

(a) Ownership in excess of 50 percent constitutes control;

(b) Ownership of 10 through 50 percent creates a presumption of control; and

(c) Ownership of less than 10 percent creates a presumption of noncontrol which MMS may rebut if it demonstrates actual or legal control, including the existence of interlocking directorates.

Notwithstanding any other provisions of this subpart, contracts between relatives, either by blood or by marriage, are not arm's-length contracts. The MMS may require the lessee to certify ownership control. To be considered arm's-length for any production month, a contract must meet the requirements of this definition for that production month as well as when the contract was executed.

"Audit" means a review, conducted in accordance 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.

"BIA" means the Bureau of Indian Affairs of the Department of the Interior.

"BLM" means the Bureau of Land Management of the Department of the Interior.

"Compression" means the process of raising the pressure of gas.

"Condensate" means liquid hydrocarbons (normally exceeding 40 degrees of API gravity) recovered at the surface without resorting to processing. Condensate is the mixture of liquid hydrocarbons that results from condensation of petroleum hydrocarbons existing initially in a gaseous phase in an underground reservoir.

"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.

"Field" means a geographic region situated over one or more subsurface oil and gas reservoirs encompassing at least the outermost boundaries of all oil and gas 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.

"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.

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

"Gathering" means the movement of lease production to a central accumulation and/or treatment point on the lease, unit or communitized area, or to a central accumulation or treatment point off the lease, unit or communitized area as approved by BLM or MMS OCS operations personnel for onshore and OCS leases, respectively.

"Gross proceeds" (for royalty payment purposes) means the total monies and other consideration accruing to an oil and gas lessee 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 but is not limited to: 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. Payments or credits for advanced exploration or development costs or prepaid reserve payments that are subject to recoupment through credits against the purchase price or through reduced prices in later sales and which are made before production commences become part of gross proceeds as of the time of first production. Monies and other consideration, including the forms of consideration identified in this paragraph, to which a lessee is contractually or legally entitled but which it does not seek to collect through reasonable efforts are also part of gross proceeds.

"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.

"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 in trust by the United States or which is subject to Federal restriction against alienation.

"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.

"Lease products" means any leased minerals attributable to, originating from, or allocated to Outer Continental Shelf or onshore Federal or Indian leases.

"Lessee" means any person to whom the United States, an Indian Tribe, or an Indian allottee issues a lease, and any person who has been assigned an obligation to make royalty or other payments required by the lease. This includes any person who has 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.

"Like-quality lease products" means lease products which have similar chemical, physical, and legal characteristics.

"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.

"Marketing affiliate" means an affiliate of the lessee whose function is to acquire only the lessee's production and to market that production.

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

"Net-back method" (or work-back method) means a method for calculating market value of gas at the lease. Under this method, costs of transportation, processing, or manufacturing are deducted from the proceeds received for the gas, residue gas or gas plant products, and any extracted, processed, or manufactured products, or from the value of the gas, residue gas or gas plant products, and any extracted, processed, or manufactured products, at the first point at which reasonable values for any such products may be determined by a sale pursuant to an arm's-length contract or comparison to other sales of such products, to ascertain value at the lease.

"Net output" means the quantity of residue gas and each gas plant product that a processing plant produces.

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

"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.

"Person" means any individual, firm, corporation, association, partnership, consortium, or joint venture (when established as a separate entity).

"Posted price" means the price, net of all adjustments for quality and location, specified in publicly available price bulletins or other price notices available as part of normal business operations for quantities of unprocessed gas, residue gas, or gas plant products in marketable condition.

"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 is not considered processing.

"Residue gas" means that hydrocarbon gas consisting principally of methane resulting from processing gas.

"Section 6 lease" means an OCS lease subject to section 6 of the Outer Continental Shelf Lands Act, as amended, 43 U.S.C. 1335.

"Selling arrangement" means the individual contractual arrangements under which sales or dispositions of gas, residue gas and gas plant products are made. Selling arrangements are described by illustration in the MMS Royalty Management Program Oil and Gas Payor Handbook.

"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 normally require a cancellation notice to terminate, and which does not contain an obligation, nor imply an intent, to continue in subsequent periods.

"Warranty contract" means a long-term contract entered into prior to 1970, including any amendments thereto, 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.

§ 206.152 Valuation standards—unprocessed gas.

(a)(1) This section applies to the valuation of all 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. This section also applies to processed gas which must be valued prior to processing in accordance with § 206.155.

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

(3)(i) For any Indian leases which provide that the Secretary may consider the highest price paid or offered for a major portion of production (major portion) in determining value of production for royalty purposes, if data are available to compute a major portion MMS will, where practicable, compare the value determined in accordance with this section with the major portion. The value to be used in determining the value of production for royalty purposes shall be the higher of those two values.

(ii) For purposes of this paragraph, major portion means the highest price paid or offered at the time of production for the major portion of gas production from the same field. The major portion will be calculated using like-quality gas sold under arm's-length contracts from the same field (or, if necessary to obtain a reasonable sample, from the same area) for each month. All such sales will be arrayed from highest price to lowest price (at the bottom). The major portion is that price at which 50 percent (by volume) plus 1 mcf of the gas (starting from the bottom) is sold.

(b)(1)(i) The value of gas which is sold pursuant to an arm's-length contract shall be the gross proceeds accruing to the lessee, except as provided in paragraphs (b)(1)(ii) and (b)(1)(iii) of this section. The lessee shall have the burden of demonstrating that its contract is arm's-length. The value which the lessee reports, for royalty purposes, is subject to monitoring, review, and audit. For purposes of this section, gas which is sold or otherwise transferred to the lessee's marketing affiliate and then sold by the marketing affiliate pursuant to an arm's-length contract shall be valued in accordance with this paragraph based upon the sale by the marketing affiliate.

(ii) In conducting reviews and audits, MMS will examine whether the contract reflects the total consideration actually transferred either directly or indirectly from the buyer to the seller for the gas. If the contract does not reflect the total consideration, then the MMS may require that the gas sold pursuant to that contract be valued in accordance with paragraph (c) of this section. Value may not be less than the gross proceeds accruing to the lessee, including the additional consideration.

(iii) If the MMS determines that the gross proceeds accruing to the lessee pursuant to an arm's-length contract do not reflect the reasonable value of the production because of misconduct by or between the contracting parties, or because the lessee otherwise has breached its duty to the lessor to market the production for the mutual benefit of the lessee and the lessor, then MMS shall require that the gas production be valued pursuant to paragraphs (c)(2) or (c)(3) of this section, and in accordance with the notification requirements of paragraph (e) of this section. When MMS determines that the value may be unreasonable, MMS will notify the lessee and give the lessee an opportunity to provide written information justifying the lessee's value.

(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. The lessee must request a value determination in accordance with paragraph (g) of this section for gas sold pursuant to a warranty contract; provided, however, that any value determination for a warranty contract in effect on the effective date of these regulations shall remain in effect until modified by MMS.

(3) MMS may require a lessee to certify that its arm's-length contract provisions include all of the consideration to be paid by the buyer, either directly or indirectly, for the gas.

(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 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 (or, if necessary to obtain a reasonable sample, from the same 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) 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 saleability of the gas; or

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

(d)(1) 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 MMS shall accept such maximum price as the value. For purposes of this section, price limitations set by any State or local government shall not be considered as a maximum price permitted by Federal law.

(2) The limitation prescribed in paragraph (d)(1) of this section 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, the lessee shall retain all data relevant to the determination of royalty value. Such data shall be subject to review and audit, and MMS will direct a lessee to use a different value if it determines that the reported value is inconsistent with the requirements of these regulations.

(2) Any Federal or Indian lessee will make available upon request to the authorized MMS, State, or Indian representatives, to the Office of the Inspector General of the Department of the Interior, or other person authorized to receive such information, arm's-length sales and volume data for like-quality production sold, purchased or otherwise obtained by the lessee from the field or area or from nearby fields or areas.

(3) A lessee shall notify MMS if it has determined value pursuant to paragraph (c)(2) or (c)(3) of this section. The notification shall be by letter to the MMS Associate Director for Royalty Management or his/her designee. The letter shall identify the valuation method to be used and contain a brief description of the procedure to be followed. The notification required by this paragraph is a one-time notification due no later than the end of the month following the month the lessee first reports royalties on a Form MMS-2014 using a valuation method authorized by paragraph (c)(2) or (c)(3) of this section, and each time there is a change in a method under paragraph (c)(2) or (c)(3) of this section.

(f) If MMS determines that a lessee has not properly determined value, the lessee shall pay 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 pay interest on that difference 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 a value determination method, and may use that method in determining value for royalty purposes until MMS issues its decision. The lessee shall submit all available data relevant to its proposal. The MMS shall expeditiously determine the value based upon the lessee's proposal and any additional information MMS deems necessary. In making a value determination MMS may use any of the valuation criteria authorized by this subpart. 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 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.

(i) The lessee is required to place gas in marketable condition at no cost to the Federal Government or Indian lessor unless otherwise provided in the lease agreement. 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 lessee can receive through legally enforceable claims under its contract. If there is no contract revision or amendment, and 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. If the lessee makes timely application for a price increase or benefit 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 unless or until monies or consideration resulting from the price increase or additional benefits are received. This paragraph 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 or timely, for a quantity of gas.

(k) Notwithstanding any provision in these regulations to the contrary, no review, reconciliation, monitoring, or other like process that results in a redetermination by the MMS of value under this section shall be considered final or binding as against the Federal Government, its beneficiaries, the Indian Tribes, or allottees until the audit period is formally closed.

(l) Certain information submitted to MMS to support valuation proposals, including transportation or extraordinary cost allowances, is exempted from disclosure by the Freedom of Information Act, 5 U.S.C. 552, or other Federal Law. Any data specified by law 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 subpart are to be submitted in accordance with the Freedom of Information Act regulation of the Department of the Interior, 43 CFR Part 2. Nothing in this section is intended to limit or diminish in any manner whatsoever the right of an Indian lessor to obtain any and all information as such lessor may be lawfully entitled from MMS or such lessor's lessee directly under the terms of the lease, 30 U.S.C. 1733, or other applicable law.

§ 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 production to which this subpart applies and that is not subject to the valuation provisions of § 206.152 of this subpart. This section applies 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 (in which event these regulations will apply to determine value as if the person actually selling or disposing of the residue gas or gas plant products were the lessee of the Federal or Indian lease).

(2) The value of production, 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, plus the value of any condensate recovered downstream of the point of royalty settlement without resorting to processing determined pursuant to § 206.102 of this part, less applicable transportation allowances and processing allowances determined pursuant to this subpart.

(3)(i) For any Indian leases which provide that the Secretary may consider the highest price paid or offered for a major portion of production (major portion) in determining value for royalty purposes, if data are available to compute a major portion MMS will, where practicable, compare the values determined in accordance with this section for any lease product with the major portion determined for that lease product. The value to be used in determining the value of production for royalty purposes shall be the higher of those two values.

(ii) For purposes of this paragraph, major portion means the highest price paid or offered at the time of production for the major portion of gas production from the same field, or for residue gas or gas plant products from the same processing plant, as applicable. The major portion will be calculated using like-quality lease products sold under arm's-length contracts from the same field or processing plant (or, if necessary to obtain a reasonable sample, from the same area or nearby processing plants) for each month. All such sales will be arrayed from highest price to lowest price (at the bottom). The major portion is that price at which 50 percent (by volume) plus 1 mcf of the gas (starting from the bottom) is sold, or for gas plant products, 50 percent (by volume) plus 1 unit.

(b)(1)(i) 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 to the lessee, except as provided in paragraphs (b)(1)(ii) and (b)(1)(iii) of this section. The lessee shall have the burden of demonstrating that its contract is arm's-length. The value that the lessee reports for royalty purposes is subject to monitoring, review, and audit. For purposes of this section, residue gas or any gas plant product which is sold or otherwise transferred to the lessee's marketing affiliate and then sold by the marketing affiliate pursuant to an arm's-length contract shall be valued in accordance with this paragraph based upon the sale by the marketing affiliate.

(ii) In conducting these reviews and audits, MMS will examine whether or not the contract reflects the total consideration actually transferred either directly or indirectly from the buyer to the seller for the residue gas or gas plant product. If the contract does not reflect the total consideration, then the MMS may require that the residue gas or gas plant product sold pursuant to that contract be valued in accordance with paragraph (c) of this section. Value may not be less than the gross proceeds accruing to the lessee, including the additional consideration.

(iii) If the MMS determines that the gross proceeds accruing to the lessee pursuant to an arm's-length contract do not reflect the reasonable value of the residue gas or gas plant product because of misconduct by or between the contracting parties, or because the lessee otherwise has breached its duty to the lessor to market the production for the mutual benefit of the lessee and the lessor, then MMS shall require that the residue gas or gas plant product be valued pursuant to paragraphs (c)(2) or (c)(3) of this section, and in accordance with the notification requirements of paragraph (e) of this section. When MMS determines that the value may be unreasonable, MMS will notify the lessee and give the lessee an opportunity to provide written information justifying the lessee's value.

(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. The lessee must request a value determination in accordance with paragraph (g) of this section for gas sold pursuant to a warranty contract; provided, however, that any value determination for a warranty contract in effect on the effective date of these regulations shall remain in effect until modified by MMS.

(3) MMS may require a lessee to certify that its arm's-length contract provisions include all of the consideration to be paid by the buyer, either directly or indirectly, for the residue gas or gas plant product.

(c) The value of residue gas or 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 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 residue gas or gas plant products from the same processing plant (or, if necessary to obtain a reasonable sample, from nearby plants). 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 products, volume, and such other factors as may be appropriate to reflect the value of the residue gas or gas plant products;

(2) 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 the same gas plant or 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 the saleability of such residue gas or gas plant products; or

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

(d)(1) Notwithstanding any other provisions of this section, except paragraph (h) 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. For the purposes of this section, price limitations set by any State or local government shall not be considered as a maximum price permitted by Federal law.

(2) The limitation prescribed by paragraph (d)(1) of this section 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, the lessee shall retain all data relevant to the determination of royalty value. Such data shall be subject to review and audit, and MMS will direct a lessee to use a different value if it determines upon review or audit that the reported value is inconsistent with the requirements of these regulations.

(2) Any Federal or Indian lessee will make available upon request to the authorized MMS, State, or Indian representatives, to the Office of the Inspector General of the Department of the Interior, or other persons authorized to receive such information, arm's-length sales and volume data for like-quality residue gas and gas plant products sold, purchased or otherwise obtained by the lessee from the same processing plant or from nearby processing plants.

(3) A lessee shall notify MMS if it has determined any value pursuant to paragraph (c)(2) or (c)(3) of this section. The notification shall be by letter to the MMS Associate Director for Royalty Management or his/her designee. The letter shall identify the valuation method to be used and contain a brief description of the procedure to be followed. The notification required by this paragraph is a one-time notification due no later than the end of the month following the month the lessee first reports royalties on a Form MMS-2014 using a valuation method authorized by paragraph (c)(2) or (c)(3) of this section, and each time there is a change in a method under paragraph (c)(2) or (c)(3) of this section.

(f) If MMS determines that a lessee has not properly determined value, the lessee shall pay 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 pay interest computed on that difference 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 a value determination method, and may use that method in determining value for royalty purposes until MMS issues its decision. The lessee shall submit all available data relevant to its proposal. The MMS shall expeditiously determine the value based upon the lessee's proposal and any additional information MMS deems necessary. In making a value determination, MMS may use any of the valuation criteria authorized by this subpart. 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 of production for royalty purposes be less than the gross proceeds accruing to the lessee for residue gas and/or any gas plant products, less applicable transportation allowances 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 unless otherwise provided in the lease agreement. 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 products in marketable condition.

(j) Value shall be based on the highest price a prudent lessee can receive through legally enforceable claims 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. If the lessee makes timely application for a price increase or benefit 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 unless or until monies or consideration resulting from the price increase or additional benefits are received. This paragraph 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, or timely, for a quantity of residue gas or gas plant product.

(k) Notwithstanding any provision in these regulations to the contrary, no review, reconciliation, monitoring, or other like process that results in a redetermination by MMS of value under this section shall be considered final or binding against the Federal Government, its beneficiaries, the Indian Tribes, or allottees, until the audit period is formally closed.

(l) Certain information submitted to MMS to support valuation proposals, including transportation allowances, processing allowances or extraordinary cost allowances, is exempted from disclosure by the Freedom of Information Act, 5 U.S.C. 552, or other Federal law. Any data specified by law 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. Nothing in this section is intended to limit or diminish in any manner whatsoever the right of an Indian lessor to obtain any and all information as such lessor may be lawfully entitled from the MMS or such lessor's lessee directly under the terms of the lease, 30 U.S.C. 1733, or other applicable law.

§ 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 at the point of royalty settlement approved by BLM or MMS for onshore and OCS leases, respectively.

(2) If the value of gas determined pursuant to § 206.152 of this subpart 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 of this subpart 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 paragraph (c) of 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 the net output of the plant.

(2) When the net output of a processing plant is derived from gas obtained from more than one lease producing gas of uniform content, the quantity of the residue gas and gas plant products allocable to each lease shall be in the same proportions as the ratios obtained by dividing the amount of gas delivered to the plant from each lease by the total amount of gas delivered from all leases.

(3) When the net output of a processing plant is derived from gas obtained from more than one lease producing gas of nonuniform content, the quantity of the residue gas allocable to each lease will be determined by multiplying the amount of gas delivered to the plant from the lease by the residue gas content of the gas, and dividing the arithmetical product thus obtained by the sum of the similar arithmetical products separately obtained for all leases from which gas is delivered to the plant, and then multiplying the net output of the residue gas by the arithmetic quotient obtained. The net output of gas plant products allocable to each lease will be determined by multiplying the amount of gas delivered to the plant from the lease by the gas plant product content of the gas, and dividing the arithmetical product thus obtained by the sum of the similar arithmetical products separately obtained for all leases from which gas is delivered to the plant, and then multiplying the net output of each gas plant product by the arithmetic quotient obtained.

(4) A lessee may request MMS approval of other methods for determining the quantity of residue gas and gas plant products allocable to each lease. If approved, such method will be applicable to all gas production from Federal and Indian leases that is processed in the same plant.

(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 royalty settlement metering or measurement point will not be subject to royalty provided that such loss is determined to have been unavoidable by BLM or MMS, as appropriate.

(2) Except as provided in paragraph (d)(1) of this section and 30 CFR 202.151(c), 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 subpart, less applicable allowances. There can be no reduction 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) Except as provided in paragraph (b) of this section, where the lessee (or a person to whom the lessee has transferred gas pursuant to a non-arm's-length contract or without a contract) processes the lessee's 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 combined value, for royalty purposes, of the residue gas and gas plant products resulting from processing the gas determined pursuant to § 206.153 of this subpart, plus the value, for royalty purposes, of any condensate recovered downstream of the point of royalty settlement without resorting to processing determined pursuant to § 206.102 of this subpart; or (2) the value, for royalty purposes, of the gas prior to processing determined in accordance with § 206.152 of this subpart.

(b) The requirement for accounting for comparison contained in the terms of leases, particularly Indian leases, will govern as provided in § 206.150(b) of this subpart. When accounting for comparison is required by the lease terms, such accounting for comparison shall be determined in accordance with paragraph (a) of this section.

§ 206.156 Transportation allowances—general.

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

(b) Transportation costs must be allocated among all products produced and transported as provided in § 206.157.

(c)(1) Except as provided in paragraph (c)(3) of this section, for unprocessed gas valued in accordance with § 206.152 of this subpart, the transportation allowance deduction on the basis of a selling arrangement shall not exceed 50 percent of the value of the unprocessed gas determined in accordance with § 206.152 of this subpart.

(2) Except as provided in paragraph (c)(3) of this section, for gas production valued in accordance with § 206.153 of this subpart the transportation allowance deduction on the basis of a selling arrangement shall not exceed 50 percent of the value of the residue gas or gas plant product determined in accordance with § 206.153 of this subpart. For purposes of this section, natural gas liquids shall be considered one product.

(3) Upon request of a lessee, MMS may approve a transportation allowance deduction in excess of the limitations prescribed by paragraphs (c)(1) and (c)(2) of this section. The lessee must demonstrate that the transportation costs incurred in excess of the limitations prescribed in paragraphs (c)(1) and (c)(2) of this section were reasonable, actual, and necessary. An application for exception shall contain all relevant and supporting documentation necessary for the MMS to make a determination. Under no circumstances shall the value for royalty purposes under any selling arrangement be reduced to zero.

(d) If, after a review and/or audit, MMS determines that a lessee has improperly determined a transportation allowance authorized by this subpart, then the lessee shall pay 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) *Arm's-length transportation contracts.* (1)(i) 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 products under that contract, except as provided in paragraphs (a)(1)(ii) and (a)(1)(iii) of this section, subject to monitoring, review, audit, and adjustment. The lessee shall have the burden of demonstrating that its contract is arm's-length. Such allowances shall be subject to the provisions of paragraph (f) of this section. Before any deduction may be taken, the lessee must submit a completed page one of Form MMS–4295 (and Schedule 1), Gas Transportation Allowance Report, in accordance with paragraph (c)(1) of this section. A transportation allowance may be claimed retroactively for a period of not more than 3 months prior to the first day of the month that Form MMS–4295 is filed with MMS, unless MMS approves a longer period upon a showing of good cause by the lessee.

(ii) In conducting reviews and audits, MMS will examine whether or not the contract reflects more than the consideration actually transferred either directly or indirectly from the lessee to the transporter for the transportation. If the contract reflects more than the total consideration, then the MMS may require that the transportation allowance be determined in accordance with paragraph (b) of this section.

(iii) If the MMS determines that the consideration paid pursuant to an arm's-length transportation contract does not reflect the reasonable value of the transportation because of misconduct by or between the contracting parties, or because the lessee otherwise has breached its duty to the lessor to market the production for the mutual benefit of the lessee and the lessor, then MMS shall require that the transportation allowance be determined in accordance with paragraph (b) of this section. When MMS determines that the value of the transportation may be unreasonable, MMS will notify the lessee and give the lessee an opportunity to provide written information justifying the lessee's transportation costs.

(2)(i) If an arm's-length transportation contract includes more than one product in a gaseous phase and the transportation costs attributable to each product cannot be determined from the contract, the total transportation costs shall be allocated in a consistent and equitable manner to each of the products transported in the same proportion as the ratio of the volume of each product (excluding waste products which have no value) to the volume of all products in the gaseous phase (excluding waste products which have no value). Except as provided in this paragraph, no allowance may be taken for the costs of transporting lease production which is not royalty bearing without MMS approval.

(ii) Notwithstanding the requirements of paragraph (i), the lessee may propose to MMS a cost allocation method on the basis of the values of the products transported. MMS shall approve the method unless it determines that it is not consistent with the purposes of the regulations in this part.

(3) If an arm's-length transportation contract includes both gaseous and liquid products 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 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 relevant data to support its proposal. The initial proposal must be submitted by June 30, 1988 or within 3 months after the last day of the month for which the lessee requests a transportation allowance, whichever is later (unless MMS approves a longer period). The MMS shall then determine the gas transportation allowance based upon the lessee's proposal and any additional information MMS deems necessary.

(4) Where the lessee's payments for transportation under an arm's-length contract are not based on a dollar per unit, the lessee shall convert whatever consideration is paid to a dollar value equivalent for the purposes of this section.

(5) Where an arm's-length sales contract price or a posted price includes a provision whereby the listed price is reduced by a transportation factor, MMS will not consider the transportation factor to be a transportation allowance. The transportation factor may be used in determining the lessee's gross proceeds for the sale of the product. The transportation factor may not exceed 50 percent of the base price of the product without MMS approval.

(b) *Non-arm's-length or no contract.* (1) If a lessee has a non-arm's-length transportation 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 provided in this paragraph. All transportation allowances deducted under a non-arm's-length or no contract situation are subject to monitoring, review, audit, and adjustment. Before any estimated or actual deduction may be taken, the lessee must submit a completed Form MMS–4295 in accordance with paragraph (c)(2) of this section. A transportation allowance may be claimed retroactively for a period of not more than 3 months prior to the first day of the month that Form MMS–4295 is filed with MMS, unless MMS approves a longer period upon a showing of good cause by the lessee. The MMS will monitor the allowance deductions to ensure that deductions are reasonable and allowable. When necessary or appropriate, MMS may direct a lessee to modify its estimated or actual transportation allowance deduction.

(2) The transportation allowance for non-arm's-length or no-contract situations shall be based upon the lessee's actual costs for transportation during the reporting period, including operating and maintenance expenses, overhead, and either depreciation and a return on undepreciated capital investment in accordance with paragraph (b)(2)(iv)(A) of this section, or a cost equal to the initial depreciable investment in the transportation system multiplied by a rate of return in accordance with paragraph (b)(2)(iv)(B) of this section. Allowable capital costs are generally those costs for depreciable fixed assets (including costs of delivery and installation of capital equipment) which are an integral part of the transportation system.

(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.

(iv) A lessee may use either depreciation or a return on depreciable capital investment. After a lessee has elected to use either method for a transportation system, the lessee may not later elect to change to the other alternative without approval of the MMS.

(A) To compute depreciation, the lessee may elect to use either a straight-line depreciation method based on the life of equipment or on the life of the reserves which the transportation system services, or a unit of production method. 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.

(B) The MMS shall allow as a cost an amount equal to the allowable initial capital investment in the transportation system multiplied by the rate of return determined pursuant to paragraph (b)(2)(v) of this section. No allowance shall be provided for depreciation. This alternative shall apply only to transportation facilities first placed in service after March 1, 1988.

(v) The rate of return shall be the industrial rate associated with Standard and Poor's BBB rating. The rate of return shall be the monthly average rate as published in *Standard and Poor's Bond Guide* for the first month of the reporting period for which the allowance is applicable and shall be effective during the reporting period. The rate shall be redetermined at the beginning of each subsequent transportation allowance reporting period (which is determined pursuant to paragraph (c) of this section).

(3)(i) The deduction for transportation costs shall be determined on the basis of the lessee's cost of transporting each product through each individual transportation system. Where more than one product in a gaseous phase is transported, the allocation of costs to each of the products transported shall be made in a consistent and equitable manner in the same proportion as the ratio of the volume of each product (excluding waste products which have no value) to the volume of all products in the gaseous phase (excluding waste products which have no value). Except as provided in this paragraph, the lessee may not take an allowance for transporting a product which is not royalty bearing without MMS approval.

(ii) Notwithstanding the requirements of paragraph (i), the lessee may propose to the MMS a cost allocation method on the basis of the values of the products transported. MMS shall approve the method unless it determines that it is not consistent with the purposes of the regulations in this part.

(4) 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 relevant data to support its proposal. The initial proposal must be submitted by June 30, 1988 or within 3 months after the last day of the month for which 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.

(5) A lessee may apply to the MMS for an exception from the requirement that it compute actual costs in accordance with paragraphs (b)(1) through (b)(4) of this section. The MMS will grant the exception only if the lessee has a tariff for the transportation system approved by the Federal Energy Regulatory Commission (FERC) (for both Federal and Indian leases) or a state regulatory agency (for Federal leases). The MMS shall deny the exception request if it determines that: (i) The tariff is excessive as compared to arm's-length transportation charges by the lessee or others providing similar transportation services; or (ii) if there are no arm's-length transportation charges by the lessee or others providing similar transportation services, the tariff significantly exceeds the lessee's actual costs for transportation as determined under this section.

(c) *Reporting requirements*—(1) *Arm's-length contracts.* (i) With the exception of those transportation allowances specified in paragraphs (c)(1)(v) and (c)(1)(vi) of this section, the lessee shall submit page one of the initial Form MMS–4295 (and Schedule 1) prior to, or at the same time as, the transportation allowance determined pursuant to an arm's-length contract is reported on Form MMS–2014, Report of Sales and Royalty Remittance. A Form MMS–4295 received by the end of the month that the Form MMS–2014 is due shall be considered to be timely received.

(ii) The initial Form MMS–4295 shall be effective for a reporting period beginning the month that the lessee is first authorized to deduct a transportation allowance and shall continue until the end of the calendar year, or until the applicable contract or rate terminates or is modified or amended, whichever is earlier.

(iii) After the initial reporting period and for succeeding reporting periods, lessees must submit page one of Form MMS–4295 (and Schedule 1) within 3 months after the end of the calendar year, or after the applicable contract or rate terminates or is modified or amended, whichever is earlier, unless MMS approves a longer period (during which period the lessee shall continue to use the allowance from the previous reporting period).

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

(v) Transportation allowances which are based on arm's-length contracts and which are in effect at the time these regulations become effective will be allowed to continue until such allowances terminate. For the purposes of this section, only those allowances that have been approved by MMS in writing shall qualify as being in effect at the time these regulations become effective.

(vi) The MMS may establish, in appropriate circumstances, reporting requirements which are different from the requirements of this section.

(2) *Non-arm's-length or no contract.* (i) With the exception of those transportation allowances specified in paragraphs (c)(2)(v), (c)(2)(vii), and (c)(2)(viii) of this section, the lessee shall submit an initial Form MMS–4295 prior to, or at the same time as, the transportation allowance determined pursuant to a non-arm's-length contract or no-contract situation is reported on Form MMS–2014, Report of Sales and Royalty Remittance. A Form MMS–4295 received by the end of the month that the Form MMS–2014 is due shall be considered to be timely received. The initial report may be based upon estimated costs.

(ii) The initial Form MMS–4295 shall be effective for a reporting period beginning the month that the lessee first is authorized to deduct a transportation allowance and shall continue until the end of the calendar year, or until the transportation under the non-arm's-length contract or the no contract situation terminates, whichever is earlier.

(iii) For calendar-year reporting periods succeeding the initial reporting period, the lessee shall submit a completed Form MMS–4295 containing the actual costs for the previous reporting period. If the transportation is continuing, the lessee shall include on

Form MMS-4295 its estimated costs for the next calendar year. The estimated transportation allowance shall be based on the actual costs for the previous reporting period plus or minus any adjustments which are based on the lessee's knowledge of decreases or increases which will affect the allowance. Form MMS-4295 must be received by MMS within 3 months after the end of the previous reporting period, unless MMS approves a longer period (during which period the lessee shall continue to use the allowance from the previous reporting period).

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

(v) Non-arm's-length contract or no contract based transportation allowances which are in effect at the time these regulations become effective will be allowed to continue until such allowances terminate. For the purposes of this section, only those allowances that have been approved by MMS in writing shall qualify as being in effect at the time these regulations become effective.

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

(vii) The MMS may establish in appropriate circumstances, reporting requirements which are different from the requirements of this section.

(viii) If the lessee is authorized to use its FERC-approved tariff as its transportation cost in accordance with subsection (b)(5) of this section, it shall follow the reporting requirements of subsection (c)(1) of this section.

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

(4) Transportation allowances must be reported as a separate line item on Form MMS-2014, unless MMS approves a different reporting procedure.

(d) *Interest assessments for incorrect or late reports and failure to report.* (1) If a lessee deducts a transportation allowance on its Form MMS-2014 without complying with the requirements of this section, the lessee shall pay interest only on the amount of such deduction until the requirements of this section are complied with. The lessee also shall repay the amount of any allowance which is disallowed by this section.

(2) If a lessee erroneously reports a transportation allowance which results in an underpayment of royalties, interest shall be paid on the amount of that underpayment.

(3) Interest required to be paid by this section shall be determined in accordance with 30 CFR 218.54.

(e) *Adjustments.* (1) 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 to reflect actual costs, together with any payment, in accordance with instructions provided by MMS.

(3) For lessees transporting gas production from leases on the OCS, if the lessee's estimated transportation allowance exceeds the allowance based on actual costs, the lessee must submit a corrected Form MMS-2014 to reflect actual costs, together with its payment, in accordance with instructions provided by MMS. If the lessee's estimated transportation allowance is less than the allowance based on actual costs, the refund procedure will be specified by MMS.

(f) *Actual or theoretical losses.* Notwithstanding any other provisions of this subpart, for other than arm's-length contracts no cost shall be allowed for transportation which results from payments (either volumetric or for value) for actual or theoretical losses. This section does not apply when the transportation allowance is based upon a FERC or state regulatory agency approved tariff.

(g) *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) Where the value of gas is determined pursuant to § 206.153 of this subpart, 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. Natural gas liquids (NGL's) shall be considered as one product.

(c)(1) Except as provided in paragraph (d)(2) of this section, the processing allowance shall not be applied against the value of the residue gas. Where there is no residue gas MMS may designate an appropriate gas plant product against which no allowance may be applied.

(2) Except as provided in paragraph (c)(3) of this section, the processing allowance deduction on the basis of an individual product shall not exceed 66⅔ percent of the value of each gas plant product determined in accordance with § 206.153 of this subpart (such value to be reduced first for any transportation allowances related to postprocessing transportation authorized by § 206.156 of this subpart).

(3) Upon request of a lessee, MMS may approve a processing allowance in excess of the limitation prescribed by paragraph (c)(2) of this section. The lessee must demonstrate that the processing costs incurred in excess of the limitation prescribed in paragraph (c)(2) of this section were reasonable, actual, and necessary. An application for exception shall contain all relevant and supporting documentation for MMS to make a determination. Under no circumstances shall the value for royalty purposes of any gas plant product be reduced to zero.

(d)(1) Except as provided in paragraph (d)(2) of this section, 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. In such event, the lessee shall be eligible for a processing allowance as determined in accordance with this subpart. However, MMS will not grant any processing allowance for processing lease production which is not royalty bearing.

(2)(i) If the lessee incurs extraordinary costs for processing gas production from a gas production operation, it may apply to MMS for an allowance for those costs which shall be in addition to any other processing allowance to which the lessee is entitled pursuant to this section. Such an allowance may be granted only if the lessee can demonstrate that the costs are, by reference to standard industry conditions and practice, extraordinary, unusual, or unconventional.

(ii) Prior MMS approval to continue an extraordinary processing cost allowance is not required. However, to retain the authority to deduct the allowance the lessee must report the deduction to MMS in a form and manner prescribed by MMS.

(e) If MMS determines that a lessee has improperly determined a processing allowance authorized by this subpart, then the lessee shall pay 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) *Arm's-length processing contracts.* (1)(i) 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, except as provided in paragraphs (a)(1)(ii) and (a)(1)(iii) of this section, subject to monitoring, review, audit, and adjustment. The lessee shall have the burden of demonstrating that its contract is arm's-length. Before any deduction may be taken, the lessee must submit a completed page one of Form MMS-4109, Gas Processing Allowance Summary Report, in accordance with paragraph (c)(1) of this section. A processing allowance may be claimed retroactively for a period of not more than 3 months prior to the first day of the month that Form MMS-4109 is filed with MMS, unless MMS approves a longer period upon a showing of good cause by the lessee.

(ii) In conducting reviews and audits, MMS will examine whether the contract reflects more than the consideration actually transferred either directly or indirectly from the lessee to the processor for the processing. If the contract reflects more than the total consideration, then the MMS may require that the processing allowance be determined in accordance with paragraph (b) of this section.

(iii) If the MMS determines that the consideration paid pursuant to an arm's-length processing contract does not reflect the reasonable value of the processing because of misconduct by or between the contracting parties, or because the lessee otherwise has breached its duty to the lessor to market the production for the mutual benefit of the lessee and the lessor, then MMS shall require that the processing allowance be determined in accordance with paragraph (b) of this section when MMS determines that the value of the processing may be unreasonable, MMS will notify the lessee and give the lessee an opportunity to provide an opportunity to provide written information justifying the lessee's processing costs.

(2) If an arm's-length processing contract includes more than one gas plant product and 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. No allowance may be taken for the costs of processing lease production which is not royalty-bearing.

(3) 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 relevant data to support its proposal. The initial proposal must be submitted by June 30, 1988, or within 3 months after the last day of the month for which the lessee requests a processing allowance, 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. No processing allowance will be granted for the costs of processing lease production which is not royalty bearing.

(4) Where the lessee's payments for processing under an arm's-length contract are not based on a dollar per unit basis, the lessee shall convert whatever consideration is paid to a dollar value equivalent for the purposes of this section.

(b) *Non-arm's-length or no contract.* (1) If a lessee has a non-arm's-length processing 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 as provided in this paragraph. All processing allowances deducted under a non-arm's-length or no-contract situation are subject to monitoring, review, audit, and adjustment. Before any estimated or actual deduction may be taken, the lessee must submit a completed Form MMS-4109 in accordance with paragraph (c)(2) of this section. A processing allowance may be claimed retroactively for a period of not more than 3 months prior to the first day of the month that Form MMS-4109 is filed with MMS, unless MMS approves a longer period upon a showing of good cause by the lessee. The MMS will monitor the allowance deduction to ensure that deductions are reasonable and allowable. When necessary or appropriate, MMS may direct a lessee to modify its estimated or actual processing allowance.

(2) The processing allowance for non-arm's-length or no-contract situations shall be based upon the lessee's actual costs for processing during the reporting period, including operating and maintenance expenses, overhead, and either depreciation and a return on undepreciated capital investment in accordance with paragraph (b)(2)(iv)(A) of this section, or a cost equal to the initial depreciable investment in the processing plant multiplied by a rate of return in accordance with paragraph (b)(2)(iv)(B) of this section. Allowable capital costs are generally those costs for depreciable fixed assets (including costs of delivery and installation of capital equipment) which are an integral part of the processing plant.

(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.

(iv) A lessee may use either depreciation or a return on depreciable capital investment. When a lessee has elected to use either method for a processing plant, the lessee may not later elect to change to the other alternative without approval of the MMS.

(A) To compute depreciation, the lessee may elect to use either a straight-line depreciation method based on the life of equipment or on the life of the reserves which the processing plant services, or a unit-of-production method. 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.

(B) The MMS shall allow as a cost an amount equal to the allowable initial capital investment in the processing plant multiplied by the rate of return determined pursuant to paragraph (b)(2)(v) of this section. No allowance shall be provided for depreciation. This alternative shall apply only to plants first placed in service after March 1, 1988.

(v) The rate of return shall be the industrial rate associated with Standard and Poor's BBB rating. The rate of return shall be the monthly average rate as published in *Standard and Poor's Bond Guide* for the first month of the reporting period for which the allowance is applicable and shall be effective during the reporting period. The rate shall be redetermined at the beginning of each subsequent processing allowance reporting period (which is determined pursuant to paragraph (c)(2) of this section).

(3) 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. The lessee may not take an allowance for the costs of processing lease production which is not royalty bearing.

(4) A lessee may apply to MMS for an exception from the requirement that it compute actual costs in accordance with paragraphs (b)(1) through (b)(3) of this section. The MMS may grant the exception only if: (i) The lessee has arm's-length contracts for processing other gas production at the same processing plant; and (ii) at least 50 percent of the gas processed annually at the plant is processed pursuant to arm's-length processing contracts; if the MMS grants the exception, the lessee shall use as its processing allowance the volume weighted average prices charged other persons pursuant to arm's-length contracts for processing at the same plant.

(c) *Reporting requirements.* (1) Arm's-length contracts. (i) With the exception of those processing allowances specified in paragraphs (c)(1)(v) and (c)(1)(vi) of this section, the lessee shall submit page one of the initial Form MMS-4109 (and Schedule 1) prior to the time, or at the same time as, the processing allowance determined pursuant to an arm's-length contract is reported on Form MMS-2014, Report of Sales and Royalty Remittance. A Form MMS-4109 received by the end of the month that the Form MMS-2014 is due shall be considered to be timely received.

(ii) The initial Form MMS-4109 shall be effective for a reporting period beginning the month that the lessee is first authorized to deduct a processing allowance and shall continue until the end of the calendar year, or until the applicable contract or rate terminates or is modified or amended, whichever is earlier.

(iii) After the initial reporting period and for succeeding reporting periods, lessees must submit page one of Form MMS-4109 within 3 months after the end of the calendar year, or after the applicable contract or rate terminates or is modified or amended, whichever is earlier, unless MMS approves a longer period (during which period the lessee shall continue to use the allowance from the previous reporting period).

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

(v) Processing allowances which are based on arm's-length contracts and which are in effect at the time these regulations become effective will be allowed to continue until such allowances terminate. For the purpose of this section, only those allowances that have been approved by MMS in writing shall qualify as being in effect at the time these regulations became effective.

(vi) The MMS may establish, in appropriate circumstances, reporting requirements which are different from the requirements of this section.

(2) Non-arm's-length or no contract. (i) With the exception of those processing allowances specified in paragraphs (c)(2)(v), (c)(2)(vii) and (c)(2)(viii) of this section, the lessee shall submit an initial Form MMS-4109 prior to, or at the same time as, the processing allowance determined pursuant to a non-arm's-length contract or no contract situation is reported on Form MMS-2014, Report of Sales and Royalty Remittance. A Form MMS-4109 received by the end of the month that the Form MMS-2014 is due shall be considered to be timely received. The initial report may be based upon estimated costs.

(ii) The initial Form MMS-4109 shall be effective for a reporting period beginning the month that the lessee first is authorized to deduct a processing allowance and shall continue until the end of the calendar year, or until the processing under the non-arm's-length contract or the no-contract situation terminates, whichever is earlier.

(iii) For calendar-year reporting periods succeeding the initial reporting period, the lessee shall submit a completed Form MMS-4109 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 calendar year. The estimated gas processing allowance shall be based on the actual costs for the previous period plus or minus any adjustments which are based on the lessee's knowledge of decreases or increases which will affect the allowance. Form MMS-4109 must be received by MMS within 3 months after the end of the previous reporting period, unless MMS approves a longer period (during which period the lessee shall continue to use the allowance from the previous reporting period).

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

(v) Processing allowances based on non-arm's-length or nocontract situations which are in effect at the time these regulations become effective will be allowed to continue until such allowances terminate for gas production from onshore Federal and Indian leases. For gas production from OCS leases such allowances will be allowed to continue until they terminate or until the end of the calendar year, whichever is earlier. For the purposes of this section, only those allowances that have been approved by MMS in writing shall qualify as being in effect at the time these regulations become effective.

(vi) Upon request by MMS, the lessee shall submit all data used by the lessee to prepare its Form MMS-4109. The data shall be provided within a reasonable period of time, as determined by MMS.

(vii) The MMS may establish, in appropriate circumstances, reporting requirements which are different from the requirements of this section.

(viii) If the lessee is authorized to use the volume weighted average prices charged other persons as its processing allowance in accordance with paragraph (b)(4) of this section, it shall follow the reporting requirements of paragraph (c)(1) of this section.

(3) The 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.

(4) Processing allowances must be reported as a separate line on the Form MMS-2014, unless MMS approves a different reporting procedure.

(d) *Interest assessments for incorrect or late reports and failure to report.* (1) If a lessee deducts a processing allowance on its Form MMS-2014 without complying with the requirements of this section, the lessee shall pay interest only on the amount of such deduction until the requirements of this section are complied with. The lessee also shall repay the amount of any allowance which is disallowed by this section.

(2) If a lessee erroneously reports a processing allowance which results in an underpayment of royalties, interest shall be paid on the amount of that underpayment.

(3) Interest required to be paid by this section shall be determined in accordance with 30 CFR 218.54.

(e) *Adjustments.* (1) If the actual gas 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 day of 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 to reflect actual costs, together with any payment, in accordance with instructions provided by MMS.

(3) For lessees processing gas production from leases on the OCS, if the lessee's estimated processing allowance exceeds the allowance based on actual costs, the lessee must submit a corrected Form MMS-2014 to reflect actual costs, together with its payment, in accordance with instructions provided by MMS. If the lessee's estimated costs were less than the actual costs, the refund procedure will be specified by MMS.

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

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